Cornerstone Macro

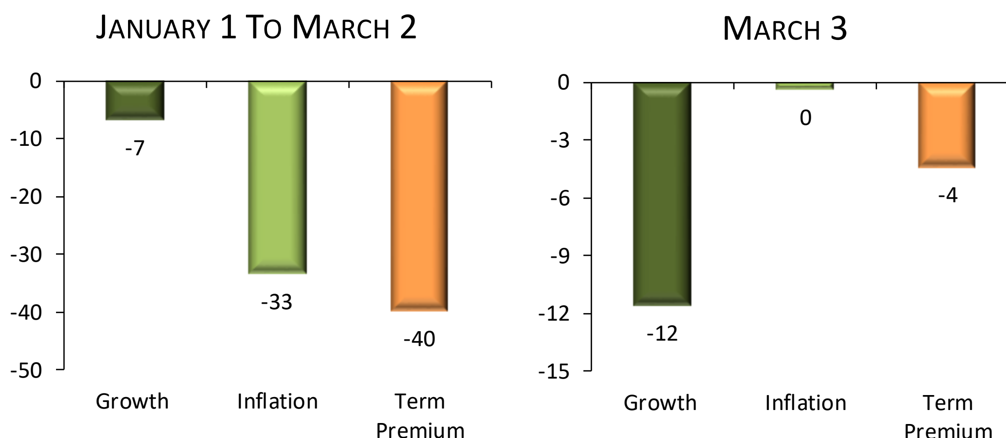
Economics, Policy, Strategy & Technicals

Global Policy

A Big – And Troubling – Change In The Treasury Market Yesterday

- **The Fed cut rates 50 bps yesterday because, as Powell said, "risks to the US outlooks have changed materially" because of the coronavirus. Still, he also said that the US fundamentals remain "strong."**
- **But while the Fed perceives the coronavirus as presenting a *risk* of recession, the market instead is increasingly perceiving recession as a *base case*.**
- **There were signs that such market perceptions were already taking hold (e.g., the massive drop in Fed policy expectations we flagged here); yesterday, however, we saw a massive drop in our proxy for growth expectations embedded in the ten-year Treasury rate.**
- **Only 25 other times since 1997 (a total of 6024 trading days) has our growth expectation proxy dropped more than yesterday. Most of those drops occurred during or before recession times.**
- **Until yesterday, growth expectations were declining, but gently and in line with consensus views that US growth wasn't going to be much better than 2%. Yesterday was a sea change.**
- **This is troubling because our proxy for growth expectations has been the best predictor of past recessions: When it starts dropping fast, the economy typically rolls over.**
- **Of course, yesterday could have been just a fluke and the market's message might change going forward. But this variable is definitely worth watching closely.**

Decomposition Of Ten-Year Rate Changes This Year



Until yesterday, most of the decline in the ten-year rate was accounted for by a lower term premium and inflation expectations. Yesterday, however, 75% of the decline was due to lower growth expectations.

Source: Cornerstone Macro.

The FOMC was surely hoping to calm markets by giving the market what it wanted – a big rate cut. However, the market has a way to pay attention not just to Fed actions but also the reasons for such actions. **Powell tried to cast the cut as a way to manage a risk against the backdrop of a strong economy, but the market did not buy it.**

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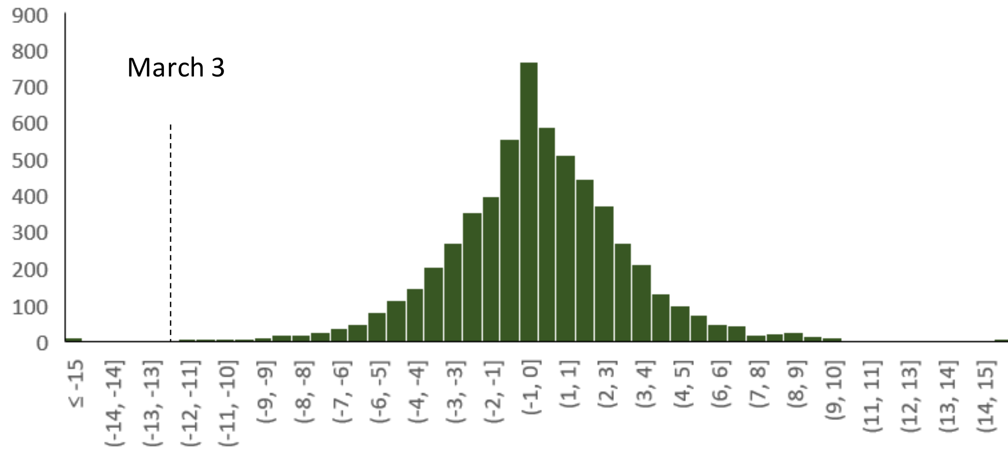
It might have been a bit of a stretch to characterize an economy that grows at barely 2% as "strong." But the market is likely also thinking that the risk must be very serious if it warrants an intra-meeting cut of 50 bps. The market can be justified in that assumption: **Such cuts only happened in the past at times when the US economy was headed into recession.** In any case, whatever the reason, the market clearly upped its odds of recession yesterday.

