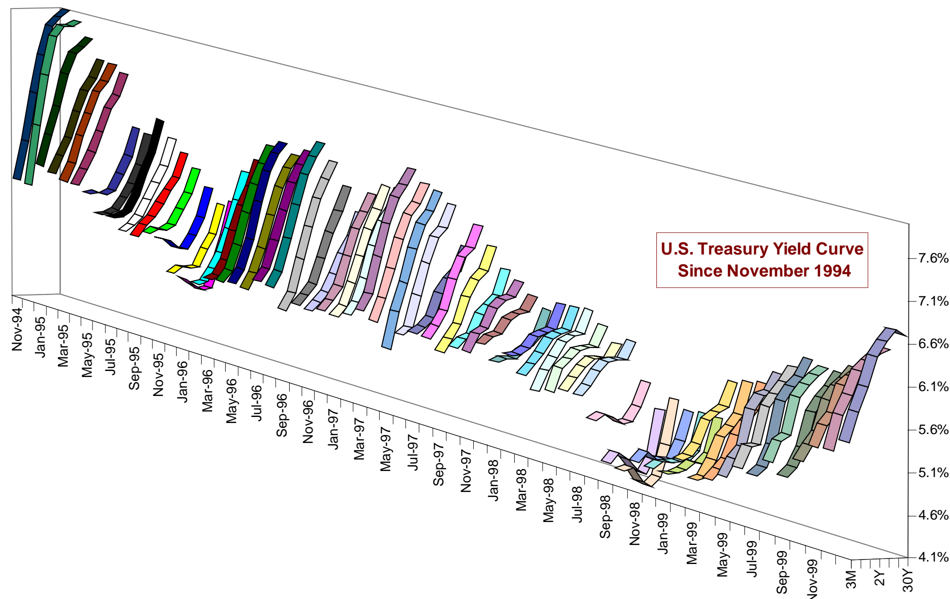
Throw 'Em A Curve

OK, sports fans! Remember when the only diversion between the Super Bowl and the various swimsuit issues was… what? Nothing I can remember, either. Fortunately, the Federal Reserve has stepped into the void this year by holding an Open Market Committee meeting starting on February 2. While these assembled worthies are unlikely to scare anyone on the gridiron -- swimsuits are another matter -- the trading in the immediate aftermath of their puff-of-white-smoke will certainly be more exciting than the Super Bowl itself, protestations of those long-suffering lifelong Jacksonville Jaguars fans notwithstanding.

Easy Living

Yield curves, like people, come in all shapes and sizes and exist at all levels. Generally speaking, the more positively sloped the yield curve, depicted below across a range from 90-day bills to 30-year bonds, the easier the monetary policy, and the greater the inflationary expectations. The opposite is true as well: The flatter the yield curve, the tighter the monetary policy. At the breakout point of the bull market in November 1994, the curve's range extended over 220 basis points from a base of 570 basis points. As global price pressures evaporated in the aftermath of the Asian financial crisis beginning in late 1997, the curve flattened by the long end moving lower until the spread reached a mere 62 basis points from a base of 436 basis point at the end of September 1998.



