Key recession indicator sends investors sharpest warning in 42 years

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The Treasury market is sending its sharpest warning about recession risks since 1981.

On Tuesday, the difference in the yield on 2-year and 10-year Treasury notes further inverted, with the yield on the 10-year falling 103 basis points, or 1.03 percentage points, below the yield on the 2-year yield. This dynamic has preceded each of the last eight U.S. recessions.

By this measure, the yield curve has been inverted since July of last year as investors bet aggressive interest rate hikes from the Federal Reserve to combat inflation would tip the economy into recession.

In an appearance before the Senate Banking Committee on Tuesday, Fed Chair Jerome Powell signaled the central bank will likely be more aggressive than it previously forecast in raising interest rates this year as inflation proves stubborn and the labor market remains strong.

"The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated," Powell told the Senate Banking Committee in prepared remarks. "If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes."

"Although inflation has been moderating in recent months, the process of getting inflation back down to 2 percent has a long way to go and is likely to be bumpy," Powell added.

The Fed will announce its next policy decision on March 22, a statement that will also be accompanied by new projections on where Fed officials see interest rates headed over the rest of this year and the next two.

Federal Reserve Chair Jerome H. Powell testifies before a U.S. Senate Banking, Housing, and Urban Affairs Committee hearing on “The Semiannual Monetary Policy Report to the Congress” on Capitol Hill in Washington, U.S., March 7, 2023. REUTERS/Kevin Lamarque

Ryan Sweet, chief U.S. economist at Oxford Economics, wrote in a note to clients Tuesday that Powell "opened the door for the central bank to accelerate the pace of rate hikes and raise the target range of the fed funds rate more than anticipated because of the recent hot data on job growth and inflation."

Sweet noted investors are now pricing in 100 basis points of additional rate hikes from the Fed this year, up from the 75 basis points previously expected by most economists. Data from the CME Group showed Wednesday morning markets are now pricing in a nearly 80% chance the Fed raises rates by 50 basis points, or 0.50%, at its meeting later this month.

What's in a yield?

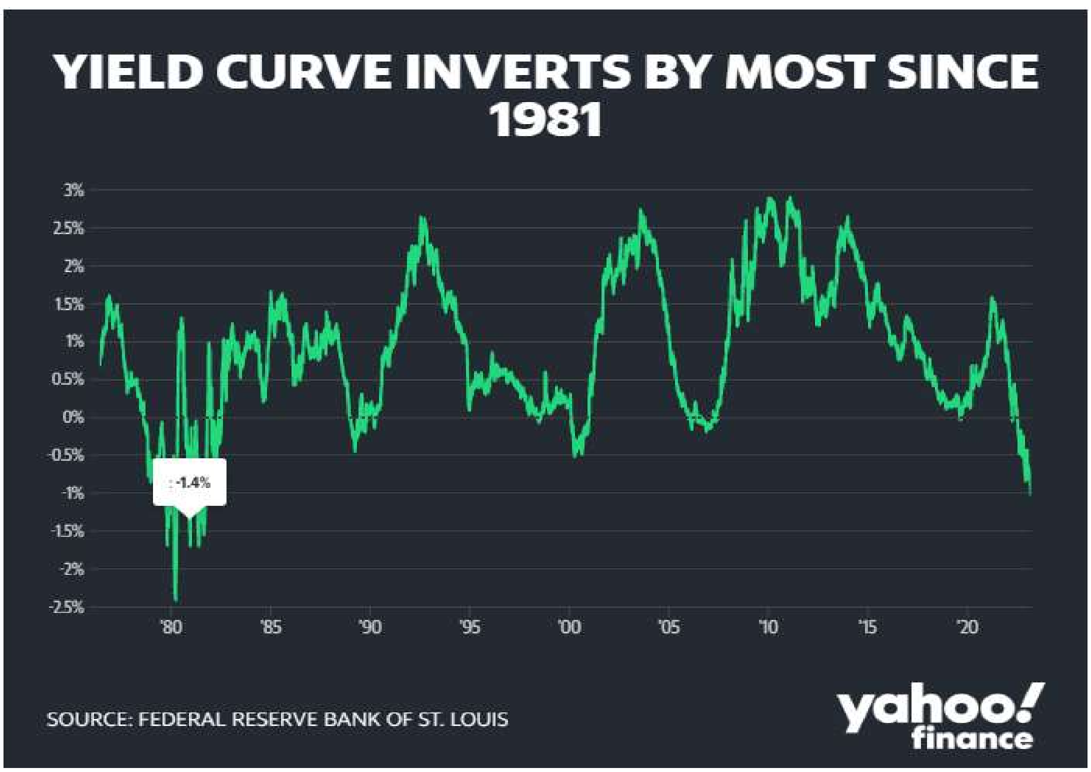
As Yahoo Finance's Brian Cheung noted last year, there is nothing about Treasury yields themselves, or the relationship between the yield at any two points along the curve, that signals recession.

Rather, it is what yields imply about future interest rates — and in turn future economic growth — that offers worrying signs for investors.

While it is hotly debated what, exactly, "goes into" the yield for any Treasury security, a simple axiom used by many investors says Treasury yields indicate what the expected average of the fed funds rate, or the Fed's benchmark interest rate, will be over a given time period.

With the 2-year yield standing at around 5% as of Wednesday morning, this implies investors think the fed funds rate will be, on average, 5% over the next two years.

Today, the fed funds rate stands at roughly 4.6%, as the Fed's target interest rate range is 4.5%-4.75% following its decision last month to raise rates an additional 25 basis points.



Therefore, we can say investors are anticipating the Fed will raise rates to at least 5% and keep them there for two years, or raise rates above 5% for some period of time before cutting them such that the average Fed funds rate is 5%.

Duke professor Campbell Harvey, who uncovered this "recession indicator" in the 1980s, told Bloomberg in an interview earlier this year he thinks the economy can avoid recession despite warnings coming from his work.

In part, in Harvey's view, this is because market awareness of this indicator has lessened its potency as a predictive measure.

Notably, Harvey's worked actually focused on the spread between the 3-month Treasury bill and the 10-year Treasury note as the most potent recession indicator, not the now-popular 2-year/10-year spread. The spread between these two tenors along the curve currently stands at minus 107 basis points, still a clear recession signal by Harvey's work.