DISTRIBUTION OF CHANGES IN TEN-YEAR RATE US GROWTH EXPECTATIONS SINCE 1997

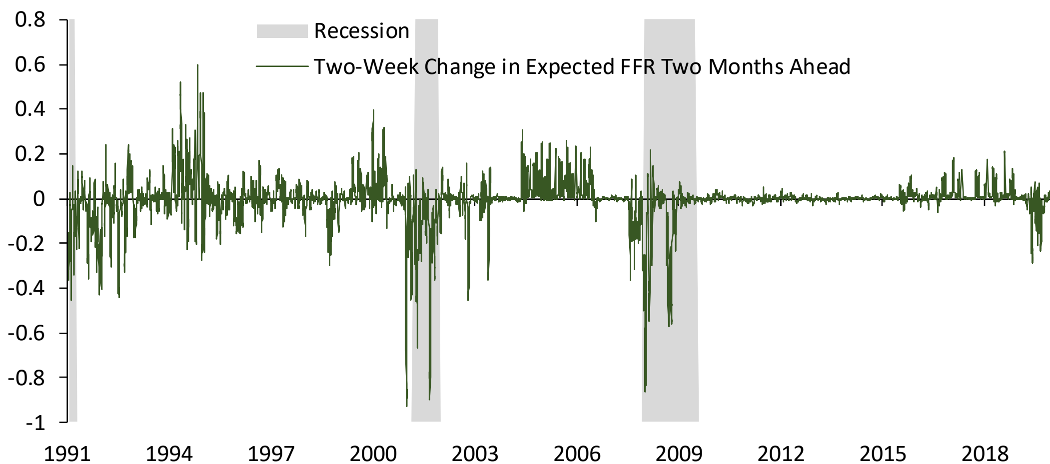
The change in our growth expectations proxy yesterday was clearly outsized: only 25 other times since 1997 (or 0.4% of the times) has our proxy dropped as much as yesterday in one day.



Source: Cornerstone Macro.

There is no better sign of that than the big drop in our proxy for US growth expectations embedded in the ten-year Treasury rate. As a reminder, the proxy is the ten-year real rate net of the term premium, which tries to isolate the market growth assumptions from other factors (the term premium). As the chart on page 1 shows, **US growth expectations dropped 12 bps yesterday, accounting for most of the drop in the ten-year rate.** Until yesterday, the vast majority in the decline in Treasury rates was accounted for by lower inflation expectations and lower term premiums, which are tied to global, more than US, factors.

TWO-WEEK CHANGES IN THE EXPECTED FED FUNDS RATE TWO MONTHS AHEAD



Source: Cornerstone Macro.

The drop in US growth expectations backs up the other scary message from the bond market, namely that expectations of fast and large Fed rate cuts are surging.

The top chart on this page puts yesterday's move into a historical context. Since 1997, ten-year growth expectations have dropped more than yesterday only 25 times, or 0.4% of the times. Virtually all of those drops occurred at times immediately preceding or already in recessions.

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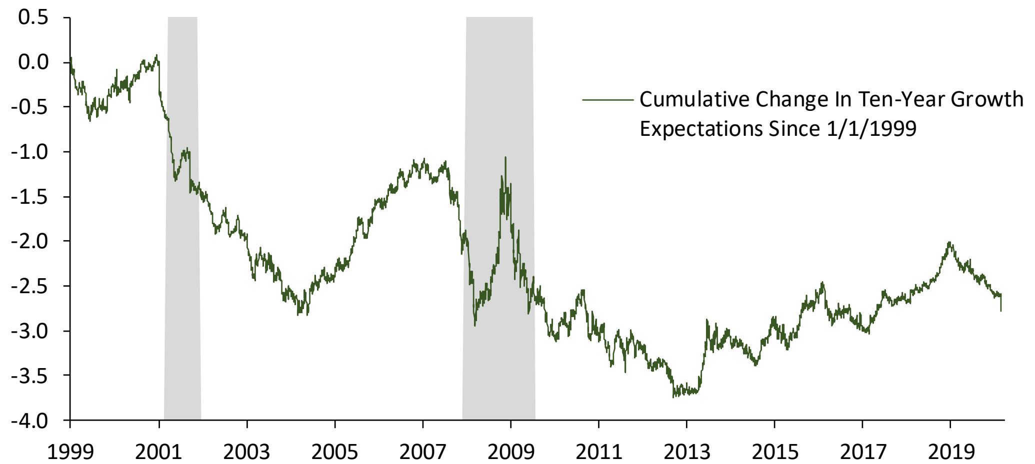
The bond market was already nervous before yesterday, as witnessed for example by the sharp drop in the expected federal funds rate two months ahead (the bottom chart on page 2). As we noted on Monday, that drop is also historically outsized, and it only got even bigger yesterday. **We view the drop in growth expectations as confirming the sinister message sent by the drop in Fed policy expectations. It's never a good sign when the market sees US growth dropping fast and projects the Fed to cut fast.**

Our proxy for US growth expectations embedded in the ten-year rate has dropped fast only prior or during to past recessions. A continuation of yesterday's move would be a very troubling sign.

Time For Another Grey Bar?



Source: Cornerstone Macro.

In fact, as the chart above illustrates, **sharp and fast drops in the growth expectations embedded into the ten-year Treasury rate have been historically a good predictor of recessions** – better and more timely than yield curve inversions, for example.

It's obviously very difficult to predict how the coronavirus will evolve and what its economic impact will be. The market, like us, will continue to adjust its views based on incoming data, and it's perfectly possible that those data will paint a rosier picture than the market has in mind. **The behavior of our proxy for growth expectations offers the best cues of what market sentiment is, and as of now its message is troubling.** We will report any changes or confirmations of yesterday's move in future notes.

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