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Fact-Checking Bernanke's Yield Curve Comments

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I am not going to summarize Bernanke's remarks to the Economic Club of New York of last night entitled "Reflections on the Yield Curve and Monetary Policy." The speech was relatively short and easy to understand, so you can read it for yourself at this url: <http://www.federalreserve.gov/BoardDocs/speeches/2006/20060320/default.htm>. What I am going to do is a little fact checking related to some of his comments.

"I have argued elsewhere that improved monetary policies, which stabilized inflation and better anchored inflation expectations, are an important reason for this positive development; no doubt, structural changes in the economy such as deregulation, improved inventory control methods, and better risk-sharing in financial markets also contributed.³ Whatever the reason for the fall in macroeconomic volatility, if investors have come to expect this past performance to continue, they might believe that less compensation for risk--and thus a lower term premium--is required to justify holding longer-term bonds. *In that regard, it is interesting to observe that long-term forward rates were also low in the 1950s and 1960s. With long-term inflation expectations apparently anchored at low levels and with the prospect of continued economic stability, market participants may believe that it is appropriate to price bonds for an environment like that which prevailed four or five decades ago.*" [emphasis added]

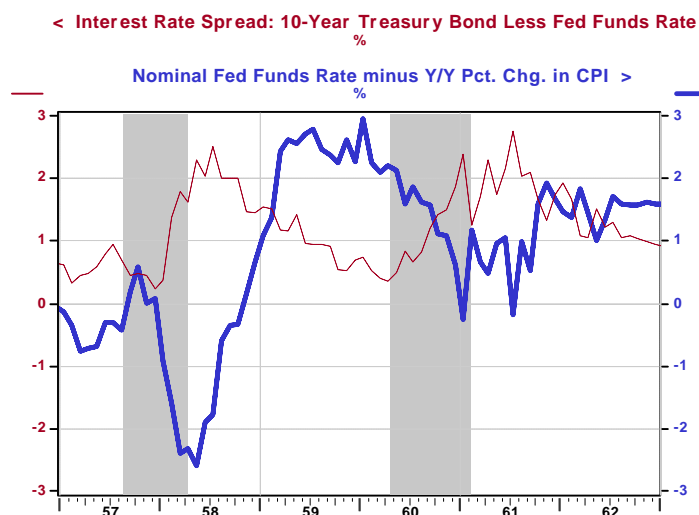
"I would not interpret the currently very flat yield curve as indicating a significant economic slowdown to come, for several reasons. First, in previous episodes when an inverted yield curve was followed by recession, the level of interest rates was quite high, consistent with considerable financial restraint. *This time, both short- and long-term interest rates--in nominal and real terms--are relatively low by historical standards.*⁵ Second, as I have already discussed, to the extent that the flattening or inversion of the yield curve is the result of a smaller term premium, the implications for future economic activity are positive rather than negative." [emphasis added]

So, there you have it. The low level of term premia in the bond market today is reminiscent of the 1950s and 1960s. And, the flattening in the yield curve today has been accompanied by low nominal and real interest rates. So, from this, can we then assume that the behavior of the yield curve in the 1950s and 1960s was not a good leading indicator of economic activity? Let's see. Chart 1 shows that both the August 1957 – April 1958 and April 1960 – February 1961 recessions were preceded by a narrowing but *not* an inversion in the yield spread between the Treasury 10-year security and fed funds. So, back in the 1950s and 1960s, when term premia were low, a yield curve inversion was not necessary to signal a recession – *just a*

flattening was sufficient. So, perhaps Bernanke should not be so quick to say that the macroeconomic implications of the recent flattening of the yield curve is different this time.

Also note in Chart 1 the level of the CPI-inflation-adjusted fed funds rate as the yield curve flattened prior to the 1957 and 1960 recessions. In August 1957, the peak of that economic expansion, the “real” fed funds rate level was *minus* 0.42% (nominal level was 3.24%). In April 1960, the peak of that expansion, the level of the real fed funds rate was 2.20% (nominal level was 3.92%). So, both the real and nominal levels of the fed funds rate were relatively low as the yield curve flattened and the economy went into a recessions in 1957 and 1960. Again, why is it different this time?

