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Preparing for an Inverted Yield Curve

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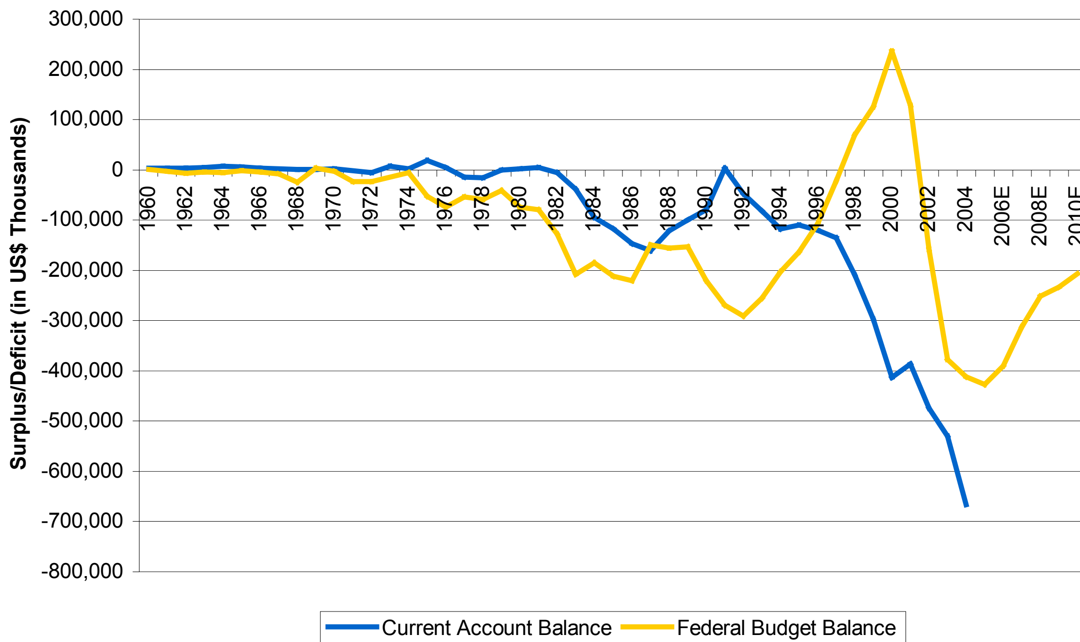
Who's in Control?

Should we stay calm or panic? And should we believe Mr. Greenspan when he says that the yield curve no longer presages the economic outcome? Let's assume for now that the yield curve has no predictive value. So, what is the economic data saying about the current situation? Consumer spending (retail sales) for May fell further than the consensus expectation. Fluctuating auto sales and interest rates affected May's negative result; however, the overall trend shows that consumption is fairly solid. Inflation remains tamed, and unemployment remains benign.

Double Deficits

So where are the major risks? Perhaps the current account deficit and the federal budget deficit could shed some light.

Current Account and Federal Budget Balances



Source: Bureau of Economic Analysis, U.S. Office of Management & Budget

The above chart shows that the U.S. has faced a current account deficit for nearly two decades, which continues to grow to record levels. Our trade relations with export-led countries, such as China and other Asian countries, may explain and support the ballooning deficits.

Americans love buying everything from cars to clothes, especially when we find great deals. Our government has also been spending more than it was able to collect in the recent years (as shown in the chart above). The U.S. Treasury has had to issue more Treasury debt to finance this overspending. These excess dollar-holding institutions have looked to Treasuries as a safe haven for their cash and have been supporting U.S. consumption.

Our government is currently running a deficit after having been in surplus between 1999 and 2003. Cuts in federal spending plans are shown in the federal budget estimates and illustrated in the previous chart. However, this estimate may be overly optimistic, and we believe that they are "whistling past the graveyard" numbers. Previous to the mid 90's, the federal budget deficits outpaced that of the current account balance. However, that trend has reversed as our current account deficit continues to outpace the federal budget deficit at an accelerating pace.

Several other factors should be kept in mind. Not only has the Internet created a more efficient pricing, but also these export-led countries offer cheaper products by artificially depreciating their domestic currencies. These effects have kept inflation at bay even though we have seen the fed funds rate rise eight consecutive times.

