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Yield Curve

The Short and Long of It

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WHERE'S the economy heading?

Are rates heading higher?

Is the Federal Reserve being too easy?

A simple chart long favored by bond investors and analysts throws light on these questions. Known as the yield curve, it measures the rate on Treasury securities with increasing maturities and therefore offers an up-to-the-minute snapshot of the bond market. It also reveals a good deal about sentiment and expectations among informed investors.

The current graph shows a steep curve because 30-year bonds yield a lot more than three-month Treasury bills. In fact, the current gap, at four percentage points, is one of the widest in decades. By way of comparison, the average margin over the past 10 years has been closer to two points.

Thirty-year bonds generally yield more than three-month bills because investors want some incentive to tie up their money for long periods. The need for a yield premium on long-term bonds has been particularly evident during the past decade because the government has been borrowing so heavily to finance the deficit. But these factors aren't enough to account for the current shape of the yield curve. Rather, this curve has taken on its current shape largely because the Federal Reserve has aggressively cut short-term rates to the lowest levels in a generation in a bid to spark the economy and reliquefy the banks. However, long rates, which the Fed's power can't control, haven't fallen apace largely because those very super-accommodative credit policies, it is feared, will rekindle inflation, now running at 3%-4% a year.

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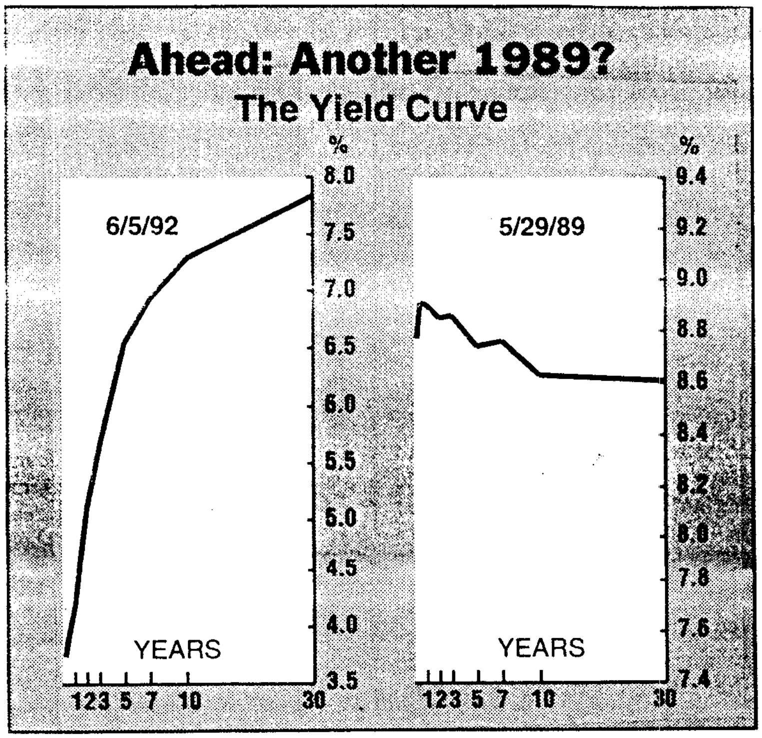
Why should anyone care about the yield curve and its odd shape? Well, the unusually steep slope offers insights into what bond investors think about the economy, future rates and the Fed. Specifically, the current shape points to a decided strengthening in the economy and significantly higher rates over the next few years. It also reflects a lack of confidence in the Fed's ability to control inflation.

"It's remarkable, if you look at the shape of the yield curve over time, how accurately it has forecast what's going to happen in the economy," says Campbell Harvey, a professor at Duke University's Fuqua School of Business. "It has correctly called every turning point in the economy since the 1960s. Right now, it's screaming recovery."

Harvey explains that when short rates are very low relative to long rates, it indicates a stimulative monetary policy. And when the Fed slashes short rates to goose the economy, as it has been doing for more than a year, it's generally successful, although there's typically a lag of about five quarters between a yield-curve shift and the economic impact.



Harvey views the progressive steepening in the yield curve since mid 1991 — the spread of 30-year bond yields above three-month T-bills has widened more than one percentage point — as heralding a robust economic recovery. He looks for above-consensus growth in gross domestic product of 4% this year and in 1993.

In contrast, when the Fed pushes up short-term rates in an effort to reduce borrowing incentives and thus dampen the economy, the result often is an inverted yield curve, with short rates higher than long rates. The last example was in mid-1989 (see chart), when the Fed was concerned — wrongly, it turned out — about an overheating economy and inflation pressures.

Harvey contends that the inverted yield curve of 1989, as well as similar configurations in 1968, 1978 and late 1980, turned out to be surefire predictors of impending recession. What's more, he adds, the inversion of yield curves in the British and German bond markets, caused mostly by the tight-money policy of the German central bank, has correctly signaled weakness in those economies.

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Besides acting as a useful economic forecasting tool, the yield curve offers a clear picture of interest-rate expectations. And to judge by its current shape, investors are downright pessimistic because they're demanding significantly higher yields for bonds of longer maturity.

The fears of higher rates are particularly pronounced for the next few years. Investors are willing to accept a yield of just 4.20% on a one-year T-bill, but they're demanding 5.25% to tie up their money in a two-year note, 5.75% for a three-year note and 6.70% for a five-year note.

Investors buying one-year bills are effectively saying they expect yields on one-year instruments in June 1993 to be about 6.30%, more than two percentage points above current levels. Why 6.30%? Because investors now accepting 4.20% for one year would need 6.30% in the next year to give them a return equal to a two-year note now yielding 5.25%. What's more, the current shape of the yield curve indicates that one-year bills in June 1997 will be at more than 8%.

Many analysts say this extreme view of rates is all wet, and that it's very unlikely that yields will rise so much. "There's been a trend toward a steeper yield curve for some time, but there has been no upward pressure on rates," argues William Sullivan, director of money-market research at Dean Witter Reynolds. Indeed, yields on short- and medium-term Treasury issues are a lot lower than they were last June, despite the steep yield curve then prevailing.

"Maybe in 1993, we could see some rate pressures, but you can't use the yield curve as an accurate predictor of when rates will rise in general terms because you don't know the timing of the shift," says Sullivan. "It's like predicting that the Cleveland Indians will win the pennant. The question is when."

Many investors have made a lot of money during the past year by betting that the yield curve was sending the wrong signal about rates. These investors bought medium-dated securities with three- to five-year maturities yielding 7% or 8% and saw the value of those issues rise as rates actually declined.

Retail and institutional investors continue to make the same choice by plowing tens of billions into medium-term Treasuries, mortgage securities or funds investing in those instruments rather than stashing their money in money-market funds paying 3.5%.

Yet, the abnormal shape of the yield curve is definitely a warning signal, because if the Fed's huge monetary stimulus does jump-start the economy, and GDP does begin to expand rapidly, inflation worries would rise markedly, and that would spell trouble for bondholders. ■