Bond curve worrisome

Long-term rates below short-term foretell slump

By Roger Fillion
Reuter

WASHINGTON — Investors are turning the bond market on its head, with long-term interest rates poised to drop below shorter-term rates — a signal the economy is headed for a sharp slowdown, or possibly a recession.

The yield on the 10-year Treasury bond already has slipped temporarily below a key overnight interest rate for the first time since 1989, before the economy skidded into recession in 1990.

While the "yield curve" reflecting the interest rates on short-term Treasury bills and longer-term notes and bonds has not flipped altogether, its flattening shape is significant, according to economists.

Typically, the curve slopes upward to the right, with yields on longer-term instruments — such as five-year and 10-year Treasury notes — higher than those on three- and six-month Treasury bills.

"The current yield curve is saying we will have little or virtually no economic growth in the near future," said Sung Won Sohn at Norwest Corp.

Charles Carlstrom of the Federal Reserve Bank of Cleveland put the message this way: "Some time over the next year it looks like economic activity will slow, with the possibility of a recession."

The outlook would be even gloomier if the curve were to invert and stay flipped for at least a few months, a harbinger that a downturn may well be on the way in the next year or so.

In that case, the curve would slope downward to the right.

Yields on overnight federal funds or 90-day bills would exceed yields on five- or 10-year Treasury notes.

"This is a leading indicator of the business cycle," said Campbell Harvey of Duke University's Fuqua School of Business.

Why does a flipped curve signal recession?

When investors expect the economy to slow or contract, longer-term rates typically drop as inflation fears fade. And prices on longer-term notes and bonds rise as their yields fall, boosting the attraction of such investments.

By contrast, shorter-term interest rates are anchored to interest-rate policies set by the Federal Reserve, the United States central bank.

If the Fed tightens credit or declines to cut interest rates, short-term yields on bills with a maturity of one year or less do not have as much leeway to fall. An inverted yield curve suggests the Fed is keeping interest rates too high.

Analysts are quick to note that the yield curve has not yet flipped outright. But its current shape offers a warning.

"It's a little premature to talk of an imminent recession. But it is not premature to talk about a recession that may be on the horizon," said Anirvan Banerji of Columbia University's Centre for International Business Cycle Research.

Duke's Harvey expects the curve may well flip in coming weeks, with the interest rate attached to the 90-day Treasury bill — now around 5.70 per cent — exceeding that on the five- or 10-year note. On Tuesday, the gap was about a tenth of a point for the five-year note and less than a half point for the 10-year.

Harvey, who developed a forecasting model based on the curve, said that inversion has accurately forecast the five recessions of the past 25 years. The curve must stay flipped for at least one quarter.

The time between when the curve inverts and a recession begins ranges from nine to 15 months.

Sohn of Norwest Corp. is keeping an eye on the gap between the federal funds rate — which banks charge one another on overnight loans — and the 10-year note.

The yield on 10-year paper, which is just over six per cent, temporarily fell below the fed funds rate of six per cent Friday and again Monday, inverting for the first time since January 1989.

"During the post-war period, it has predicted economic recessions without fail with one exception," Sohn said of this inversion. The exception was in 1966 when federal spending on the Vietnam war buildup boosted the economy.

The one way to avert a recession is for the Fed to cut rates, Sohn said.