Asia's Influence on the Yield Curve

It's as if the Chinese authorities have just learned the game of capitalism and may soon experience the detrimental consequences of continuing their recent policies. The Chinese government possesses material influence and investments in (domestic Chinese) private and public companies. Rich Kuslan of Asia Business Intelligence asserts that Chinese authorities own approximately 2/3 of the companies listed on the Chinese stock markets. These policy makers probably understand that U.S. consumers represent a large portion of Chinese producers' profits. By keeping the Yuan weak, and thus their products cheap for us, the Chinese offer cheaper exports to price-conscientious. However, lower prices may come with the question regarding quality.

Once these companies receive dollar profits, the dollar ends up in the Chinese central bank. In the past, Asian central banks have invested the greenback in dollar-denominated assets such as Treasuries. Richard Duncan, author of *The Dollar Crisis* attributes this to explain the falling 10-year Treasury yields. He believes that as the supply of new Treasuries run out, so excess investments will go into existing securities. If these dollar-holding central banks have been buying "off-the-run" 10-year Treasury, then that would explain their rising prices and falling yields. Whatever the case, as foreign entities have bought up Treasury notes and bonds, this has affected the entire fixed-income sector especially mortgage debt. This effect has further increased the growing housing bubble pressures as mortgage rates have been dropping again, and thus fueling more property purchases.

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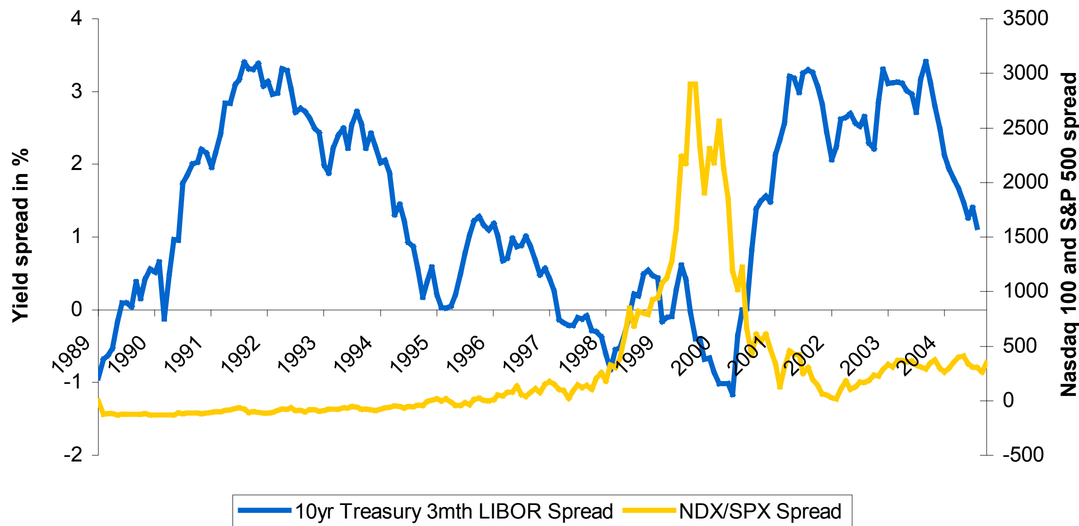
Yield Curve on the Markets

The previously mentioned pressures have accelerated the flattening yield curve as the Fed has increased short-term rates to slow the pace of purchases before they reach unsustainable levels. So what happens when the yield curve flattens and, as in the past, inverts. The following charts show these effects.

Yield Spread vs. NASDAQ 100 and S&P 500 Spread



Source: Federal Reserve, Fannie Mae, Commodity Systems Inc.

