

Predictive Power of Yield Curve Inversions

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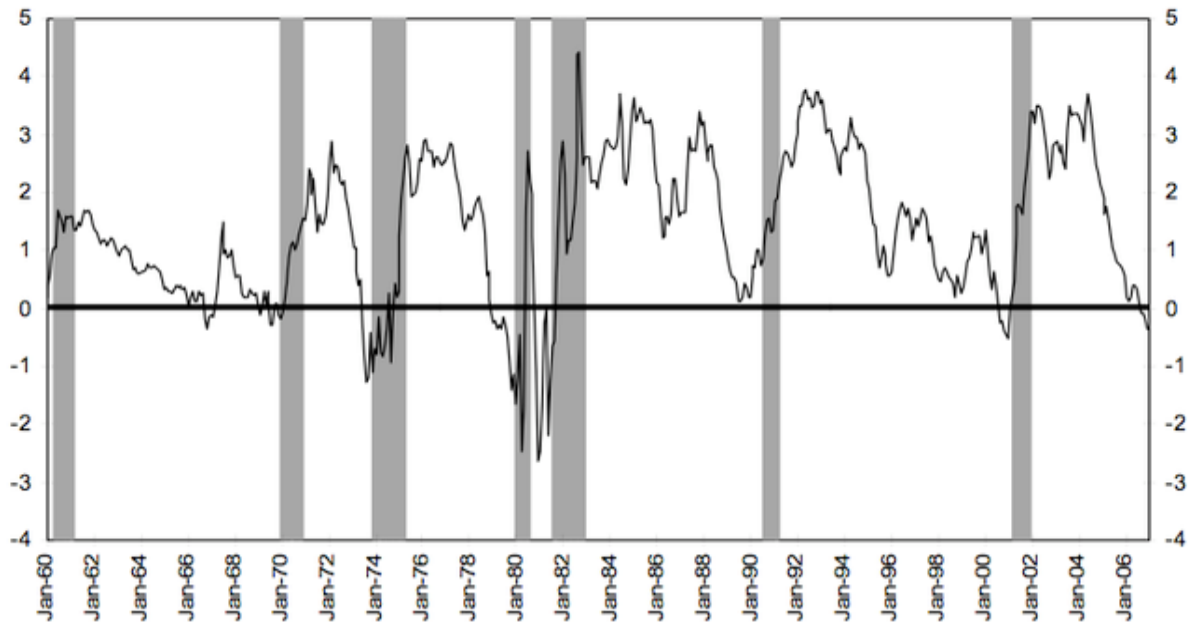
As most of us know the yield curve continues to be inverted and has the potential to be the longest inverted yield curve in history. Are we in a new paradigm because of the billions China and others must reinvest each month, or are we in for an interesting ride. The US is not the only country going through this phenomenon. England, Australia, and briefly the EU are also experiencing inverted yield curves. We don't have all the answers but here are some of the facts.

The WSJ reported that the bond market is having relationship issues that are getting harder to ignore. Normally, yields on long-term government bonds are higher than yields on short-term ones. Investors demand a bigger return for the risk that comes with holding an investment that takes longer to repay. The relationship has been upside-down since July, with yields on short-term U.S. Treasury bills exceeding those on long-term Treasury notes. Late Friday, the yield on the three-month Treasury bill stood at 5.05%, well above the 4.648% yield on the 10-year note.

This unusual state of affairs -- known as an inverted yield curve -- has gone on longer than many economists expected and has some wondering whether the bond market is signaling that the economy itself could turn upside down. Even non-Wall Street types are starting to notice. Charlotte Observer sports columnist Rick Bonnell likens an inverted yield curve to a basketball player whose shooting percentage is lower at the free-throw line than from the field. It's uncommon and nerve-wracking.

Yield inversions, many analysts say, are harbingers of hard times. When bond investors see a recession coming, they tend to buy long-term Treasury securities for two reasons. First, they are safer than stocks. Second, they are appealing when inflation is low, and recessions tend to beat down inflation. The buying that comes with recession fears drives down a long-term bond's yield, sometimes below the prevailing yield on short-term Treasury securities. But those who think highly of the yield curve's predictive power have history on their side. Seven times between 1965 and 2005, yields on the 10-year note have dropped below those on the three-month Treasury bill for an extended span. In six of those instances, the U.S. economy went into recession soon after. The following table shows the past seven instances of an inverted yield curve and the final result.

Spread and Recessions
 (10-year minus 3-month Treasury yields, secondary market monthly averages, source: St. Louis Fed)



Date of Inverted Yield Curve	Result
July 2000 to January 2001	Recession March 2001
May 1989 to August 1989	Recession July 1990
October 1980 to September 1981	Recession July 1981
November 1978 to May 1980	Recession January 1980
June 1973 to November 1974	Recession November 1973
December 1968 to February 1970	Recession December 1969
September 1966 to February 1967	Economic Slowdown 1967

The WSJ reported that the market, in effect, is betting that the Federal Reserve, which dictates short-term rates, will have to cut its overnight fund rate to boost the economy, and investors are pushing long-term rates down in anticipation. Inverted curves often come toward the end of Fed rate-increase cycles. Fed Chairman Ben Bernanke halted the central bank's latest rate-increase campaign in August.

The Fed's overnight funds rate now stands at 5.25%. "The market is pricing in that the Fed funds rate is not going to stay at 5.25% over the next 10 years; it's pricing in that it's going to be considerably lower," said Bill Irving, who runs a long-term Treasury-bond-index fund for Fidelity Investments.

Some economists doubt the yield curve's effectiveness as a recession-forecasting tool. They think long-term rates are exceptionally low right now for other reasons, including lower long-term expectations about inflation and growing demand for U.S. government bonds from foreign investors needing somewhere to park their money.

For example, the 2001 recession was predated by a yield-curve inversion that lasted from July 2000 to January 2001. In the one time when a recession didn't follow, in the mid-1960s, there was still a sharp slowdown in growth.

"The yield curve gives you information that you should pay attention to," said David Roberts, chief economist at Dominion Bond Rating Service.

If the yield curve has predicted the last six recessions and we have a housing market that is currently in the dumps, we better be buckling our safety belts and looking out below.