

Inverted yield curve: why does it scare markets, and who really owns US debt?

When the 2-year yield climbs above the 10-year, markets get nervous. What an inverted curve reveals, why it hurts banks, and who really funds the US government: hint, it isn't China.

The analysis: what a curve that flips is telling you

The yield curve is simply the yield on US Treasuries plotted by maturity: 3 months, 2 years, 10 years, 30 years, on a single chart.

Normally, the curve slopes upward. Lending for 10 years pays more than lending for 2, because your money is tied up longer and you carry more risk. An upward curve is a market that believes in growth.

But sometimes the 2-year yield rises above the 10-year. The curve inverts. Why? Because the two ends of the curve answer to different masters:

- **short-term rates follow the Fed**, which raises them to fight inflation;
- **long-term rates reflect what the market expects next.**

If investors are willing to lend for 10 years at a lower rate than for 2, they expect a slowdown, and Fed rate cuts down the road.

Why banks hate an inverted curve

A bank borrows short term (your deposits) and lends long term (mortgages, business loans). Its margin is the gap between the two.

When the curve inverts, that margin shrinks. Credit tightens, companies invest less. **That is how a simple chart ends up weighing on the real economy.** In March 2023, in the middle of the inversion, the collapse of Silicon Valley Bank, the largest US bank failure since 2008, drove the point home.

The historical fact: 2022-2024, the longest inversion ever recorded

This signal has come before almost every US recession of the past fifty years. The gap between the US 10-year and 2-year yields turned negative in July 2022 and stayed there until September 2024: **more than two years of inversion, a record**. At the low point, in July 2023, the 2-year paid about 4.9% and the 10-year about 3.8%: more than a full point, upside down.

But the lag between an inversion and a possible recession has always varied, from a few months to more than two years. Anyone who sold everything in the summer of 2022 had a long wait.

The story: a student's thesis that became a global indicator

In 1986, a Canadian PhD student at the University of Chicago, **Campbell Harvey**, showed in his dissertation that the shape of the yield curve helps forecast growth, and that an inverted curve tends to come before recessions.

Almost forty years later, his indicator is watched worldwide. Harvey, now a professor at Duke, keeps repeating: it is an alarm, not a prophecy.

Who really owns US debt?

A stubborn myth says China holds America hostage through its debt. The numbers tell a different story.

Federal debt held by the public is around \$30 trillion. Roughly **one third** is in foreign hands. Close to **14%** sits at the Fed, a legacy of its massive bond buying (QE). And **more than half** is held by American investors: funds, banks, insurers, pension plans, households.

Among foreign holders, **Japan** is number one by a wide margin. Since 2025, China ranks only third, overtaken by the United Kingdom. It has even cut its holdings, from about \$1.3 trillion in 2013 to roughly \$750 billion, sales spread over years that the market absorbed.

What if it dumped everything at once? Bond prices would fall and yields would rise. But Beijing would hurt itself too: it would devalue its own reserves and push the yuan higher, which would penalize its exports. A double-edged sword.

KEY FIGURES — THE YIELD CURVE AND US DEBT

More than 2 years: length of the 10-year / 2-year inversion, July 2022 to September 2024, a record

About 4.9% vs 3.8%: US 2-year and 10-year yields in July 2023

About \$30 trillion: federal debt held by the public in 2025

Roughly one third: share held by foreigners, versus close to 14% for the Fed

Over \$1.1 trillion: Japan's holdings, the largest foreign holder

From \$1.3 trillion to \$750 billion: drop in China's holdings between 2013 and 2025

The takeaway for your portfolio

An inverted curve is not a date, it is a warning. It tells you the bond market expects a slowdown, not when it will arrive. And when the curve steepens again, ask why: because the economy is picking up, or because the Fed is cutting rates in a hurry.

As for US debt, it is first and foremost an American affair: the Fed, inflation and American investors move yields far more than Beijing does.

Both topics are also explained on video in the "Bons du Trésor" (Treasury Bills) series on the Axone-Capital YouTube channel.

Risk: no indicator is perfect. The yield curve should be read alongside other data (jobs, credit, inflation) and is never, on its own, a signal to buy or sell.

Frequently asked questions

What is an inverted yield curve?

It is when short-term yields, such as the 2-year, rise above long-term yields, such as the 10-year. Normally, lending for longer pays more. An inversion signals that the market expects a slowdown and future rate cuts.

Does an inverted curve always mean a recession is coming?

It has come before almost every US recession of the past fifty years, but the lag ranges from a few months to more than two years. It is a warning about the cycle, not a precise timetable.

Could China crash the US debt market?

Unlikely. China holds only about \$750 billion of roughly \$30 trillion in debt held by the public, and it is now just the third-largest foreign creditor. A sudden sell-off would also cost China dearly.

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