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False Positive

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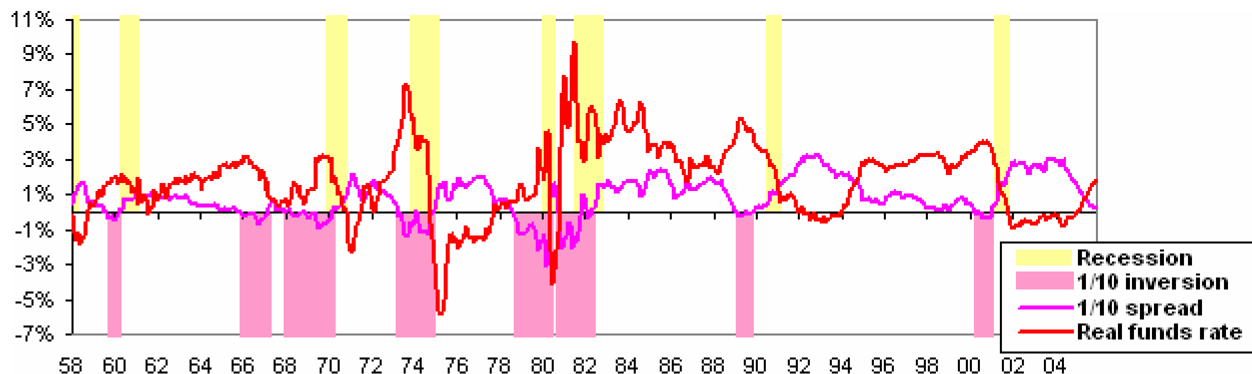
Inverted yield curves don't cause recessions -- and this one isn't signaling one, either.

The mainstream media's tireless efforts to find a dark cloud in the blue sky of this **economy** picked up some added steam when a tiny **inversion** (less than one basis point) of the **2-10 yield curve** last week offered the skeptics another opportunity to vent. Thus, we had a round of reports typified by the ***Wall Street Journal's*** front-page declaration that the "bond market interrupted the holiday season with a downbeat message yesterday: Many investors expect the economy to hit tougher times within the next year or so."

To be sure, yield curve inversions have had a fairly good track record anticipating **recessions**, and we would not be sanguine about this one were it to deepen significantly and challenge the 2000 inversion (which reached 50 basis points) or the one in 1981 (which exceeded 240 bps at its depths). The coincidence of curve inversions with subsequent recessions, however, does not establish the inverted curve as the **causal factor**. At best it is an **indicator** -- one not to be relied upon when we can, in fact, directly observe true causal factors.

When inversions have presaged recessions, such as in '81 and '00, they have accompanied exceptionally **tight monetary policy**, with a **real fed funds** rate exceeding 4% (see the chart below, which for illustrative purposes uses the 1-10 curve due to the unavailability of longer-term data for the **2-year note**). In fact, in the last nine inversions, the real funds rate has averaged close to 5%. What's critical to note is that the last two times a curve inversion registered as a false positive for a forthcoming recession -- in 1966 and 1998 -- the real funds rate was at 2.75% and 3.7%, respectively.



This reinforces our view that recessions are caused by excessively tight money, not inverted yield curves. With a real funds rate -- relative to the **core CPI and PCE indexes** -- currently just slightly above 2%, it's a stretch to think that monetary policy can currently be considered "tight." Given the ample signs that this economy remains in vigorous health amid solid expectations for sustained growth -- including tight **credit spreads**, rapid **growth in household wealth** and a

highly positive outlook for **capital spending** -- we view the chances as minimal that the curve is signaling that recession or even a significant slowdown is in the offing.

That being said, it remains to be explained why the curve has **flattened** to the extent it has (actually, the 2-10 curve today has **steepened** and is showing a positive upward slope of 3 bp). In the late stages of **tightening cycles**, curve-flattening is not unusual; while the **short end** remains pegged to near-term funds rate expectations, **longer maturities** begin to price for the end of **rate hikes** and the chances for subsequent **rate cuts**. To a considerable extent, that appears to be the explanation in this case as well. The market at this point remains in step with the dovish case regarding the outlook for **Fed** action. While **interest rate futures** are nearly fully priced for the funds rate to move up another 25 bps to 4.5% at **Alan Greenspan's** final **FOMC** meeting at the end of this month, they are only showing about a 50% chance for another 25 bps at **Ben Bernanke's** first meeting as chairman in late March. They remain less than fully priced for a 4.75% funds rate out to June, and show a small chance of a rate cut late in the year.

We continue to regard that as an improbable scenario. As we have noted, we view it as nearly certain that Bernanke, in the interests of institutional continuity, will want to raise rates at his first meeting. Beyond that, we expect that Bernanke and his colleagues will become increasingly attuned to the **macro data** to guide policy going forward. While the funds rate is nearing a level viewed as being in the range of **"neutral,"** the **demand-management** proclivities of this central bank are likely to keep them leaning toward remaining in rate hiking mode as the economy moves toward **full "resource utilization."** Moreover, with the price of **gold** again touching its recent highs around $530, from our **market price** perspective it's clear that the end of the Fed's **policy normalization** task is not yet in sight. Even should policymakers believe that they are nearing the conclusion of this rate-hiking exercise, as the lagged effects of the 40% increase in gold over the past two years begin to show through in **core inflation** data, the Fed will be hard pressed to call an early end to the cycle.

The **minutes** of the December 13 FOMC meeting released this afternoon can be viewed as an exercise in the Fed keeping its options open. While the headlines gravitated to the suggestion that "additional firming steps required would probably not be large," the minutes also reflected a panel with significant ongoing concerns about current conditions. "In the view of a number of participants, the economy was possibly producing in the neighborhood of its potential, and the persistent strength in spending of late suggested that resource markets could tighten further and inflation pressures build," the policy record says. "Under these circumstances, and with policy having been accommodative for some time, inflation expectations could rise if monetary policy were not seen as responding to contain such risks." On balance, these do not appear to reflect the views of a policy committee seriously contemplating a near-term end to this process. That was reflected in the **bond pits** as well, as the initial knee-jerk response to the minutes, with the 10-year up 10 ticks, gave way to a much more subdued gain of less than one-eighth of a point.

Bottom line: A slight and perhaps fleeting yield curve inversion offered another opportunity for skeptics of the economy's staying power to voice their doubts. Curve inversions are widely considered a reliable precursor of economic downturns, but we find that is an inadequate explanation of the dynamics at work. Curve inversions are reliable recession forecasters when they accompany excessively tight monetary policy, with a real funds rate above 4%. Too-tight money is the causal factor, not the yield curve. In the current environment, a real funds rate of just slightly more than 2% is not likely to choke off growth. It appears that this curve flattening is a bet that the Fed is not only close to the conclusion of its tightening cycle, but also likely to start cutting rates in the not-too-distant future. We think both those propositions are unlikely to pan out, and while the yield curve is likely to remain relatively flat, rates are likely headed higher across the curve as the Fed moves the short end higher than the market is currently priced for.
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