Chart 1



“Finally, the yield curve is only one of the financial indicators that researchers have found useful in predicting swings in economic activity. Other indicators that have had empirical success in the past, including *corporate risk spreads*, would seem to be consistent with continuing solid economic growth.” [emphasis added]

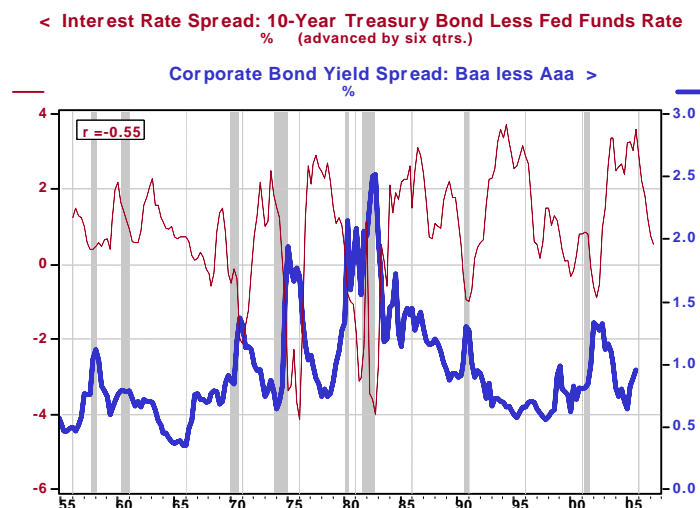
If by “corporate risk spreads,” Bernanke is referring to corporate bond credit yield spreads, then he’s looking at a *lagging* or *coincident*, at best, economic indicator, *not* a leading one. Chart 2 shows that credit spreads tend to widen out *after* a recession has been entered. Moreover, the highest absolute-value correlation between the

Treasury 10-year – fed funds spread and corporate bond credit spread occurs when the 10-year – fed funds spread is *advanced* by six quarters. To say that the flattening in the yield curve is

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not signaling an economic slowdown because credit spreads are still narrow (actually, they have widened out somewhat) is akin to driving forward while looking in the rearview mirror.

Chart 2



Lastly, Bernanke lived up to the rap put on most economists – on the one hand, on the other hand. After devoting a lot of words to why the implications of the flat yield curve might be different this time, he opens the escape hatch. But he doesn't even get this one right.

“An alternative perspective holds that the recent behavior of interest rates does not presage an economic slowdown but suggests instead that the level of real interest rates consistent with full employment in the long run--the natural interest rate, if you will--has declined.” [emphasis added]

“About a year ago, I offered the thesis that a "global saving glut"--an excess, at historically normal real interest rates, of desired global saving over desired global investment--was contributing to the decline in interest rates ... So long as these factors persist, global equilibrium interest rates (and, consequently, the neutral policy rate) will be lower than they otherwise would be.”

The “escape hatch” part of this is that perhaps the relatively low structure of interest rates is *not* a sign of easy financial conditions. But if this is so, then the flat yield curve *is* sending the message that slower economic growth lies ahead.

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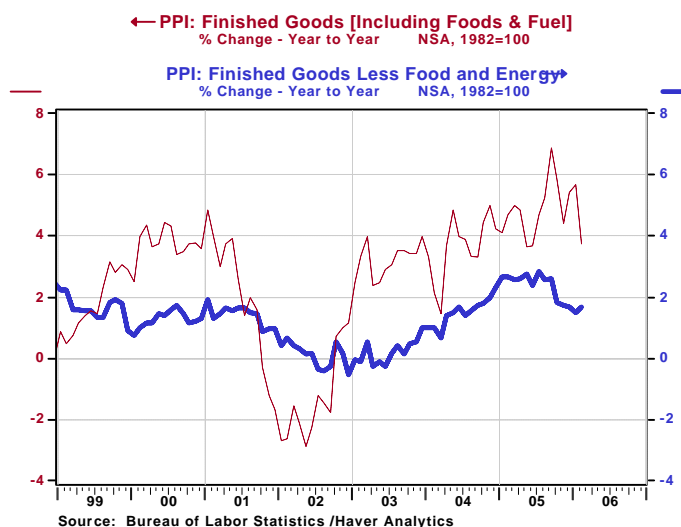
The headlines in the financial press seemed to reflect at which part of the Bernanke speech the headline writer was awake during the speech. The headline in the *FT* was “Bernanke sees no sign of slowdown.” The writer was awake at the beginning then dozed off. The teaser on the front page of the *WSJ* was “Bernanke said the Fed should keep short-term rates lower than normal if a glut of world saving is keeping long-term rates low.” The writer was napping early on, and then someone nudged him at the end.

