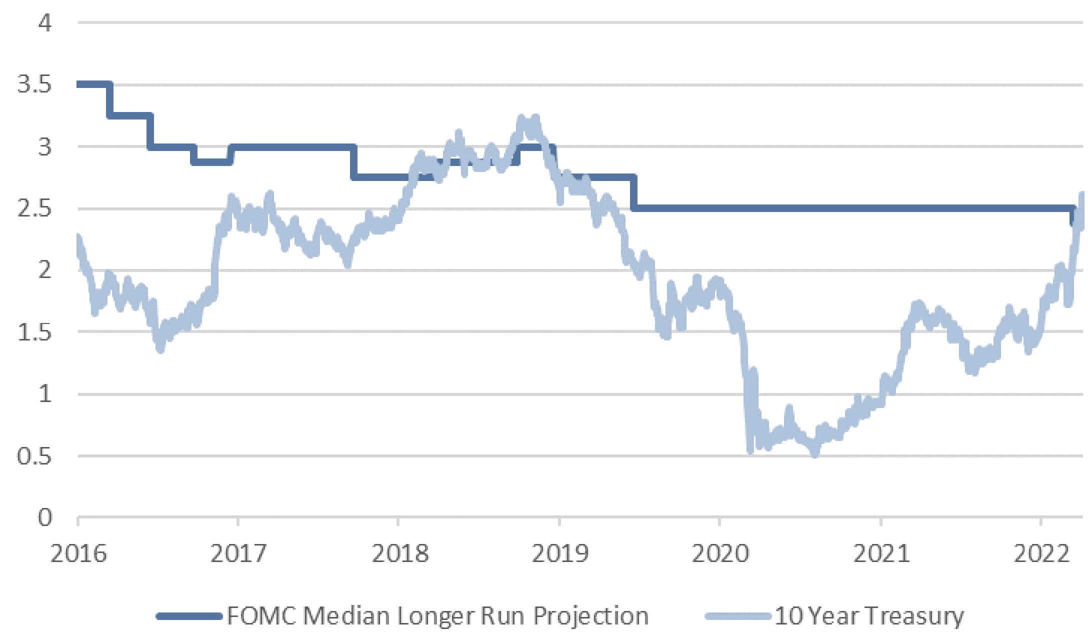
MARKET COMMENTARY

Fig. 1: **The 10-Year Treasury rarely trades significantly higher than the FOMC median long-term projection for the Fed Funds rate**



Source: Bloomberg, Mill Creek

We saw a lot of handwringing in the media last week when the US Treasury yield curve inverted for a few days. An inverted yield curve means that longer-term interest rates are lower than shorter-term interest rates. Many prognosticators specifically focus on the difference between the 2-year Treasury yield and the 10-year Treasury yield.

An inverted yield curve is a peculiar phenomenon that means investors are willing to loan money to the US Treasury for a lower interest rate over 10 years than over two years. Therefore, the implication is that the Fed will lower short-term rates at some point over that decade — likely due to a recession.

Yield curve inversion has been a reasonable forecasting tool for recessions — it inverted a year or more before the recessions of 1980, 1981, 1990, 2001, and 2008 — so we should take the message seriously. It also inverted in 2019, but we probably shouldn't give it credit for predicting COVID in 2020.

Even so, we're not overly concerned about last week's brief yield curve inversion. We covered some reasons for caution in our Quarterly Outlook, but the current yield curve isn't one of them. Higher longer-term rates are needed to prevent the yield curve from inverting as the Fed hikes quickly this year. The Fed can encourage higher long-term rates by moving up their longer-run forecast for the Fed Funds rate, which usually puts a bit of a cap on how high the 10-year can go (Fig. 1). We expect them to guide this forecast higher over the course of 2022.

QUICK LINKS

- Q2 2022 Outlook: Simplify, Simplify, Simplify!
- The worst (bond) bear market in 40 years
- The Fed Hiking Cycle Has Begun
- The Driving Forces of Inflation

This week's contributor: *Michael Crook, CAIA*

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