Published: Sep 4, 2005
Modified: Sep 4, 2005 3:15 AM

One sign of slower growth

By JONATHAN B. COX, Staff Writer

Tracking the economy is not science. At times, consulting a fortune cookie can seem more fruitful than talking with the experts.

But in these days of soaring fuel prices, a frothy housing market and increasing global competition, the need to know where we're headed is magnified.

Well, here's one indicator that the professionals are watching for a little help: the yield curve.

Wait, don't flip the page. This gets interesting.

The yield curve is simply the difference, or spread, between short-term and long-term interest rates. So if short-term rates are 2 percent and long-term rates are 5 percent, the spread is 3 percentage points.

The rates typically move in roughly the same direction. But long-term rates are holding steady, even though the Federal Reserve has raised short-term interest rates 10 times in a row.

That gives economists pause. The scenario could be a sign of a weakening economy.

Why is that? When long-term rates drop below short-term rates, that's a warning sign of possible trouble. In fact, that has happened before the last six recessions.

"This thing has got a really good ability to call a recession," said Campbell Harvey, a finance professor at Duke University's Fuqua School of Business, who wrote his dissertation on the yield curve.

Is a recession looming? Don't hit the panic button yet. While the spread is narrowing, long-term interest rates have not dropped below short-term rates.

Right now, short-term rates are about half a percentage point below long-term rates. There's only about a 27 percent chance of a recession beginning in three quarters, said Gary Shoesmith, a Wake Forest University economist who has a model to predict recessions.

Should I really care, then? Yes. If short-term rates go half a percentage point above long-term rates, the probability of a recession jumps to 58 percent, according to Shoesmith's model.

Why aren't long-term rates going up? There are a number of possible reasons.

* Short-term interest rates were too low. The Fed has just been pushing them back to a more natural level, and long-term rates had no reason to respond.

* U.S. companies pay China, Japan and other countries in dollars for all the stuff they buy. The central banks in those Asian countries have plowed a lot of those dollars back into U.S. bonds. Because of the way the market works, that keeps rates low.

* Bond investors may anticipate weaker economic growth and keep long-term rates lower.

Will short term rates go above long-term rates? Probably not, said Harvey of Duke. But the pros are watching "extremely closely."