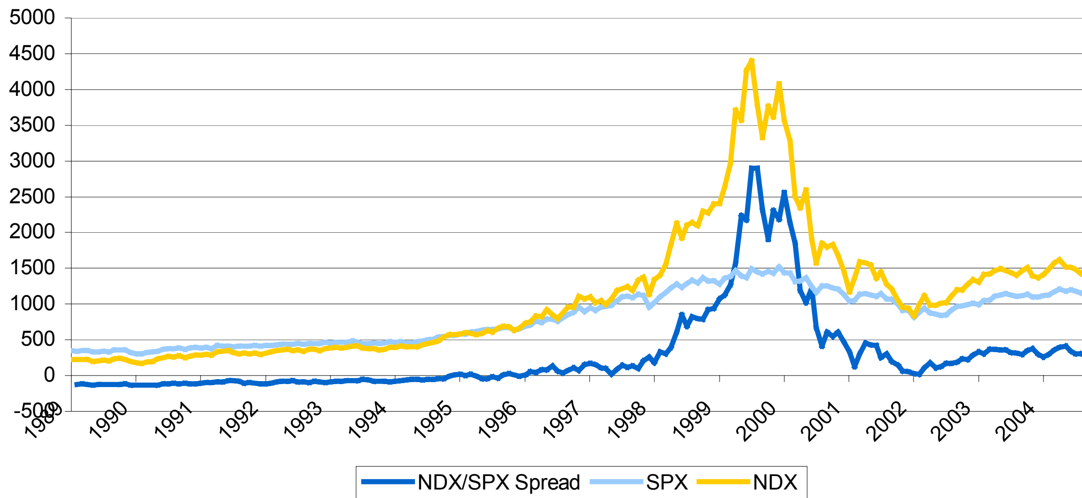
The blue line plots the difference between the 3-month LIBOR and 10-year Treasury, which is the proxy used by market participants to determine the shape of the yield curve. The curve appears steeply inclined when the blue line peaks and is highly positive. The curve flattens when the spread reaches zero and inverts when the line goes into negative territory. The curve will become more inverted as the spread goes further south. The yellow line shows the spread between the NASDAQ 100 (NDX) and S&P 500 (SPX) indexes. Particular attention should be paid to the period between 1997 and the earlier part of 2000.

We can see that when the yield curve inverted between 1998 and 2001, the spread between the NDX and SPX widened. This observation merits further investigation. By understanding this occurrence, we can anticipate what is ahead.

Impact on U.S. Markets

We know that the shape and degree of the yield curve impacts the debt markets. Additionally, the yield curve seems to have significant influence on stock markets. The following charts the NDX and SPX compared to their spread.

NASDAQ 100 vs. S&P 500



Source: Commodity Systems Inc.

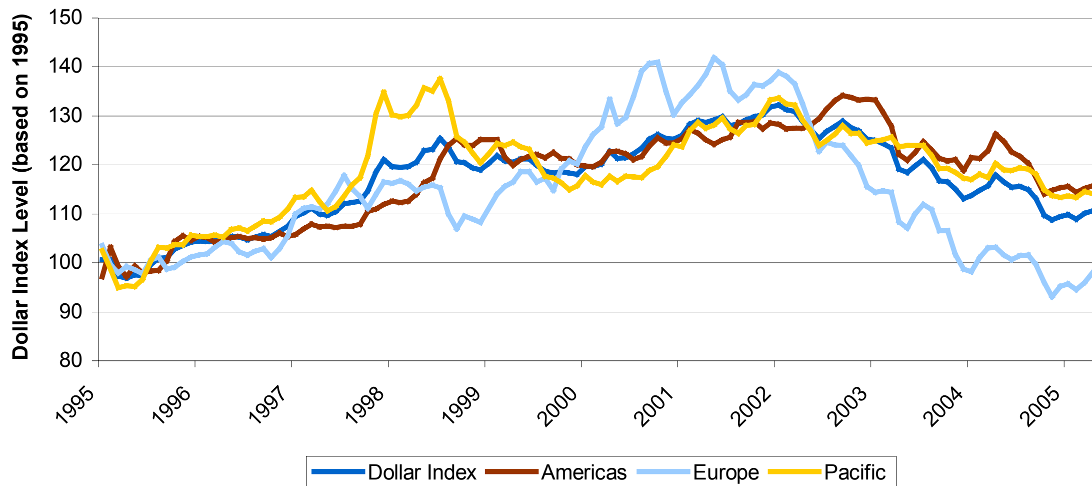
This graph shows that the spike in the NDX/SPX spread seen between 1998 and 2001 was a result of the tech bubble. Many of the companies listed on the NDX are composed of technology companies that have helped firms (both domestic and international) productively and efficiently compete on a global scale. Such companies include supply chain management software producers and consultants, among many other service and product providers.

Movements in the dollar heavily impact U.S. companies and consumers. Globally integrated companies must gauge the dollar movement to take advantage of currency fluctuation and take positions to stabilize profits. Therefore a look into the dollar index provides valuable insight into what to expect.

The Path of the Dollar

Looking at the Atlanta Fed Trade-Weighted Dollar Index chart below, the falling Pacific index between 1998 and 2000 seems idiosyncratic. This means that the dollar became weaker relative to the Asian currencies during those years.

