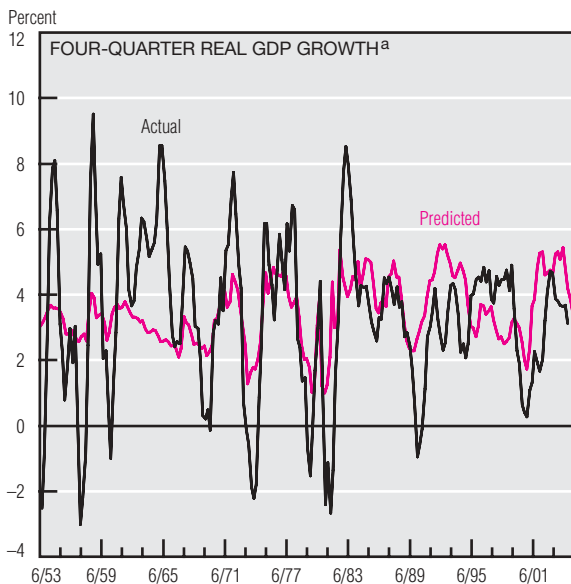
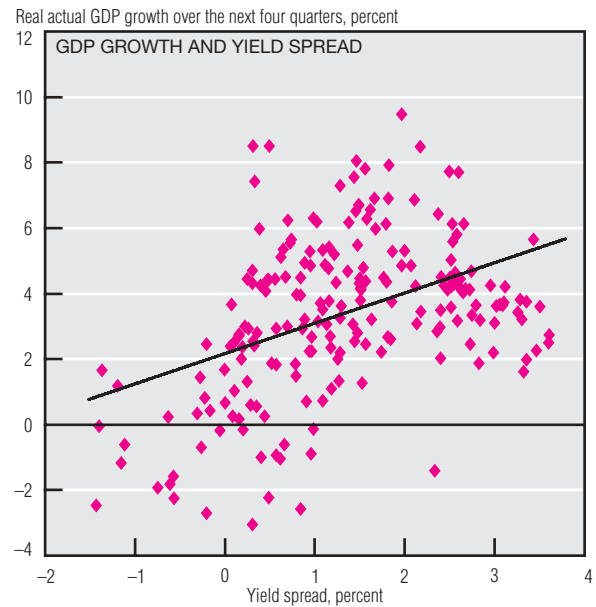
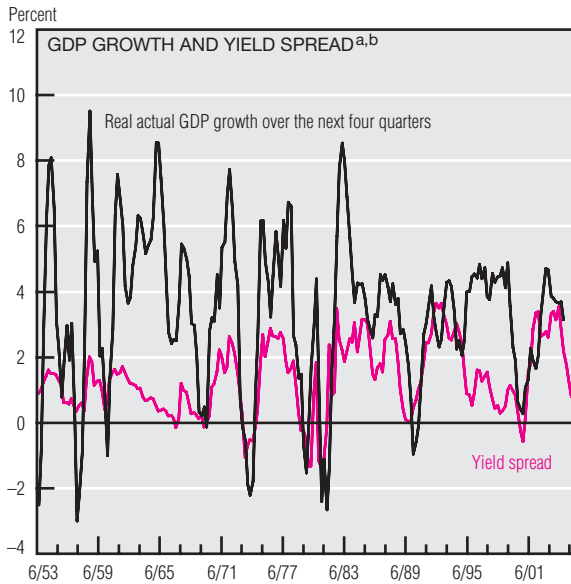


# Money and Financial Markets



## Yield Curve Predictions for 2006<sup>c</sup>

	Real GDP growth (percent)	Probability of recession (percent)
Based on data from 1954–2005		
Current prediction	2.23	34
Historical average	3.39	18
Based on data from 1990–2005		
Current prediction	2.49	45
Historical average	2.99	11

a. Quarterly data.

b. Yield spread: 10-year Treasury note minus three-month Treasury bill.

c. Author's calculations.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; National Bureau of Economic Research; and Bloomberg Financial Information Services.

The recent flattening of the yield curve has generated significant controversy. In the past several weeks, the yield curve has inverted, with both two-year and three-month rates rising above 10-year rates. For the past 50 years, the slope of the yield curve has been among the most reliable predictors of future economic growth, with steep curves indicating high growth and flat curves indicating low growth. A scatter plot of real GDP growth against the spread, however, indicates that the yield curve's

predictions show a great deal of dispersion and often miss the mark both on the high and low sides.

