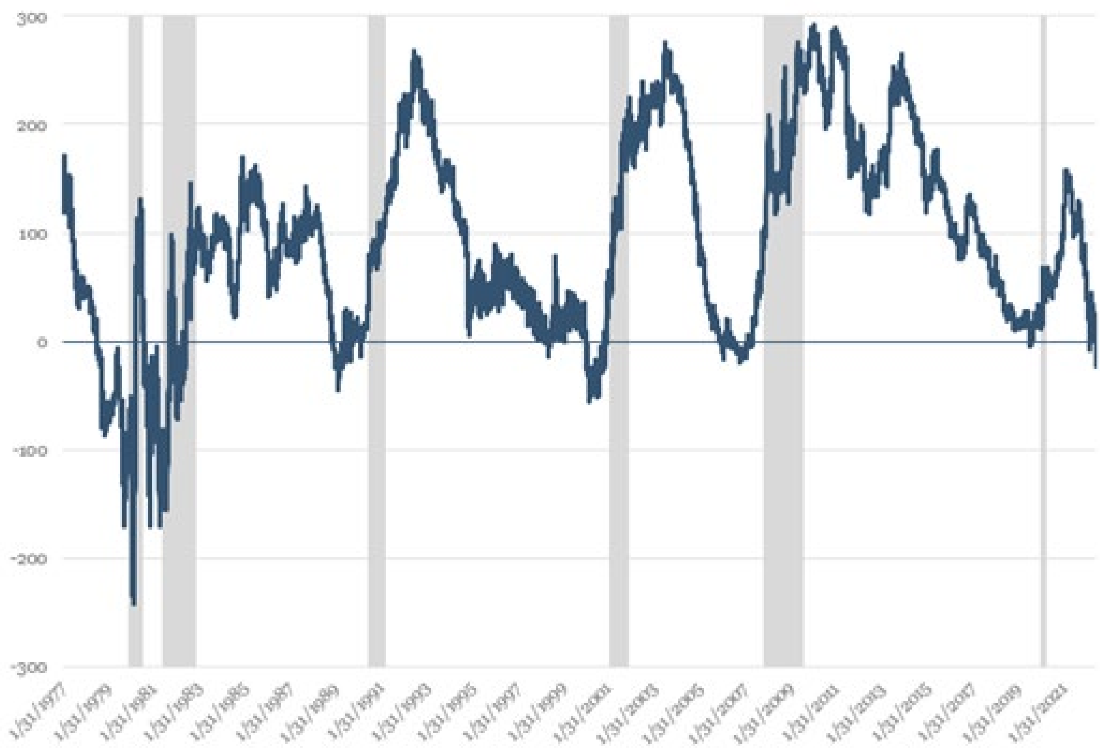
MARKET COMMENTARY

Fig. 1: Yield Curve Inversions and Recessions
10-year US Treasury yield minus 2-year yield vs US Recession



Source: Bloomberg, Federal Reserve Bank of St. Louis, Mill Creek.

The recent inversion of the US Treasury yield curve (i.e., short maturity interest rates exceed long-maturity interest rates) has once again sparked attention from market participants. An inverted yield curve is one of the most widely cited warning signs for an economic slowdown as it has preceded each US recession since 1955. Today, the spread differential between the 10-year and 2-year Treasury bond yields stands at -22 basis points, the most negative level since September 2000.

Theoretically, the yield curve's slope is partly driven by market expectations about the future path of short-term rates. A positively sloped yield curve, occurring 87% over the past 45 years, indicates that market participants expect rates to increase going forward. On the other hand, an inversion is rare and reflects market expectations that *future* short-term rates will be lower, thus pushing down the yield of long-term bonds. This often happens when investors believe the Federal Reserve will cut rates in response to slowing economic conditions.

We are facing this scenario today. The futures market is pricing in a -50 basis point *cut* to the Fed Funds rate by year-end 2023. Rising inflation, tightening financial conditions, and softening corporate earnings have led to predictions of a recession in the coming quarters. Indeed, 68% of leading economists recently polled by the Financial Times in a study released on June 6 forecast a US recession in 2023. Even if this proves correct, however, we believe a mild downturn with limited damage to corporate and consumer balance sheets is still in the cards. As noted in our Q3 2022 Outlook, the labor market remains strong, providing some resiliency through an economic rough patch. In the meantime, investors unwilling to allocate cash on hand into stocks or bonds should consider taking advantage of the inverted yield curve by deploying to short-dated bonds. This segment of the curve has minimal interest rate risk while currently providing investors with the highest yields in nearly 15 years. Access our Capital Markets Assumptions (CMAs) here.

QUICK LINKS

- Updating Our Capital Markets Assumptions
- What Did 1Q 1980, 2Q 1984, and 2Q 2022 Have in Common?
- Q3 2022 Outlook
- A Housing Reset?

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Mill Creek Capital Advisors' (MCCA) Capital Market Assumptions are forward-looking risk, return, and covariance estimates for a range of broad asset classes. They are created using a quantitative and qualitative process that incorporates current global economic and financial market conditions, market derived forecasts, and proprietary forecasts developed by the Mill Creek Investment Strategy Team. Our Capital Market Assumptions reflect our forward-looking views for one market cycle, which MCCA defines as including a bull and bear market. The duration of a market cycle has historically ranged from 2-15 years but are typically 5-10 years in length. The broad asset classes are not representative of any MCCA investment models and are used to represent general ranges of risk taking.