Trade-Weighted Dollar Index, 1995-2005



Source: Federal Reserve Bank of Atlanta

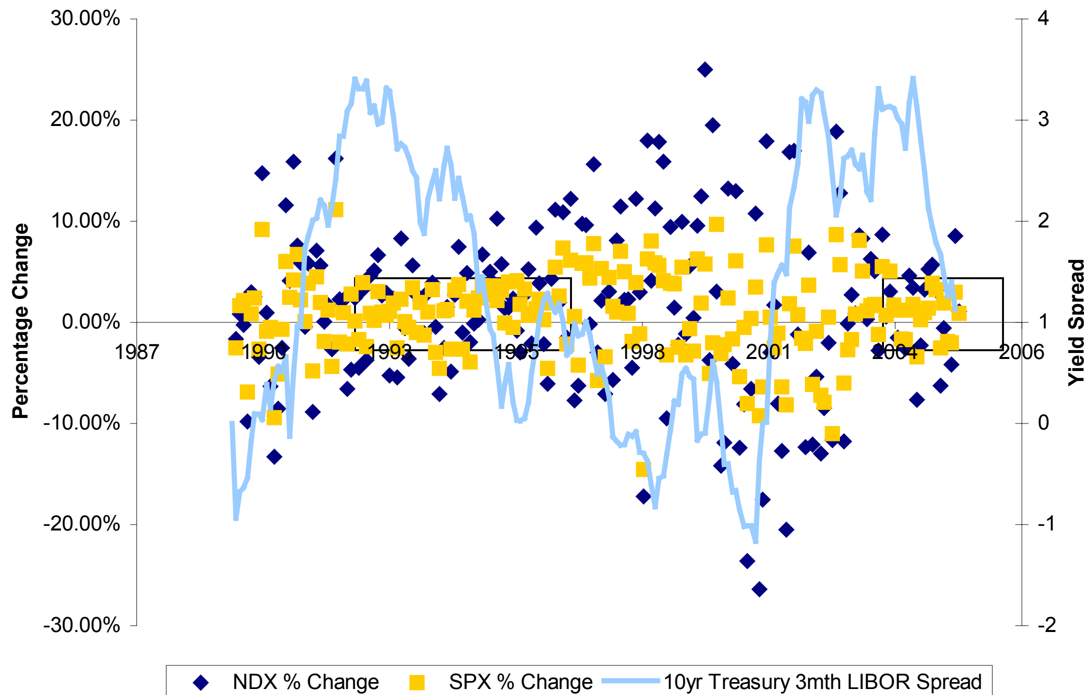
These indicators weigh the trading influence with major countries, where the largest trading partners receive the respective weights on the benchmarks.[1] Japan has the largest weight while China and Malaysia have the least impact on the Pacific index. Hence, the currently low $/Yuan exchange rate would not greatly impact this index. The dollar has generally fallen since 2002 and may partly explain the healthy profits to U.S. companies that have benefited from international exposure. We believe that the weak dollar posed an opportunistic time for Asian countries to buy U.S. goods and services, therefore driving U.S. corporate profits coming from abroad between 1998 and 2000. One note to keep in mind is that these indexes do not include India, who has experienced robust growth. Anther point to consider is the dollar that has fallen the most against the Euro among the above indicators.

[1] http://www.frbatlanta.org/invoke.cfm?objectid=227E9B48-9568-11D5-898300609459DBE6&method=display_body

Divergences to Occur

More is revealed about our stock markets when we take a look at the monthly percentage changes in the NDX and SPX indexes. The chart below scatter plots the monthly percent changes in these two indexes.

NASDAQ 100 and S&P 500 Percent Changes



Source: Commodity Systems Inc.

There seems to be a high correlation between the fluctuation in the NDX and the inverted yield curve. The cluster in the boxes that surround the years when the yield curve is positively sloped implies a time of less risk and return. However when the yield curve flattens and inverts, the NDX in particular becomes volatile, which could represent higher returns for smart and swift market participants.

What to Do

We are currently witnessing a flattening yield curve. U.S. equity (and debt) markets have recently been stable; however, this situation may change if the yield curve continues its downward path. Many fund managers and market participants could experience a wild roller-coaster ride if the yield curve inverts. The average investor should avoid attempting to beat the market, which may become extremely volatile. The markets ahead will be a severe test of investment professionals many of whom have never been through an inverted yield curve environment.

We believe the Fed will continue to raise rates at the June meeting to 3.25 percent, further increasing the likelihood of causing an inverted yield curve. The fed fund futures suggest that Greenspan will opt to take a break after this meeting in either the August or September meeting. The Committee is expected to move rates to 3.75 percent by the year-end.

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