BNY
iFlow
SHORT THOUGHTS

August 6, 2024

Market Volatility and the Yield Curve

- Market volatility has triggered yield curve volatility in the UST market
- iFlow confirms recent buying of the short end and selling the long end
- In the past, a re-steepening curve often heralds a recession
- We think much of the recent drop in the short end is due to overly aggressive expectations for Fed rate cuts

By now, it will not be news to readers that global markets have been rocked by significant volatility, beginning last Friday after a disappointing downside miss in the July jobs report (see here). Multiple factors have been at play driving the risk-off episode beyond the weaker employment data. In this note, we'll discuss the implications of the macro outlook on our Fed view and the yield curve, which has displayed outsized volatility over the past few days.

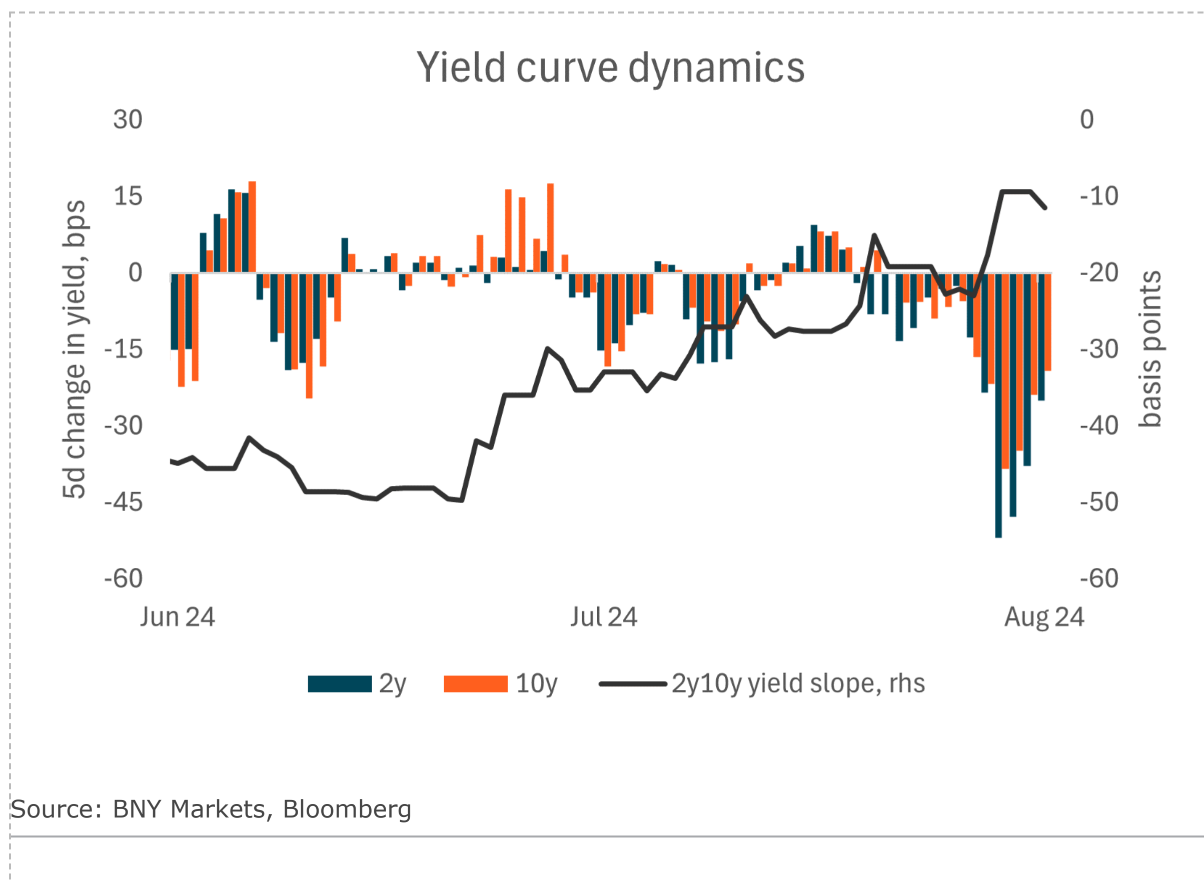
First, as we discussed in our Monday morning note (link above), we have not altered our view of a 25bp rate cut in September and don't put a lot of stock in calls for an intermeeting cut – at the moment. While Fedspeakers have been scarce so far on Monday – and there aren't many scheduled this week – the message that we did receive from Chicago Fed President Goolsbee was that the Fed will not overreact. We concur.

