

The Dark Side of the Yield Spreads and Europe's Investment Prospects

By: Dr. John A. Doukas, Editor of European Financial Management, the journal of European Financial Management Association

April 18, 2000

For the first time since 1990 the yield on 10-year U.S. Treasury bonds fell below the 1-year Treasury notes. In the parlance of bond traders and financial economists the yield curve (inverted) obtained an inverted shape. The shape of the yield curve, the difference between short and long-term maturity government bonds (risk-free assets), is traditionally considered a serious economic forecasting tool among professional investors. The yield curve contains a lot of valuable information. The rates on government securities reflect the central bank's (i.e., FEDs, ECBs) efforts to boost or curb the growth of the economy as well as investors' expectations about future inflation and economic conditions. From the investors' viewpoint the changing shape of the yield curve can provide useful insights about the future state of stock and bond markets.

When the yield curve has an upward slope with a spread of about 130 to 200 basis points, as is roughly the case for Germany, France and Italy at this moment, investors expect normal future economic growth in the range of 2-3 percent per year. When the spread is considerably larger, within the range of 300 to 400 basis points, the case of US back in 1992, investors usually expect faster growth largely because a steeper curve is likely to be associated with the efforts of the Central Bank to spur economic conditions by reducing short-term rates. Remember that the greatest impact Central Banks have on the yield curve are on the short end of the curve. A steeper yield curve implies that the cost of borrowing for companies is getting lower and therefore they can expand their investment activities. From time to time, however, the yield curve may twist itself or get twisted. This is when short-term rates exceed the rates on the long end of the curve. That is, when the spread becomes negative (inverted yield curve) future economic conditions are expected to deteriorate. Usually, this happens when Central Banks raise short-term interest rates in an attempt to curb inflation. A good example is the rise of US short-term rates due to five interest rate hikes by the FED between June 1999 and March 2000.

When long-term rates drop sharply relative to short-term rates markets expect the future rate of inflation to go down and therefore long-term bonds become very attractive investment alternatives to stocks. This kind of monetary policy, by the way, is considered "successful" because it restrains inflation from hurting the long-term performance of the economy. However, when long-term rates drop relative to short-term rates (the yield curve gets inverted) the investors expect that the economy will go into recession. As a result this often leads them to exit the stock market, often abruptly, and transfer funds into long-term bonds or park their money in bank or money market accounts. An inverted yield curve is expected to be interpreted by investors as a strong sign of looming recession sending the stock market into a crash. In fact, empirical research shows that when the spread between the yield on three-month Treasury bills and the yields on 10-year Treasuries becomes negative by 150 basis points or more there is 70% chance that the economy will go into a recession within the next 12- month period.

The negative signal of an inverted yield curve tends to become more powerful (investors become more pessimistic about the future performance of the economy) when the efforts of the Central Bank to slow down a heated economy are persistent. Actually, market's pessimism gets exacerbated when the yield curve turns from upward to downward sloping (i.e., **humped yield curve**). This is the recent state of the US yield curve. The spread between the 5-year to 1-year Treasury rates is 0.101 (6.143 for 5-year, - 6.042 for 1-year), while the spread between the 10-year to 1-year Treasury rates has turned to -1.185 (5.857 for 10-year, - 6.042 for 1-year). The recent twist in the US yield curve and the meltdown of the US stock markets Friday of April 14th appear to be consistent with the above view. The Nasdaq Composite Index plunged 9.6%, or 355.61 points, to 3,321.17, while the Dow Industrial Average fell 5.6%, or 616.23 points, to 10,307.32, its biggest point drop ever. The Nasdaq Composite, fell every day this past week, turning in a record one-week point loss of 1,131. The index is now off more than 30% from its March 10 high of 5,048, and more than 12% for the year to date. The other major indexes didn't escape the carnage. The Standard & Poor's 500 lost 5.8%, and the small-company Russell 2000 declined 7.2%. Friday's widespread selloff of stocks was led by result of market's reinforced inflation fear and more interest rate increases in the offing by the FED. Investors seem to have come to the conclusion that the humped yield curve is signaling a possible recession. An alternative interpretation of the inverted US yield curve is that it has resulted from the recent announcements of buybacks (reduce the supply) of long-term Treasuries by Greenspan and the US Treasury. If this view is correct, however, it

remains to be seen. Investors' fears of a forthcoming recession should abate while the US stock market should regain some of its lost shine. This might be an opportunity for investors (US and Foreign) to buy US stocks at more affordable prices.

An economy that tracks the US fairly well is the UK. As shown in the Table below, the UK spreads have been in line with those in the US. What is more interesting though is that the UK yield curve has become sharply more negative: from -0.396 (5-year to 1-year) to -0.972 (10-year to 1-year) reflecting market's fear of worse economic conditions for the UK economy if it remains outside the Euro-zone. In sharp contrast with grim yield-based predictions for the UK economy, economic prospects for the core of the Euro-zone area (Germany, France and Italy) appear to be promising (i.e., predicting normal growth rates). All three countries have positive (upward looking) yield spreads within the range of 1.142 to 1.236. The small spread dispersion across the three core Euro-zone countries also suggests that future economic prospects are expected to be similar. If bond rates can offer clues about future investment performance, the observed spread differences, between US, UK and the three core European economies, suggest investment opportunities favoring Germany, France and Italy. The shape of the yield curve also favors investing in Japan. If the twist in the yield curves, especially in the US, as some have argued, is due to the official US policy-switch to reduce the supply of longer-term Treasuries, the yield curve as a predictive instrument of future economic activity will be hampered.

YIELD SPREADS: WHAT LIES AHEAD?	
EURO-SPREADS NORMAL YIELD CURVE: FORECASTS NORMAL GROWTH AHEAD	
GERMAN Spread: 10 Year - 1 Year = $5.237 - 4.065 = 1.172$ FRENCH Spread: 10 Year - 1 Year = $5.356 - 4.210 = 1.146$ ITALIAN Spread: 10 Year - 1 Year = $5.520 - 4.284 = 1.236$	
US AND UK SPREADS INVERTED (HUMPED) YIELD CURVES FORECAST RECESSION AHEAD	
US Spread: 10 Year - 1 Year = $5.857 - 6.042 = -1.185$ US Spread: 5 Year - 1 Year = $6.143 - 6.042 = 0.101$	
UK Spread: 10 Year - 1 Year = $5.259 - 6.231 = -0.972$ UK Spread: 5 Year - 1 Year = $5.835 - 6.231 = -0.396$ From -0.396 to a more negative spread -0.972	
JAPANESE-SPREADS NORMAL YIELD CURVE: FORECASTS NORMAL GROWTH AHEAD	
JAPANESE Spread: 10 Year - 1 Year = $1.799 - 0.284 = 1.515$	