Credit Crisis: Curve and Spreads: Both Now Warning

Bob Hoye

August 2023

In March the Yield Curve inverted as short rates rose above long rates. We use the 2s to 20s and the inversion has always been followed by a recession, without exception. The warning becomes more acute as the Curve reverses, which it is doing now. A slowing economy reduces the ability to service debt with over-exposed banks and speculators facing increasing difficulty in meeting obligations. Rating agencies start to downgrade debt.

The other key aspect of finance is the difference between high and low risk. In a boom, confidence shows little regard for risk and too many reach for yield. And troubles are anticipated by Credit Spreads reversing to widening. Despite spreads seriously widening in lesser countries, US spreads have been narrowing. Also, despite the seasonal tendency for a turn to widening in May-June, the investing world has continued to buy risk.

However, the urge for risk has become intense, with the chart of Junk/Treasuries accomplishing technical excesses. The chart follows:

Wrap

The reversal in Spreads is a key step towards a credit crisis, as Mr. Margin overwhelms the Fed. And this melancholy event is often discovered in October. Often with considerable financial violence.