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Treasury Yield-Curve Inversions Flag Caution, Not Recession, Pimco Says

- The 2-to-10-year yield gap and 5-to-30 year are both inverted
- Powell has dismissed 2-to-10’s curve signals on growth outlook

By Liz McCormick
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Treasury-curve inversions shouldn’t be ignored, but aren’t a sure-fire way of signaling that a U.S. economic recession is around the corner. So says Marc Seidner of Pacific Investment Management Co.

“A yield-curve inversion should never be dismissed just because the backdrop has changed,” Seidner, Pimco’s chief investment officer of non-traditional strategies, wrote in a blog post. “The curve's signal may be less clear than in the past.” Yet some current inversions are “signaling caution, rather than recession.”

The Federal Reserve's plans to likely lift rates at each of its remaining policy meetings this year, after hiking by a quarter-point last month, has unmoored short-term yields and inverted several parts of the Treasury curve. That has brought to the fore an array of opinions over whether an inversion is still the historic foreshadowing event to a recession or not.

Two-year Treasury yields exceeded 10-year rates by about 4 basis points at 9:16 a.m. New York time Monday while five-year tenors traded with about a 9 basis-point premium over 30-year yields. Money-market traders are pricing in over 200 basis points of additional Fed rate increases in 2022.

“Longer-dated gauges like the two-year/10-year and five-year/30-year Treasury curves can be more valuable than the widely followed three-month/10-year curve, in our view,” Seidner said. “The reason is that the Fed has already laid out its rate-hike projections in its ‘dot plot’ forecast, and looking at market rates over a short-term horizon may be less informative than focusing on what the Fed is saying it will do.”

In the Fed’s latest “dot plot ______,” officials’ median projection was for the target rate to end 2022 at about 1.9% and rise to about 2.8% in 2023.

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Campbell Harvey at Duke University’s Fuqua School of Business was one of the first to show the historic link of inversions to recessions, focused on the spread between three-month and 10-year yields -- which is currently positive by around 185 basis points. High inflation and “geopolitical risk -- which we haven’t even felt the economic outcome of yet, besides at the gas pump -- is all acting like a tax,” Harvey said last month. “It all indicates slower economic growth.”

Read more: Powell-Backed Yield Curve Gives Fed Leeway to Go Max Hawkish (I)

Pimco’s Seidner said the most-important sector to watch is the forward curve, which projects the spread between current rates into the future. He notes that the inversion between current one-year rates relative to where they are priced one year in the future in the forward market.

“Does this mean a recession is imminent? No, but it is a risk to monitor,” Seidner said.

“Pimco is calling for above-trend growth and a gradual easing of inflation pressures from higher peaks in developed market economies. However, the risks of higher inflation and lower growth have increased, along with the risk of recession in 2023,” he said, adding that has sparked the firm to be underweight duration, primarily in the long-end of the curve.