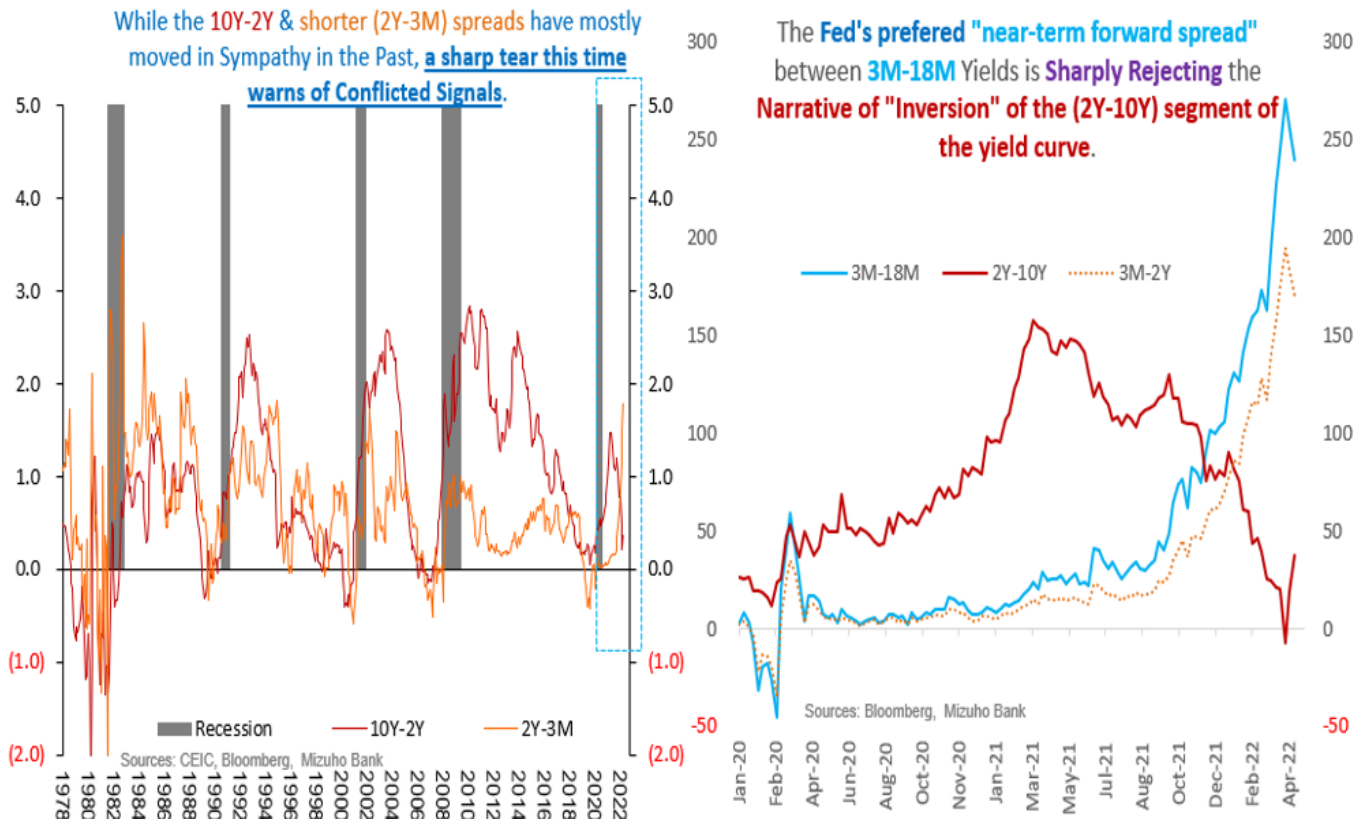


## Why Yield Curve Inversion Risks are Compromised as “Fed Circuit Breaker”



Luke Skywalker: “What’s in there?”  
 Master Yoda: Only what you take with you”  
 – Star Wars, Episode V: “The Empire Strikes Back”

Received wisdom is that an “inverted” yield curve (i.e. long-end yields lower than front-end yields), in contrast to an ordinarily upward sloping yield curve, is a harbinger of an impending recession.

One interpretation of an inverted yield curve, from excessive "flattening" (front-end yields rising faster than, and eventually exceeding, long-end yields), may be overly aggressive rate hikes (expressed as sharper front-end yield upswing) that bear down on growth/inflation expectations (represented to a greater extent in longer-yields); eventually albeit inadvertently resulting in an economic downturn.

And so, an inverted yield curve may be a very useful as a gauge of economic and associated policy risks; especially given historical precedent of inversions leading recessions by a good 6-8 quarters on average.

Apart from identifying potential recession risks down the road, an inverted yield curve could crucially provide the advance warning of policy over-ster.

That's to say, by forewarning of recession risks, an inverted yield curve may in ordinary circumstances act as a potential circuit breaker for overly hawkish Fed tightening path.

Specifically, by providing an opportunity for the Fed to temper its tightening plans; so as to avert a recession.

But these are extraordinary times. And **yield curve inversion risks as a potential “circuit breaker” appears compromised**; on three counts.

First, doubts are being cast on the value of the **signal** given **distortions from exceptional QE**. In particular, the *unprecedented blowout to a \$9trln Fed Balance Sheet (B/S)*, it is argued, *suppresses long end-yields*; thereby **exaggerating flattening and/or inversion risks**.

Second, the **Fed's compression of rate "lift-off" and balance sheet run-off (QT)** may render **yield curve trends volatile\***, and therefore less reliable;

Crucially, the **Fed deems 2Y-10Y spurious, favouring shorter (3M-18M) forward spreads**; which, in contrast to emphatic flattening (and lingering inversion risks) in the 2Y-10Y, **have steepened sharply**.

So if anything, the **Fed's focus on the exceptionally steep front-end of the yields curve (3M-18M)** is set **to embolden, not temper, already aggressive hawks**; at least for the next 3-6 months (if not more).

*As Master Yoda reveals, a hawkish Fed will only find that which it takes with it.* In this case, **a disregard for recession risks signalled by 2Y-10Y flattening** in favour of a healthy 3M-18M yield curve that validates the hawkish bias.

In turn, an **aggressively hawkish Fed** (with not just rate hikes, but QT in tow), **unchecked by compromised "conventional" (2Y-10Y) yield curve inversion risks**, inevitably **accentuates macro-stability risks for EM Asia's central banks** that lag in normalization efforts. And this will leech into FX markets, showing up as **corresponding downside volatility in AXJ**.

*\*Given QT may induce steepening whereas rate hikes motivate flattening.*

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