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Yield curve, where is thy sting?

The yield curve is presaging a recession, economists keep saying, but we keep wondering: Why is this cluster of market prices any more prophetic about business activity than alternative clusters? The graph at the top of this page plots the yield curve (three months vs. 10 years) against the Bloomberg financial-stock index. As the former has flattened, the latter has lifted. We would like to know why. A negatively sloped yield curve discourages credit formation. Less credit formation points to slower economic growth. Which begs the questions: Why aren't bank stocks going down? Why aren't credit spreads widening? What information is embedded in the yield curve that is unavailable to other departments of finance?

Whatever the answers might be, colleague Ian McCulley observes, the 10-year note is trading a mere three basis points above the two-year note, 26 basis points above the three-month bill and 17 basis points above the Fed funds rate. The five-year note yields less than the two-year. "So after months of speculation and anticipation," he writes, "the yield curve inversion has arrived (slightly—in some parts)." Will it persist?

Not if the supply of bonds keeps overwhelming the demand for bonds. Over the next several weeks, the Treasury is expected to issue $100 billion in long-dated coupons, the *Financial Times* notes, the "biggest single month of supply since a similar period in 1996." The return of the good old 30-year in February is the featured event of the new bond-issuance season. There is, besides, $250 billion worth of corporate bond debt on the first-quarter calendar. "While it's easy to dismiss 'technical' factors in the Treasury market," McCulley comments, "$100 billion is still a lot of supply. The last time so much long-dated paper gushed from the Treasury, in February 1996, 10-year yields rocketed to 7% from 5.6% in just four months."

"It's different this time," the unluckiest and least-remunerative phrase in the speculative lexicon, does seem to describe one important change in the structure of the credit markets: Hedge funds are doing more and more lending to speculative-grade borrowers. "Despite today's narrow rewards for accepting greater risks and longer maturities," writes Albert M. Wojnilower, of Craig Drill Capital, "lending institutions and hedge funds (is there any longer a functional difference between these?) are preserving their profitability." So the economy preserves its expansion.

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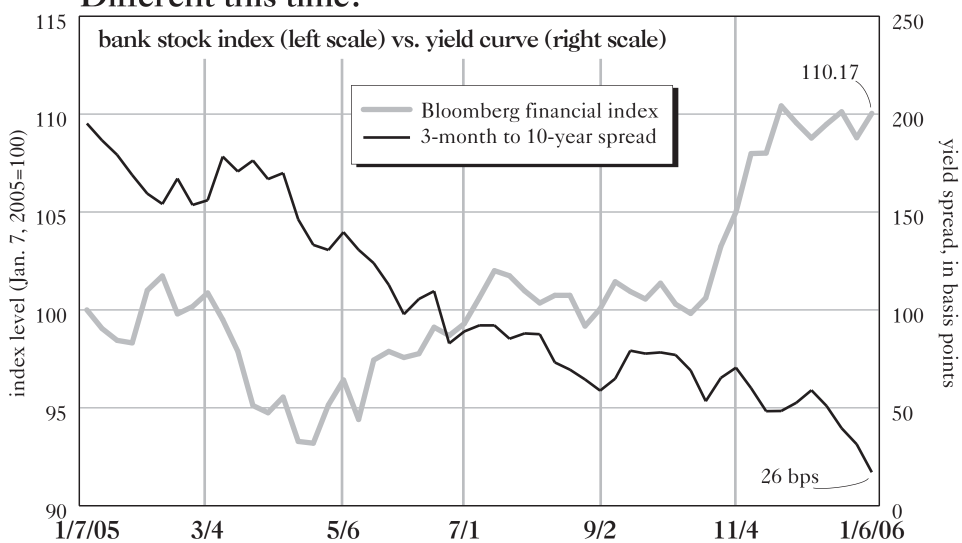
Different this time?



source: The Bloomberg