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Lower Prices of Energy and Food Bring Down Wholesale Prices, but Core Prices Are Moving Up

The Producer Price Index (PPI) declined 1.4% in February, following a 0.3% increase in the prior month. Declines in prices of food and energy led to the sharp drop in the PPI in February, the largest monthly decline since April 2003. The 4.7% drop in the energy price index reflects lower prices for gasoline, diesel and natural gas and a steady reading for the price of residential electricity. The 2.7% drop in the food price index was due to lower prices for several food items, with prices of fresh and dry vegetables posting relatively large price declines.

Chart 3

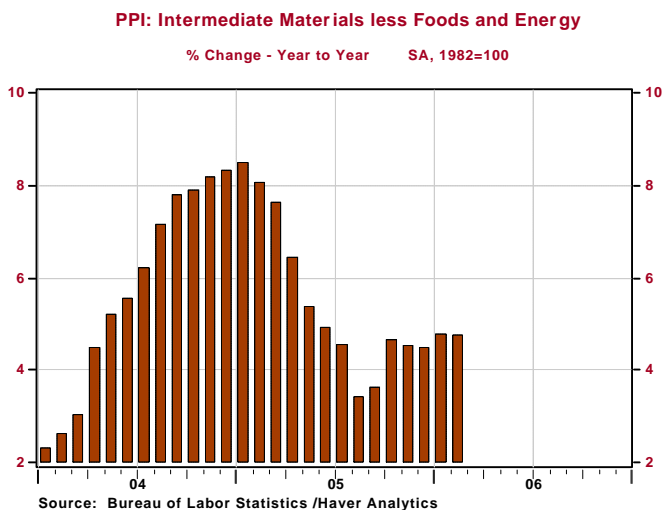


The core PPI of finished goods excluding food and energy rose 0.3% in February after a 0.4% increase in the prior month. Cigarettes (+0.5%), light trucks (+0.5%), furniture (+0.2%), and women’s and girls’ apparel (+0.1%) were some of the price gains in February. Year-to-date, the core PPI of finished goods has risen at an annual rate of 3.9% compared with a 1.7% increase in all of 2005. Similar price pressures are visible at intermediate goods stage. The intermediate goods price index declined 0.3% but the core intermediate goods price index

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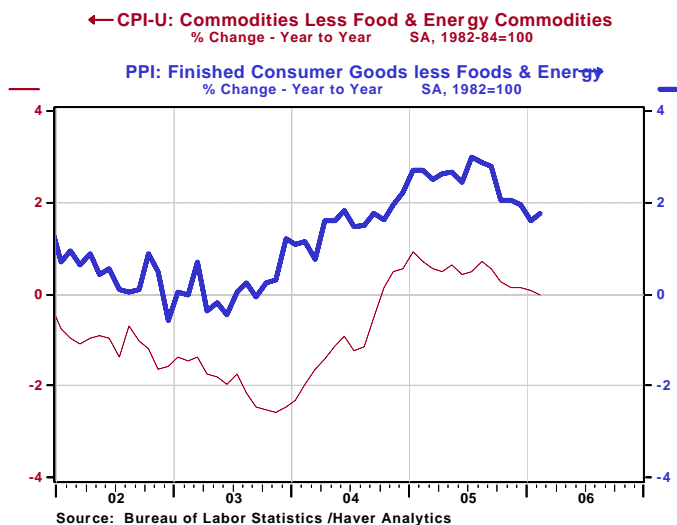
moved up 0.5% in February, putting the year-to-year gain at 4.8%. The core intermediate goods price index has shown an accelerating pace in the past five months (see chart 4).

Chart 4



Although prices of core items at the wholesale level show price gains, prices of core consumer goods show only mild growth to steady readings in recent months (see chart 5). The main implication of this trend is that firms are not able to pass through higher prices to consumers, which translates to smaller profit margins.