Although market pricing for a September cut reached well above 200% during the morning on Monday, after a relatively strong ISM Services PMI print, expectations eased back to well under 200%. Note that a probability over 100% indicates either an intermeeting cut as well as a September cut, or a chance of a "jumbo" (i.e., 50bp) rate reduction at the FOMC on the 18th of that month. As we said in Monday's piece, we find ourselves awaiting more data and watching the market to see how deep the sell-off might get.

Intermeeting cuts are generally reserved for real emergencies, such as when the financial system is at risk, or the growth outlook suddenly becomes dire. The ISM Services release did provide some comfort, as mentioned. There has been little evidence that the heightened market volatility has created any disruption in the financial sector, and while our soft landing outlook is clearly at risk, we're not yet prepared to call for deep, rapid cuts without seeing additional data to come through the next few weeks.

Nevertheless, the increasing market expectations of much deeper and faster rate cuts have served to steepen the yield curve further. 2y10y yield slope is still negative but did touch zero very briefly during Monday morning as the 2y note rallied more than the 10y. As of this writing, the curve has re-flattened and is at levels around where it closed on Friday last week, around -13bp.

Bull Steepening



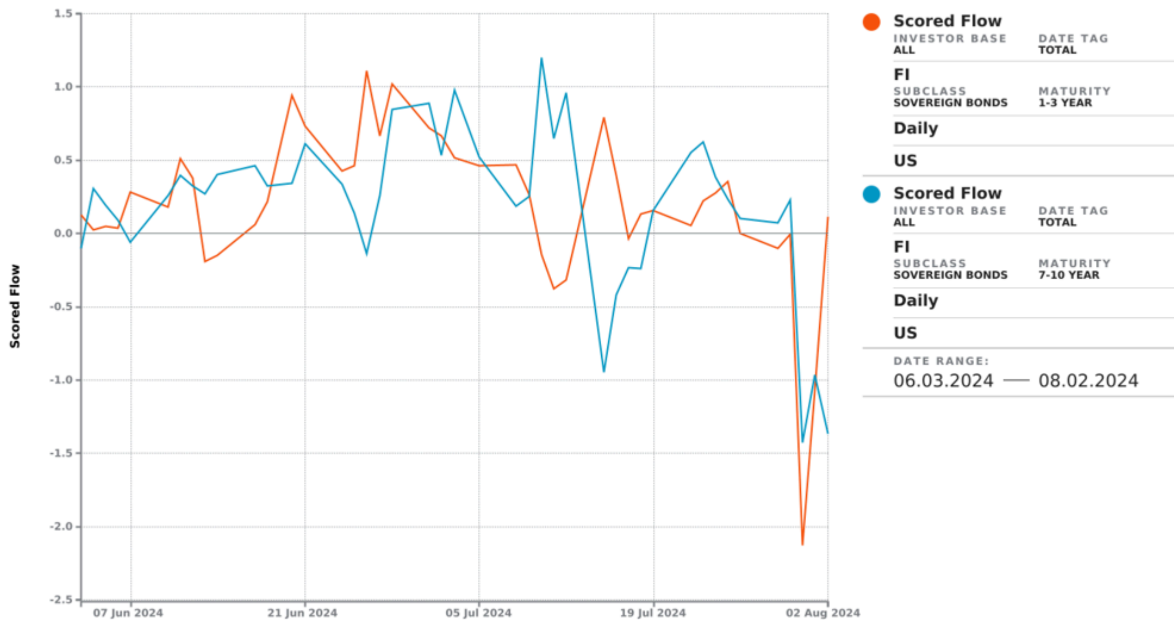
Source: BNY Markets, Bloomberg

We also see real money investor behavior of late confirming these moves. Data through last Friday's close show that flows into the 1-3y sector of the UST curve have recently eclipsed those into the 7-10y sector, as the chart below shows. As of this writing, we don't yet have

Monday’s flows but would expect a continuation of this pattern when they become available to us.

