Fixed-income fortune teller

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IN AMERICA an inverted yield curve—which occurs when long-term Treasury notes have a lower yield than their shorter-term counterparts—is now 7-1 when it comes to predicting recessions since 1960. In 2006 economists scratched their heads at the inverted curve, wondering if this time it would be different. Wishful thinking led many to think so:
In the past several months, a variety of Federal Reserve officials, market gurus, and general prognosticators have weighed in on the issue, a good many of them concluding it unlikely that the current inversion signals an incipient recession.
What determines the relationship between the yield curve and future economic activity remains an open question for economists. That may be because what drives the relationship changes over time.

In 2006 the yield curve was inverted, but arguably, for different reasons than before. Implicit inflation targeting appeared to be successful and credible. It was not outrageous to believe lower expected inflation decreased the premium on long-dated governments. It was also the peak of the savings glut. Remember how we worried about global imbalances rather than a misallocation of capital? The savings glut increased the demand for long-term governments, lowering their yields. In retrospect the inverted curve, reflecting the influx of capital (which contributed to the bubble) and a naive belief in price stability (which made us complacent about risk), did signal our undoing, but for reasons we did not anticipate.

If an inverted curve signals a looming recession, a steep curve tends to forecast a recovery. Does that mean we can take comfort in the steep curve we see today? Paul Krugman does not think so. He reckons the yield curve simply mirrors expectations of future Fed policy. The Fed is currently targeting a 0% fed funds rate, so the long end of the curve reflects that rates can not fall any further.

Another reason the curve steepened is because of the flight to quality/liquidity. These days nothing spells risk-free liquidity like T-bills. These assets are in hot demand which lowers their yield to near (and even below) zero. I find it remarkable that, with all the debt the American government plans on issuing, the curve is not even steeper. I wonder which of these factors (and the ones we overlooked) we will say was significant in two years.

When it comes to the yield curve, the more things change the more they stay the same. The slope might change for different reasons, but what it means for the economy seems to endure. Let's hope so.

http://www.economist.com/blogs/freeexchange/2009/01/
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Drachmatic yields

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Which governments are perceived to issue the riskiest and the safest debt?

HOW much does Mr Market dislike Greece's sovereign debt? The chart below, which shows the ten countries with the highest-yielding two-year paper, puts Athens in the kind of company that Greeks are unused to keeping. Shorter-dated Greek government bonds have even higher yields. On the other side of the ledger, money has flooded to safe havens like Switzerland, leading the Swiss government to announce measures to put a ceiling on the value of the Swiss franc. This brings its own risks, as our Buttonwood columnist points out.