**MarketGuru**

By Ed Tirukian

One of the conventional wisdoms of economic theory is that the stock market is a reliable forecaster of future business activity. Investors are said to be blessed with a prescience allowing them to peer in a crystal ball dotted with pie ratios and earning forecasts and collectively divine the course of the American economy. Rising stock prices are said to signify an expanding GNP, and the converse augurs a recession or worse. Even Uncle Sam's own bean-counters are convinced of the accuracy of the stock market's prognostications, since the performance of the S & P 500 is one of twelve factors comprising the Government's Index of Leading Economic Indicators.

Of course, economic pundits of a malevolent disposition are quick to note that the market has accurately foretold nine of the last four recessions. The most notable market failure is the September-October 1987 debacle during which time the Dow surrendered some 25% of its value, including 25% on Black Monday alone; amidst a nearly unanimous chorus of doomsayers who pointed to the Crash as proof irrefutable of the looming Second Great Depression, the US economy didn't even skip a beat, continuing its streak of uninterrupted growth (still intact two years later), and now the consensus is that the Crash was a hiccup, maybe even a burp, but mostly sound and fury signifying nothing.

So if the case for relying on the market as a predictor of general economic activity is less than compelling, where is the average investor and interested citizen to look for insight? According to Fuqua's own Campbell Harvey, no further than a calculator and the daily "Credit Market" column in the Wall St. Journal. For according to Professor Harvey's theory, which has been noted in Barron's, the New York Times and the International Herald Tribune, not to mention less plebeian journals like the Financial Analysts Journal, the configuration of the yield curve—the spread between yields on short- and long-term government debt instruments—is a far more reliable indicator of the future course of economic activity and the speed with which it will get there.

The core of Prof. Harvey's theory is deceptively simple: people select the time maturity of their investments in part as a hedge against anticipated economic activity. If people predict hard times around the corner, they make provisions for the future now that times are good and jobs plentiful, by avoiding shorter-term income-producing paper such as T-Bills, in favor of longer-term maturities which promise a stream of income into the far future when times will be tougher and jobs scarce. They bid up the prices of long-term obligations, and yields come down, and they eschew short term paper, whose yields climb accordingly. The result: the intuitively impossible configuration called an inverted (downward-sloping) yield curve. Why is this inversion so peculiar?

Investors share one trait—they hate unnecessary risk. It is quite natural then that a rational investor will demand greater compensation for assuming greater risk. Since the longer in time an investor commits his money, the greater risk he undertakes, it is almost a natural law that yields on longer-term instruments will offer more attractive yields. This natural order results in an upward-sloping yield curve, in which the more distant payoffs must use the bait of juicier yields to induce investors to lend their capital, while the short-term paper, to be redeemed in three or six months, is commensurately less rewarding. When investors expect prosperity around the corner, they try to keep their money as readily available as possible by committing it for the minimal durations.

Prof. Harvey's theory has stirred up considerable interest in the financial community because it is so timely. The yield curve has in fact been inverted to flat since late December 1988, as the Fed began a policy of tightening the money supply to quash inflation. At its most inverted configuration in late March, yields on 3-month T-Bills were some 25 basis points above 30 year T-Bonds. One historical reality is that an inverted yield curve has almost always presaged an economic contraction; in the last thirty years, the yield curve has been inverted only five times, and in each instance an economic contraction has followed within twelve months of the advent of the inversion, with the severity of the downturn closely correlated with the slope of the inversion. An inversion can last from seven months to well over a year, until investors regain confidence in the future. Typically the inversion sets on when the Federal Reserve begins tightening the money supply through its Open Market Operations, thereby driving up short-term interest rates. Investors fear the Fed may force the economy not just into a slowdown, but directly into recession. They therefore prepare for the lean years by buying maturities which will pay off through the near future and into the great unknown. Interestingly enough, the yield structure in all the major industrial nations has taken on an inverted configuration in the last year.

The traditional explanation for a yield inversion is simply that investors have confidence in the Fed's seriousness in slowing down the economy and bringing inflation down to the point where it no longer erodes the purchasing power of interest payments. They accord the Fed a vote of confidence by buying long-term bonds. This summer, in his second testimony on the Hill, Chairman Greenspan was quick to note that the inverted yield curve which we have had since early this year when the Fed pushed up short term rates some 250 basis points, proved that the market believed the Fed's policies were correct in the long run.

So what does today's yield curve tell us about tomorrow's economy? The yield curve first became inverted late last year and assumed a totally inverted configuration on February 7, 1989, the first time since April 1982 that T-Bills had higher yields than T-Bonds. The maximum discrepancy between short-term yields and long-term yields has so far been considerably less than 100 basis points. According to Prof. Harvey's formula, this inversion is therefore relatively mild and predicts that the economy will not sink into recession, as is widely expected, but will slow down to a 1.7% year-on-year GNP growth measured from the third quarter of 1989 to the third quarter of 1990. Such a figure would represent a slowdown from the 3.7% GNP growth recorded in the first quarter of 1989, and 2.5% in the second. More importantly, this would be a manageable and sustainable rate of growth well within the Fed's own goals, allowing for some loosening of the money supply later on this year and a gradual easing of interest rates. If Prof Harvey is in fact correct, the Fed will have engineered for the first time in its history a truly remarkable soft landing, allowing for the continuation of this otherwise quite buoyant economic expansion.