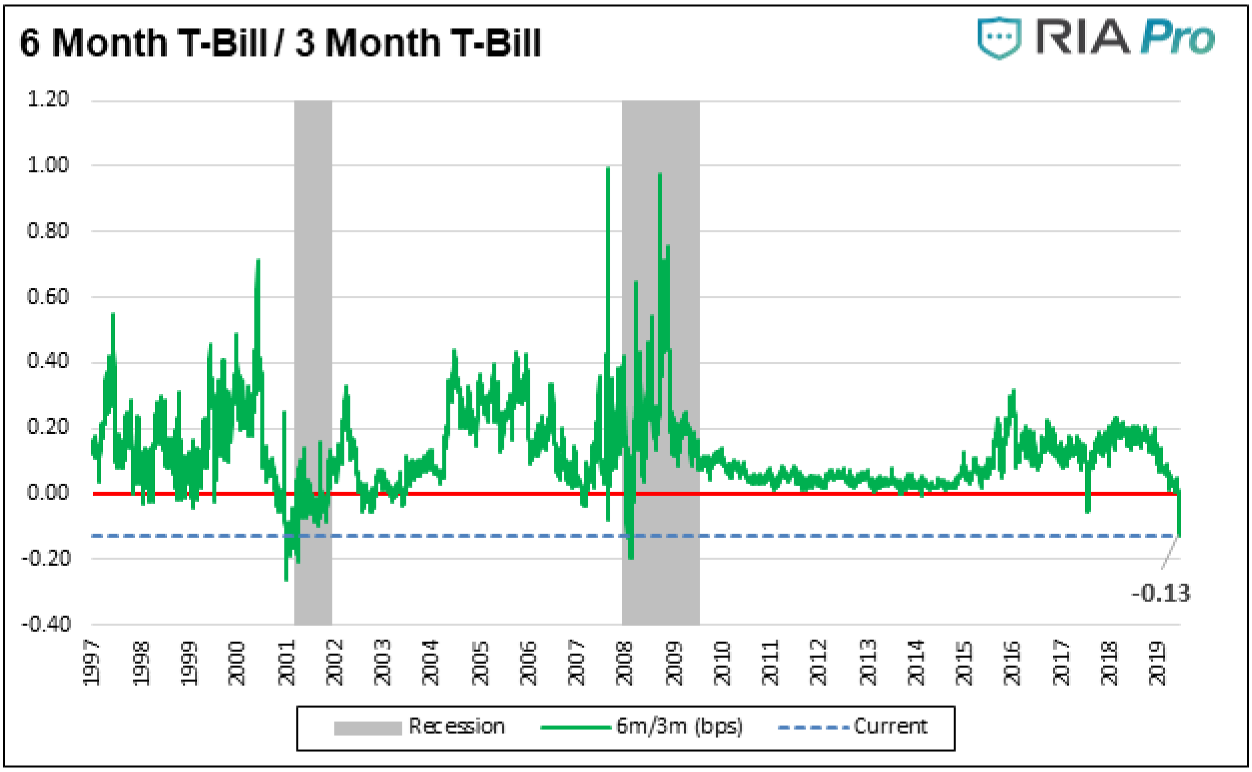
Quick Take: The Treasury Bill Yield Curve Says A Recession Is Imminent

We have discussed yield curves in quite a few commentaries and articles over the last few months. The reason we stress the topic is that yield curve inversions are not only uncommon, but their occurrence is highly correlated with recessions.

Typically, when people use the phrase ?the yield curve,? they are referring to the 10 year/2 year Treasury curve spread. While that curve is important, there are other curves that are predictive of future Fed rate policy as well as the prospects of a coming recession.

For example, the graph below shows the 6month/3month Treasury bill curve. Because the maturities making up this curve are so short, its usefulness is in providing an outlook for what the Fed might do and how soon they might do it.



As shown above, the 6m/3m curve now sits at negative 13 basis points, meaning 6 month T-bills now yield .13% *less* than 3 month T-bills. The 3 month bill is currently priced at a yield of 2.26 which is about 14 basis points below where it traded earlier this year prior to when the market thought the Fed would ease in 2019.

Given the yield decline, the timing of the Fed?s meetings, and the term to maturity, the current 3 month bill implies nearly a 100% chance that the Fed will reduce rates by 25 basis points at the July 31st meeting. The yield on the 6 month bill implies the same rate cut plus a 50% chance of another rate cut at the September 18th meeting which is the next meeting after the July 31st meeting.

Essentially the graph highlights that the last two recessions occurred shortly before or after the T-bill market implied a greater than 50% chance of consecutive rate cuts by the Fed, as it is now.

The bond markets for the moment are signaling that a recession is imminent as the chances of Fed rate cuts becomes more likely by the day. At the same time, the stock market appears to think that easier Fed policy will protect the value of the stock market. Based on historical precedence and current valuations in stocks and bonds, we would argue they cannot both be right.

Six of the last seven times the Fed has lowered rates a recession followed. August of 1998, the one instance it did not occur, was Fed action to minimize the effect of the failure of Long Term Capital Management, one of the world?s largest hedge funds at the time. It is worth noting, their actions, along with Y2K spending, likely forestalled the recession which followed two years later.

The table below shows the previous seven times the Fed reduced rates by 75 basis points or more and the maximum drawdowns that occurred in the S&P 500 over various time frames. Needless to say, heed the message of the bond market and trade with care.

RIA Pro	Fed Fund Start Rate	Total Reduction of Fed Funds	Recession Followed?	S&P 500 largest drawdown from month prior to rate cut			
				3 Month	6 Month	1 Year	3 Year
7/1/1974	12.92	-8.15	Yes	-26.01%	-34.98%	-34.98%	-34.98%
6/1/1981	19.1	-10.59	Yes	-6.63%	-18.32%	-21.31%	-24.81%
8/1/1984	11.64	-4.11	Yes	-4.29%	-4.29%	-4.29%	-4.29%
3/1/1989	9.85	-6.83	Yes	-4.76%	-4.76%	-4.76%	-4.76%
8/1/1998	5.55	-0.81	No	-21.05%	-22.45%	-22.45%	-22.45%
7/1/2000	6.54	-5.56	Yes	-5.02%	-13.03%	-27.39%	-48.38%
7/1/2007	5.26	-5.19	Yes	-11.03%	-11.03%	-18.41%	-56.72%
Average		-5.89		-11.26%	-15.55%	-19.08%	-28.06%