

Market Sense – Mind the Gap – Signals from the Yield Curve Spread

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Abstract:

- *Yield curve spreads are an important recession indicator but appear to be sending contradictory signals at this time - the spread between 10-year and 2-year (2Y10Y) Treasuries narrowed to as little as 20 basis points in September while the spread between 10-year and 3-month Treasuries (3M10Y) widened to 120 basis points.*
- *There is something to be gleaned from all the recent changes in yield across the curve, but a looming recession is not yet one of them. The latter spread has historically offered better cues for recession timing. It is currently signaling very low risk of a policy-spurred recessionary experience emerging in the year ahead.*
- *A cross of the 3M10Y under the 2Y10Y (effectively the 3M2Y), is another indicator worth following. In combination with the 3M10Y inversion signal, this caught every recession since 1976 with an average lead time of 10 months. This spread is currently widening as well.*
- *The yield curve is a useful guide for more than just anticipating recession – it also gives a sense of how the bond market is pricing Fed policy changes, and rates at large guide banking sector activity. It currently suggests the Fed's policy rate is unlikely to inhibit growth, while the 2-year forecast implies the Fed may skirt the line of becoming too tight if they execute several more hikes in the year ahead.*

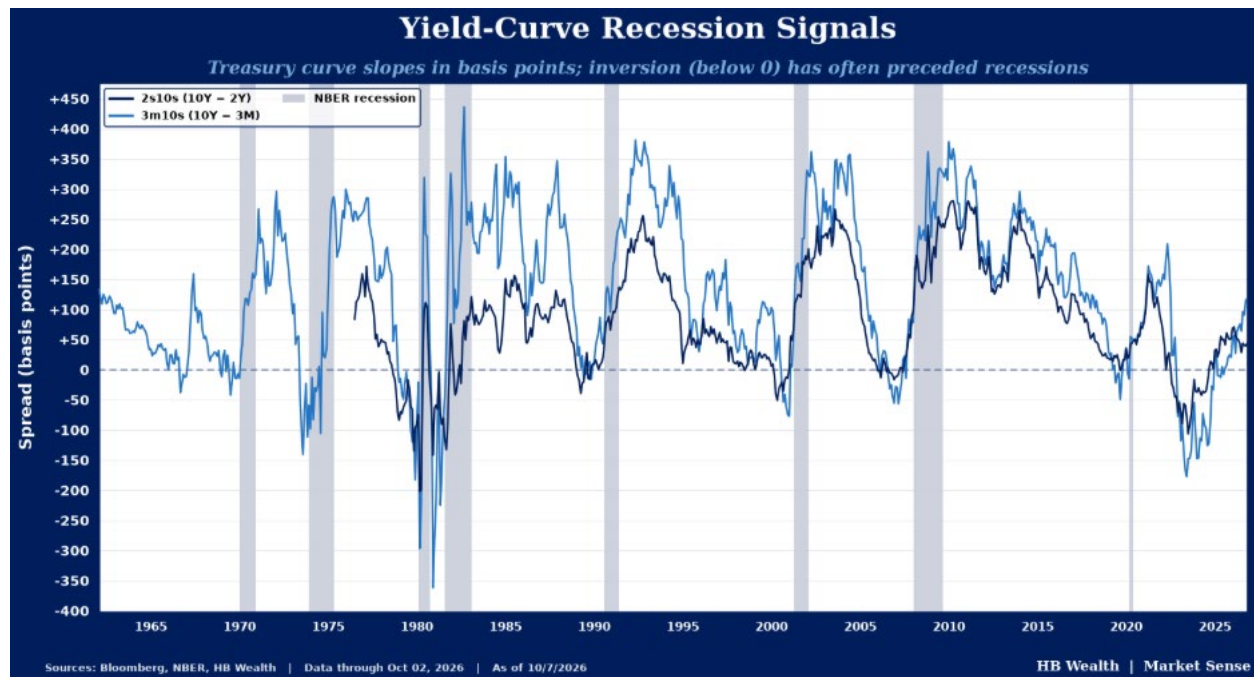
Treasury yields across the curve have been surging to multiyear highs, making waves for markets, but also resulting in an interesting divergence in spreads. From early February to September, the spread between 10-year and 2-year (2Y10Y) Treasuries compressed from 70 basis points to lows near 20,

creating some concern that an inversion is near. However, the spread between 10-year and 3-month Treasuries (3M10Y) about doubled in that same time, from 60 basis points to about 120.