Plotting the quantitative predictions that emerge from using the yield curve highlights both its strengths and weaknesses as a predictor. The predicted values clearly move in the right direction and track changes in the economy, but they rarely rise as high or fall as low as actual GDP growth. That is why some forecasters prefer an alternative approach that relates the slope to

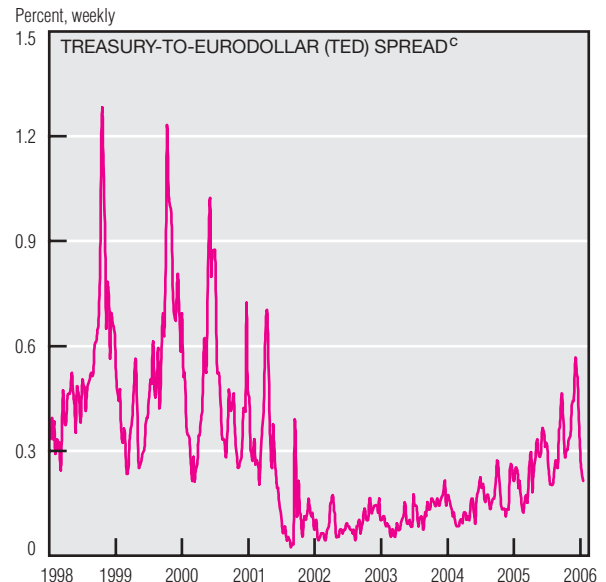
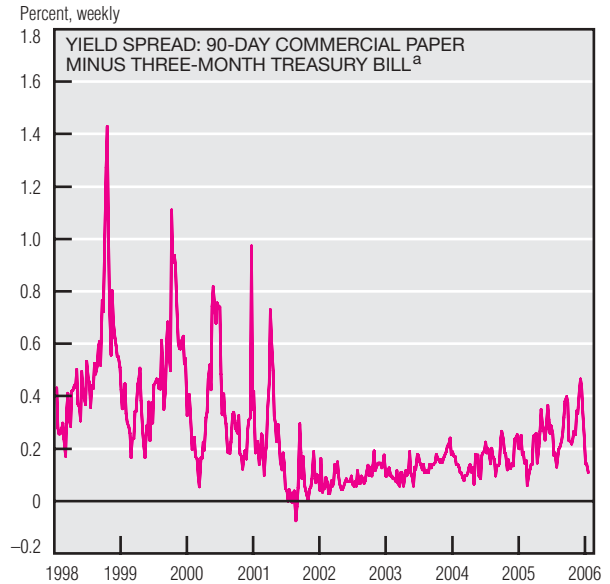
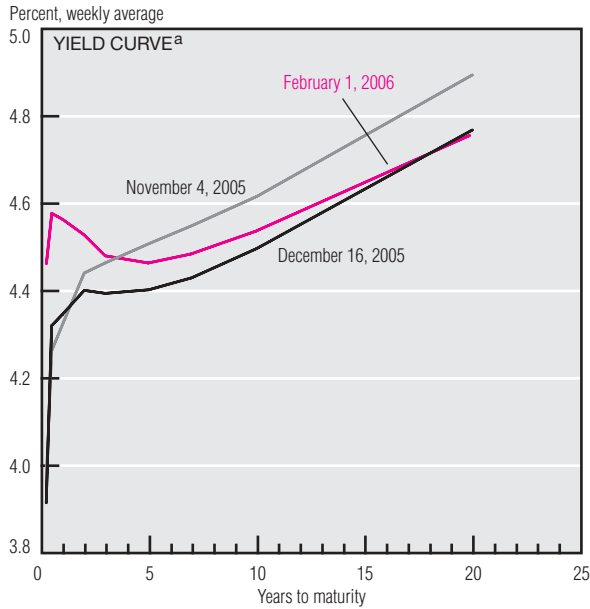
whether or not the economy is in recession; this approach uses the probit technique, which estimates the probability of being in recession.

Predictions based on the current state of the yield curve suggest that 2006 growth will slow from 2005 levels, and, although the odds of a recession are well above average, the odds of a continued recovery are still greater.

The Treasury yield curve has been in the news because its inversion might herald a recession, but Treasury

(continued on next page)

## Money and Financial Markets (cont.)



a. All yields are from constant-maturity series.

b. Merrill Lynch AA and BBB indexes, each minus the yield on the 10-year Treasury note.

c. Yield spread: three-month Eurodollar deposit minus the three-month, constant-maturity Treasury bill.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

yields are not the only rates with a name for prognostication. Besides term spreads (between different maturities of the same sort of bonds) one can look at risk spreads (between different bonds of the same maturity). The thought is that since bankruptcies and insolvencies rise during recessions, an increase in the risk spread may warn of tough times ahead as lenders demand higher rates to offset the greater chance of loss. Short-term risk spreads (between

90-day commercial paper and three-month Treasury bills) have been trending upward since 2002 but remain far below the levels posted in the late 1990s. Longer-term spreads (between corporate bonds and 10-year Treasury bonds) have also drifted upward since 2003, although again not reaching their previous levels. Thus risk spreads may inject a note of caution about the economy, but hardly signal any major concerns.

Given the many foreign policy concerns about Iraq, Afghanistan, Nigeria,

and other nations, the Treasury-to-Eurodollar (TED) spread deserves some emphasis. As the spread between the rate on dollar-denominated deposits in Europe and Treasury yields, it provides a measure of international risk without the added uncertainty of exchange rate movements. Like the other risk spreads, it has trended upward, but still indicates less risk than in the 1998–2001 period.