Chart 5



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PRODUCER PRICE INDEX – FEBRUARY 2006

	% change prior month	annualized change		% change	
		3 mo. ago	6 mo. ago	year ago	y-o-y '05**
PPI - FINISHED GOODS					
ALL ITEMS	-1.4	-2.0	2.6	3.7	5.4
CORE - ALL ITEMS LESS FOOD & ENERGY	0.3	3.1	1.7	1.7	1.7
FOOD	-2.7	-6.7	-0.1	-1.3	1.4
ENERGY	-4.7	-10.8	8.1	17.0	23.9
CAPITAL EQUIPMENT	0.1	2.5	1.2	1.6	1.3
PPI - INTERMEDIATE GOODS					
ALL ITEMS	-0.3	4.1	10.3	8.2	8.4
CORE	0.5	7.6	9.3	4.8	4.5
PPI - CRUDE GOODS					
ALL ITEMS	-9.2	-39.3	2.6	12.9	22.1
CORE	3.3	15.5	24.5	11.9	4.8

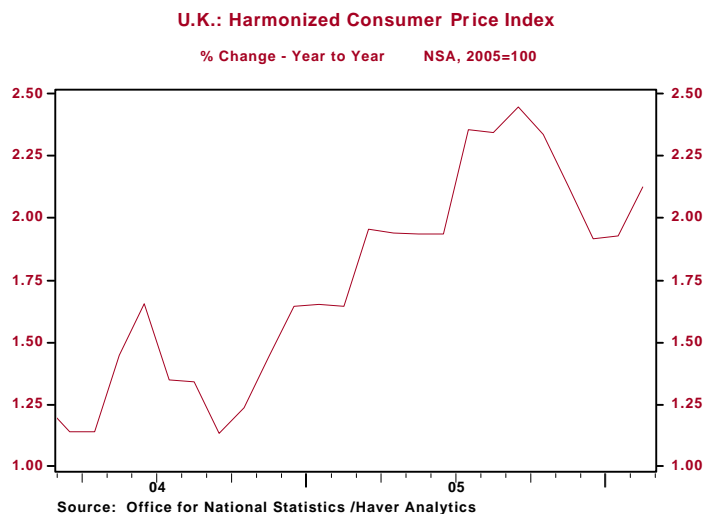
** - Dec.-to-Dec.

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UK: Say Goodbye to Rate Cut Expectations

Britain's inflation rate rose to 2.0% in February, exactly hitting the Bank of England's policy target, and the first time in five months that it's gone up on the month. Inflation had been trending downward since September, but maybe that down-trend is over. Recent hikes in utility bills of 20%+ should start feeding into overall inflation from next month.

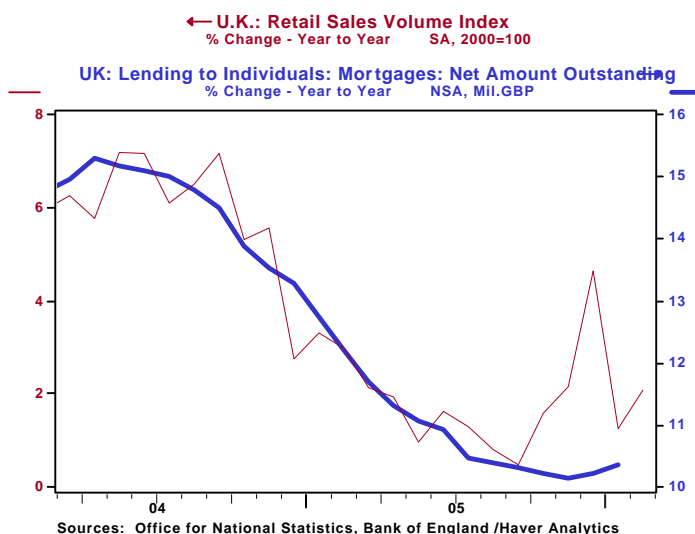
Chart 6



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The central bank targets the inflation rate (specifically, the headline harmonized index of consumer prices), but it worries about the state of the housing market and consumer demand. Consumer demand seems to be picking up again, and the housing market has been reviving some since the August rate cut. At the February meeting, the Monetary Policy Committee specifically noted that any further easing risked re-igniting the housing market.

Chart 7



The BoE's repo rate has been stuck at 4.50% since last August. Many analysts still think that relatively-slow economic growth means that another rate cut is in the offing. Data are still mixed as to the extent and strength of the UK's economic recovery, but there are enough signals to make the MPC members balk at one more rate cut. They won't want to repeat the apparent error of 2003, when one "final" rate cut in July was quickly reversed in November.

No change in interest rates is likely on April 6, or indeed for the next few months. With the data still mixed, it's not clear just where the economy will be come Q4, and hence where interest rates are headed going into 2007. For now, the next key data to watch will be February's mortgage lending and consumer credit data, which come out March 29.

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