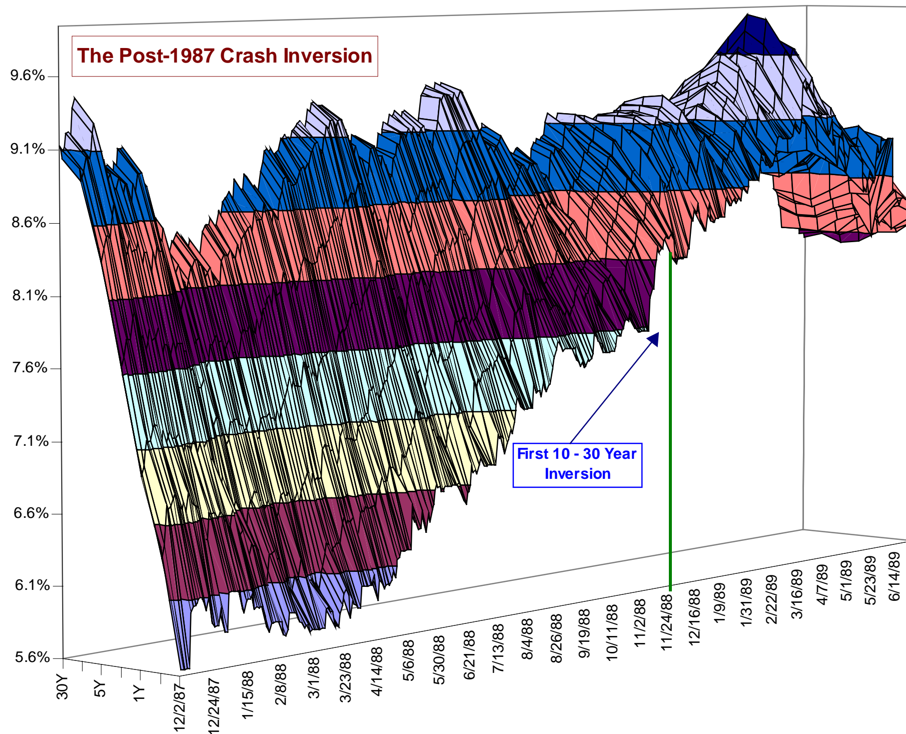
This flat curve at low levels was evidence of restrictive monetary policies, and the Fed responded in 1998, and began un-responding in 1999 as both the front end of the curve was pushed higher and the curve got steeper as a function of heightened inflationary expectations.

The yield curve is now starting to invert, the process of short rates moving over long rates, in a most unusual manner: 10-year yields are now higher than both 5-year and 30-year. Some of this inflection is due to Treasury announcements regarding long bond repurchases, but on a more fundamental basis, the market still does not see inflation growing as a function of either economic growth or, heaven forbid, the ongoing NASDAQ moonshot. As we enter the final year of the Clinton presidency, even the yield curve is humped. What should we expect?

The 1988-1989 Inversion Experience

The first hint we had of Alan Greenspan not needing a bridge to cross the Potomac came in the aftermath of the 1987 crash, when the Fed announced it would stand ready to supply all liquidity necessary, and then proceeded to do so. By early mid-1988, it started to become obvious we were not in a replay of 1929-1930,

and the Fed began to withdraw this liquidity and raise rates. The immediate consequence, as seen below, was a steady increase in the short end of the curve; long rates remained fairly steady throughout 1988. By November 28, 1988, the yield curve acquired a hump at the 10-year horizon.



Once the curve started to invert, it did so fairly quickly. By March 20, 1989, the inversion between the 12-month and 30-year maturities reached 545 basis points, with 90-day bills yielding a difficult-to-recall 9.378%. Was this the end of the world?

Hardly. Let's take a look at a few key indices at various points during this inversion episode, the first hump, the inversion peak, and the point when the 12-month yield descended below the 30-year yield for good on November 6, 1989. Not only did the S&P 500, NASDAQ Composite, and Morgan Stanley trade-weighted dollar index increase from the start to finish of the period, they all strengthened from the start to the peak as well.

	SPX	NASDAQ	Dollar Index
28-Nov-88	268.64	366.09	90.93
20-Mar-89	289.92	398.5	96.93
06-Nov-89	332.61	448.02	98.55
Gain, Start To Peak	7.92%	8.85%	6.60%
Gain, Start To End	23.81%	22.38%	8.38%

Of course, we entered a recession in late 1990 under the combined weight of an ill-advised tax increase acquiesced to by George I, and the strains imposed by the Persian Gulf War. We have been in the longest

economic expansion in American history ever since, and that period includes seven consecutive rate increases in 1994-1995.

Both the economy and the market have shown great resilience in the face of Fed jawboning, and should continue to do so -- so long as the Fed is content merely to slow the economy down. Once the crew on Constitution Avenue decides their priority is killing the market, then we'll have to dust off those analogies to 1929-1930, and that would be unfortunate indeed.