Not all Curve Spreads are Equal

Inversion of the Treasury curve (when the additional yield earned by investing in longer dated bonds is negative) is a classic signal of an impending recession. However, not all curve spreads are equal - the 2Y10Y is the inversion measure most often cited, but the 3M10Y has the edge as an economic recession signal. Compared to the more popular 2Y10Y measure, the 3M10Y has given fewer false alarms and a tighter lead time, and the Federal Reserve's own research around recessions and the NY Fed's recession-probability model also use the latter spread measure.

Over the past 64 years, there have been eight recessions recognized by the National Bureau of Economic Research (NBER). The 3M10Y has inverted ahead of all eight of those recessions, with one clear false positive in 1966-67. For the six recessions since 1977, the 3M10Y caught all six with an average lead time of 11 months (range 8-16). The 2Y10Y caught five, with an average lead time of about 16 months (range 10-22). The 2Y10Y also flashed a false positive in mid-1998 that the 3M10Y avoided (the 3M10Y did dip below zero for three days in September but never on a monthly average basis). The 3M10Y also inverted later than the 2Y10Y in every cycle, giving a timelier signal of the recessions. Both measures inverted in 2022 and remained that way for an extended period without a subsequent NBER-declared recession.



A cross of the 3M10Y under the 2Y10Y, effectively the 3M2Y, is another indicator worth following. The first two years of the curve are effectively the market's pricing of the expected Fed Funds path - an inversion in the 3M2Y curve implies an expectation that the Fed will soon see a need to cut rates to stimulate the economy. On average, in the recessions since mid-1976 (when both curves became available), the cross has occurred just 10 months before recessions. It presented false signals in late '95 – early '96 and September '98, although those were very shallow inversions at roughly 5bps on a monthly average basis, and was more recently inverted from December 2022 until February 2026 with no recession (to date).

This shorter-term perspective can serve as a useful confirmation tool to accompany 3M10Y inversion signals. A combination of the 3M10Y and 3M2Y signals (both negative) would have caught every recession since 1976 with an average lead time of 10 months. The only false positive was in 2022, when every yield curve spread suggested recession was likely, but no recession was ultimately declared.

More Than Just Technicals – Yield Curves Guide Activity

The yield curve is a useful guide for more than just anticipating recession – it also gives a sense of how the bond market is pricing Fed policy changes, and guides banking sector activity. Functionally, the 2-year yield is mostly a forecast of Fed policy, since the first two years of the Treasury curve is essentially the path of the Fed Funds rate expected by the market. In contrast, the 3-month yield largely reflects the current policy rate. A 2Y10Y inversion is thus the market saying it expects tighter policy in the future, while the 3M10Y inversion says the Fed Funds policy rate is already tight relative to longer yields.

The 3M10Y is also more closely linked to bank activity, as it indicates when bank credit conditions are changing. Bank funding is primarily through deposits, CDs, repos, etc., which are based on short-term rates, for which we can use the 3-month rate as a proxy. In turn, their lending, loans, mortgages, etc., are mostly based on longer term rates, for which we can use the 10-year as a proxy. When the 3-month rate at which they borrow is greater than the 10-year at which they lend, the margin on new lending is squeezed or turns negative. Therefore, banks tighten lending standards, credit growth slows, and the economy follows that lag. Margin pressure builds up over several quarters, which slows loan growth, which slows hiring and spending. That sequence follows logically with the 8–16 month gap between the 3M10Y inversion and start of the subsequent recession. That also helps to explain the 2022-24 exception, since deposit rates lagged behind T-bill yields, so bank margins helped up far longer than the curve implied, while borrowers locked-in fixed-rate debt and the growth of private credit further cushioned the squeeze.

In sum, there is something to be gleaned from all the recent changes in yield across the curve, but a looming recession is not yet one of them. The flattening of the 2Y10Y suggests the bond market started to get a bit nervous about the future path of Fed policy in September, but the widening in the 3M10Y suggests it is far too early to worry about the slowdown impacting bank lending activity or leading to recession. And the widening in the 3M2Y confirms that any fear that a slower growth environment is set

to emerge because of rising rates appear somewhat overblown, at least as far as the bond market is concerned.

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