Term Structure of Real Money UST Flows

FI Scored Flow

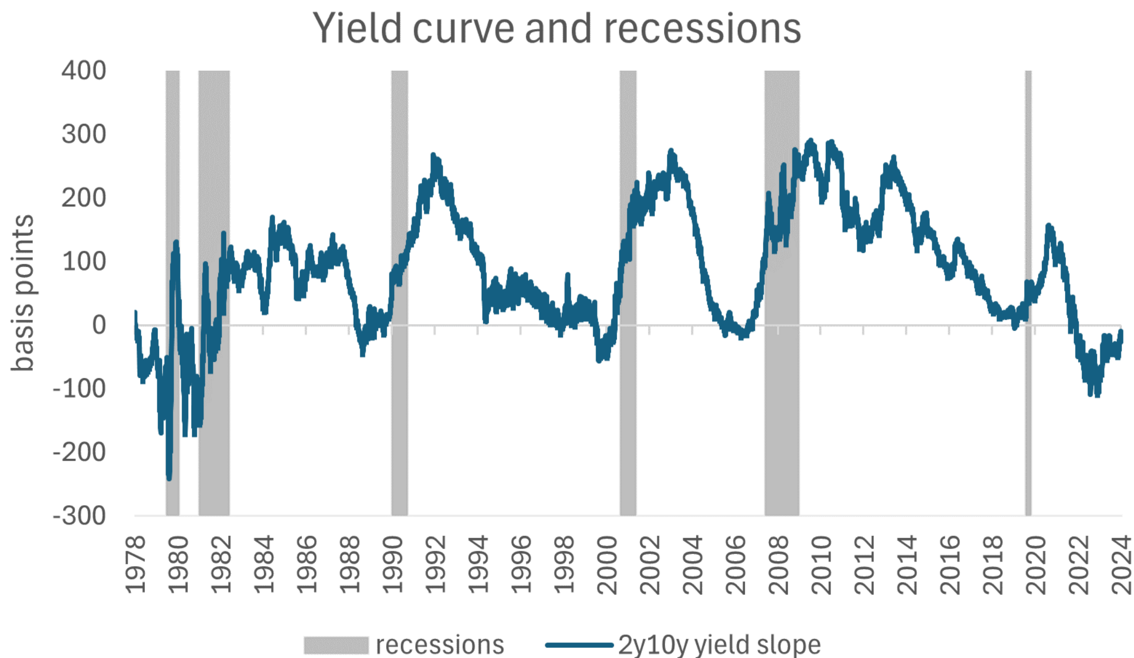


Source: BNY Markets, iFlow

In Monday’s Macro Morning Briefing, we also discussed the Sahm rule, which looks at the changes in the unemployment rate as a recession indicator (or “statistical regularity,” in Fed Chair Powell’s words). There is a body of evidence which suggests that if and when the curve does uninvert, in the past it has presaged a recession fairly soon thereafter. Here we display the 2y10y slope since 1976 versus recessions. The message is clear, but we’re not so sure that it will hold this time. To channel Powell’s reasoning, the pandemic and post-pandemic economies have been unique, and the curve has been inverted for over two years. We also, of course, acknowledge that four of the most dangerous words in financial markets are “it's different this time.”

However, if, as we currently believe, the economy is not in danger of falling into a recession, then the curve can uninvert without consequence. As we alluded above, we think that Fed rate cut expectations are severely overcooked at this point. We could see that once Fed rate cuts do start, the 10y yield could start to climb again, and if the Fed’s terminal rate in this cycle really is closer to 4% than 2% or 2.5% as had been the widely assumed case in the past, then the 2y yield is too low, pricing in a worst-case scenario for the economy and Fed response. A curve steepening of this sort could be the opposite of a recession signal.

Bad Omen, or Overdone Fed Rate Cut Expectations?



Source: BNY Markets, Bloomberg

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Please direct questions or comments to: iFlow@BNY.com

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