Eric Roseman's Eruptions: Stocks, Global Markets and Commodities BLOG

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The #1 Indicator that Correctly Predicted a U.S. Slowdown is Flashing Red Again -- Overseas

Back in 2006, when most stocks were still hitting new all-time highs in the United States and credit markets were soaring on the heels on ultra-low borrowing costs, one important leading indicator was flashing red. Nine months later, that same indicator correctly predicted a U.S. economic slowdown that morphed into the subprime mortgage monster by July 2007.

Bond yield inversion is an anomaly historically associated with an impending recession in the major industrialized economies. It occurs when short-term government bond yields trade higher than long-term interest rates, usually suggesting an economic recession or slowdown lies ahead. More often than not, this indicator has accurately forecasted a U.S. recession in the post WW II period. This time was no exception; it was right on the money, predicting a bear market in U.S. stocks and credit starting last July.

Starting in September 2006 until March 2007, benchmark two-year U.S. Treasury bonds started to yield more than their respective ten-year Treasury counterparts. It was a classic inverted yield curve, whereby short rates yield in excess of longer term rates. At the time, many pundits on Wall Street dismissed this bond anomaly as a short-term phenomenon driven mainly by foreigners accumulating quality short-term U.S. Treasury paper, thereby reducing the available supply in the marketplace. They, however, were quite wrong.

The Father of Yield Curve Inversion

Professor Campbell Harvey of Duke University was of the original fathers depicting the relationship between yield inversion and economic recession. He published his dissertation in 1988 in the Journal of Financial Economics. In 1989, he published a follow up article in the Financial Analysts Journal.

Harvey's prediction about the usefulness of the yield curve was right on target. In 1991, after the 1990 recession, he noted that inversions of the yield curve have preceded the last five US recessions, suggesting that the curve can accurately forecast the turning points of the business cycle.

Indeed, the yield curve turned negative, or inverted, in late 2006 and successfully predicted the current U.S.

economic slowdown. In some respects, the current slowdown has ballooned into the worst credit crisis since the Great Depressions, as several segments of the mortgage-backed market and other synthetic derivatives have clogged the financial system since last July.

Eight Countries Approaching or in Actual Yield Inversion

Although no in-depth analysis or research has been conducted on the universality of yield curve inversion abroad, recent evidence suggests that once it hits the United States, the world's largest credit market, it does spread to other industrialized economies.

As of mid-April, eight foreign markets are currently dogged by yield curve inversion or are approaching yield inversion. And, last year, the United Kingdom became the first G-7 economy after the United States to suffer yield curve inversion for the better part of the year until last fall. For the record, the U.K. is now slowing sharply in 2008, as several banks come under pressure. One mortgage bank has failed and the housing market is unravelling.

Currently, six industrialized markets are mired in yield curve inversion. These include Australia, New Zealand, Austria, Norway, Portugal and Switzerland. Two other markets now sport the same interest rates along the short and long end of the yield curve, including Denmark and Italy. This strongly suggests that an increasing number of mature economies are gradually being infected by America's subprime slowdown as interest rates narrow.

Historically, the Anglo-Saxon economies have typically followed similar economic cycles, whereby expansions or contractions in economic activity have been simultaneous events occurring within months of one another. This was the case in 1989-1990, when the United States suffered a recession and the United Kingdom, Australia and New Zealand soon followed suit. In the early 1980s, all three countries suffered the same economic hardships as the United States following a period of surging interest rates and inflation in the late 1970s. The same was true for most developed economies.

Decoupling or Re-coupling?

In the late 2000s, analysts have been quick to surmise that emerging markets and other economies in Europe have finally decoupled from the U.S. economic cycle. Although the emerging markets have shown incredible resilience since last July, when subprime first exploded credit markets, other major or mature economies have not been as fortunate.

The United Kingdom is probably heading into a recession or a severe slowdown. The country's credit markets have been bottled up for months, mortgages are turning sour and a leading mortgage bank collapsed last September (later rescued by The Bank of England). British real estate is now contracting, especially in overheated London. The pound, though still relatively firm versus the beleaguered dollar, trades at an all-time low against the euro. The United Kingdom, in all likelihood, will join the United States and suffer a slowdown in 2008 or, worse yet, a recession.

The majority of industrialized countries, including the European Union and Scandinavia, will increasingly share the same bond yield inversion phenomenon that occurred in the United States 18 months ago. Over this period, benchmark 10-year Treasury yields have plummeted from 5.25% in late 2006 to 3.42% recently – a sizable gain for investors.

I expect yield curve inversion and economic re-coupling to occur this year as the majority of mature economies suffer the same fate as the United States. Bond yields in Europe are poised to decline sharply despite the European Central Bank's (ECB) adamant stand against inflation. With more euro-zone bond markets inverting, it is only a matter of time until interest rates come down sharply across the continent and the ECB abandons its inflation fight.

Bond yield inversion is spreading. For European bond investors, this marks a good entry point to buy long-term government debt and investment-grade corporate paper ahead of a steeper yield curve by 2009 or 2010.

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