Market Monitor

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August 14, 2006

Gliding — or tumbling — down the yield curve?

Last week the Federal Reserve (Fed) took a breather from the steady stream of 17 consecutive short-term interest rate hikes it has been doling out since mid-2004. In deciding to pause, it left the federal funds rate target at 5.25%, a level more than five times what it was when it started tightening. But, as the Fed indicated in a message last week, further rate hikes may still be coming if inflation and growth don't moderate as expected.

Today, we'll focus on the following themes:

- Deciphering the now slightly inverted Treasury yield curve
- Prospects for the shape of the yield curve if the Fed continues to raise rates
- Prospects for a continuation of the recent modest rally in bond prices

Possibly in anticipation of the Fed's breather, the Treasury yield curve has recently become slightly inverted, meaning that the difference in the yields between 3-month Treasury bills and 10-year U.S. Treasury notes is now slightly negative (i.e., the curve slopes down as it moves from shorter to longer maturities).

To put it another way, as of today you would earn slightly more over the next few months by investing in very short-term Treasury debt than in longer-term debt. Typically, the normal yield curve rewards longer-term investors with higher yields or interest rates since there is usually more investment risk and uncertainty over longer periods than shorter periods.

Why is the opposite true now? We think there are two reasons. One is that foreigners – particularly Asian central banks – are still willing to purchase U.S. debt and they have a preference for longer-maturities. For example, the Central Bank of China and the Bank of Japan each hold approximately $1 trillion in U.S. Treasuries. They purchase hundreds of billions of these securities each year. This demand serves to keep longer-term interest rates low. A second reason is that investors in general are more risk-averse in the short run than in the long run, hence they bid up the price of short-term assets.

What does this yield curve inversion mean for the economy? In the past, an inverted Treasury yield curve has been associated with an increased probability of a slowing economy. This is especially true when the Treasury yield curve becomes sharply inverted. Often in the past, such large inversions have been harbingers of the "R" word – recession – occurring down the road (typically a year later) as investors perceive extreme short-term risk.

Currently, however, the inversion is quite small – in the order of 10 basis points (one tenth of a percentage point). In contrast, in the past it has taken an inversion of 150-200 basis points to produce a 75% probability of a coming recession. So we think the probability of recession is low, unless the Fed goes on another tear in raising short-term interest rates. We believe the chances of further Fed tightening is also low, given that "core" inflation (near 2.5% for the CPI excluding food and energy) is above, but just above, the Fed's comfort zone, and GDP growth now seems to be on a slower track.

This doesn't necessarily mean that the Fed is finished tightening, just that any near future rate hikes are likely to be limited. Indeed, despite this month's pause, there is still a non-trivial chance that the Fed will raise rates further, perhaps as much as three more times between now and early next year, since most economists would agree that the current level of the federal funds rate is at best only slightly restrictive.

For instance, if next month's CPI data indicate that "core" inflation is continuing to rise (as it has in the latest four months) or that the economy is reaccelerating (as hinted at by the

much better tone of retail sales in July), the Fed may have to start raising interest rates again to combat rising inflation expectations and to preserve its credibility as an inflation fighter.

This set of circumstances is a possibility, especially given the run-up of commodity prices and labor costs recently, even though the Fed and the investment markets apparently believe the probability is fairly low.

Key indicators here are the recent modest bond price rally and the Fed's current interest rate increase pause. But, if the Fed were to tighten again, the bond market advance we have been enjoying lately would likely evaporate and probably turn into a retreat. As for equities, it's hard to gauge how they would react to a resumption of Fed tightening, especially after their mixed performance lately.

To return to our basic theme, even if we assume that the Fed does raise short-term interest rates by a total of 75 basis points over the next six months or so, the Treasury yield curve would likely still not be sharply inverted (negatively sloped), as it has been in past instances when that situation was followed about a year later by a recession.

Based on our recent macroeconomic analysis using an econometric model well-known in the profession, our economic team would estimate that a 75-basis point increase in short-term rates, combined with little or no increase in longer-term rates, would roughly double the probability of a future recession from approximately 20% at the moment to approximately 40%.

But even with a 75-basis point Fed tightening, the odds are better than even that the economy (absent severe shocks) will not tumble into recession, but rather follow a fairly smooth glide path toward the proverbial "soft landing."

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