## HISTORY LESSON PAGE

**THIS MONTH'S HISTORY LESSON:**

**SLOPE of the TREASURY YIELD CURVE and RECESSIONS:**

The current slope of the Treasury yield curve is flat to very slightly positive. The Fed is very likely to continue raising the Federal funds rate, at least once, and perhaps two more times, to either 5.00% or 5.25%. Unless longer-term T-bond rates also rise in tandem, the slope will invert decisively. What are the likely consequences on the future direction of the economy and the stock market?

Long-term data is not available for either the 3 month T-bill or the 20yr T-bond. So we define an “approximate slope of the yield curve” as the 10yr T-bond yield minus the Fed funds rate. This approximation is close enough for our historical purposes, to study the long-term relationship between inversion in the yield slope and any subsequent recessions. The "approximate slope of the yield curve" over the last 44 years is shown in Fig 2 below.

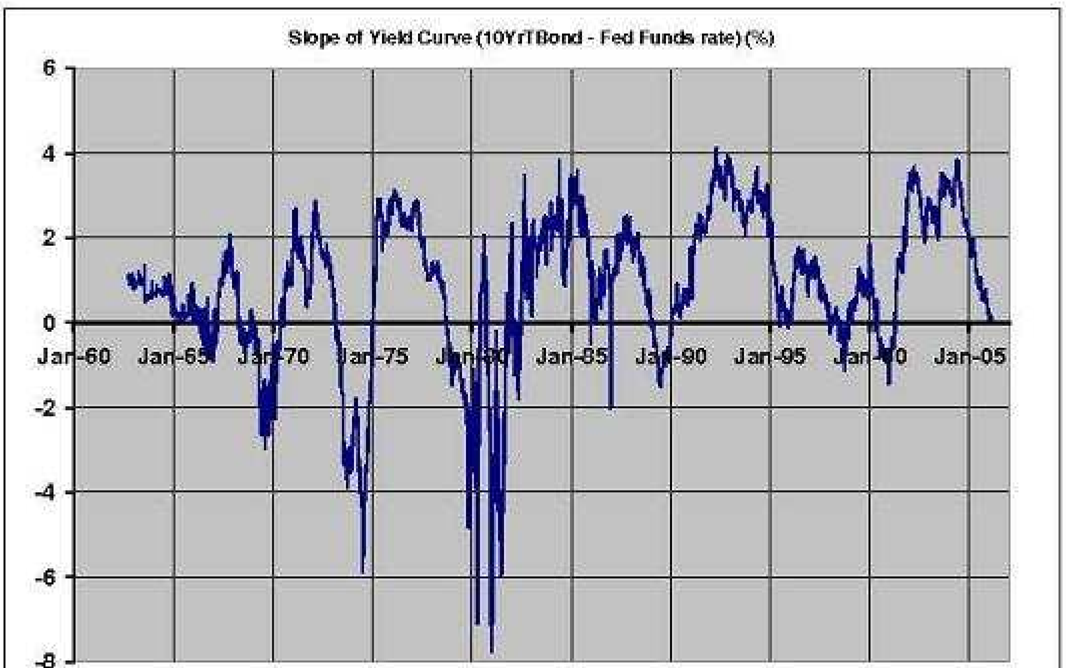
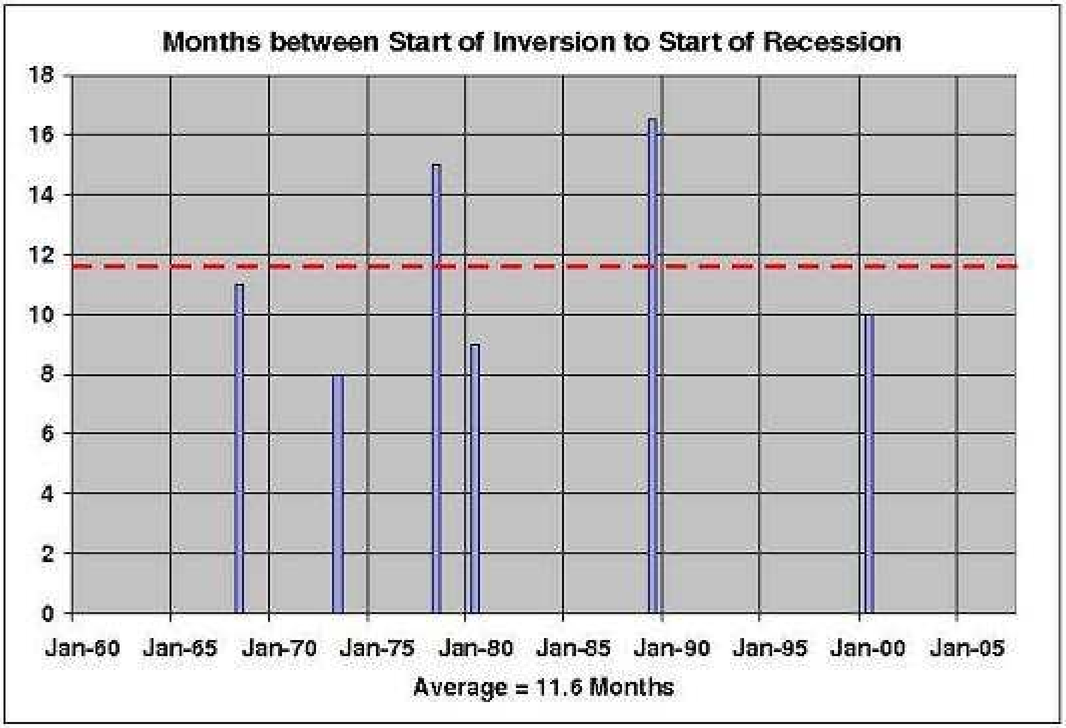



Figure 2

Over this long period, the yield slope has inverted (dropped below zero) many times. Ignoring the two sharp spikes in Jan-86 and Jan-87, there have been 8 inversions, of which 6 were followed by recessions. That is, there is a 75% probability (6 out of 8) that an inversion in the slope of the yield curve is a precursor to a recession.

In the figure below, the horizontal axis marks the start of the 6 recessions that were preceded by an inversion. The vertical axis shows the time delay in months, between the start of an inversion, and the start of the recession that followed it.




The data shows that since 1962, the average time delay between the start of a yield-slope inversion and the subsequent recession is 11.6 months, and that the effectiveness of this prediction is 75%.

Currently, the yield curve is approximately flat, and is likely to invert, depending on the reaction of the economy and bond market to further Fed tightening. If we get a decisive inversion starting soon, and history repeats itself, we are likely to have a slowing economy with negative GDP's, and a falling stock market, starting around late spring to summer of 2007.

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