



Speeches by Fed Chairman Alan Greenspan and clarification on the strength of the US economy and the direction of interest rates dominated the financial headlines this week. In this issue, we'll explore the possibility of the US yield curve staying flat for an extended period of time. Consensus forecasts moved up to 3.6% for Q2 GDP on a more positive trade report. Next week we'll look for more evidence of economic strength.

## Could the Yield Curve Stay Flat for an Extended Period?

The capital markets were hoping to get clarification on the date the Federal Reserve would stop tightening, but none was to be had. Testifying before the Joint Economic Committee this week, Chairman Greenspan said that the US economy was on “reasonably firm footing” and that underlying inflation “remained contained” but that the Fed would continue with its measured pace of tightening. Citing “froth” in some local real estate markets where home prices seem to have risen to unsustainable levels, the chairman echoed remarks he made several weeks ago at the Economic Club of New York luncheon. Commenting on the pace of turnover of existing homes in the last few years, particularly second homes used for investment or vacation purposes, the chairman said, “speculative activity may have had a greater role in generating the recent price increases than it has customarily had in the past.”

Market participants who have been around for a few business cycles know that this type of activity usually ends in disappointment for those in the midst of the bubble when it bursts. The more knowledgeable people are about the formation of bubbles and their aftermath, the more they can prepare for a setback. Nimble investors can even liquidate property when they sense that the market has gone overboard with the bubbly. In this case, they can book profits and sit back to wait for the dust to settle before getting back in. Some investors — usually those who are more experienced — enjoy the sport of speculation. Those with less skill and knowledge should study the workings of the marketplace before participating.

Greenspan also mentioned that the froth in housing markets may have spilled into mortgage markets: Witness the dramatic increase in interest-only loans and other unusual forms of adjustable-rate mortgages. In the past, these usually end up being the weakest link in the chain when pressure builds up in the market. The best case to hope for is that financial entities avoid bankruptcy, but history is replete with these cases.

In the end, the chairman seemed to be indicating that the Fed will continue to raise interest rates in 25 bps increments, thereby raising adjustable-rate mortgages, until some reasonable moderation in home price acceleration occurs. With one-year Treasuries at roughly 3.25%, it would appear that rates have a long way to go before speculative activity in second homes stops. This naturally begs the next question: If the Fed continues to raise the federal funds rate purely to eradicate speculation in real estate markets (while core inflation has peaked and is decelerating), doesn't it also risk sending the economy into recession by over-tightening and choking off domestic demand? The answer is most probably yes. A better question might be: Can the Fed, through the use of moral suasion or re-regulation in the mortgage market, stop speculation in certain real estate markets without having to send the entire economy into recession? We certainly hope so. In our opinion, the comments made by Richard Fisher of the Dallas Fed are closer to what the economy needs at this time — one or two more tightenings and then a pause. As for the overly exuberant mortgage market and speculation in select real estate locales, we say re-regulate them and allow the local bubbles to burst on their own.

At the International Monetary Conference in Beijing, Greenspan chose to expound at greater length on a topic he mentioned in only a cursory way two weeks ago: the unusual behavior of long-term interest rates over the past year. While the Fed has been gradually raising the federal funds rate, the yield on the ten-year note has been falling instead of rising in a more traditional fashion during a tightening cycle. Musing over the causes of such a phenomenon, the chairman put forward four hypotheses:

- 1) The markets are signaling economic weakness. (Clearly not the case since the economy has grown on average 3.7% since the middle of last year.)
- 2) Pension funds, with their looming liabilities for retiring baby boomers, are being pressed to make significant additions to longer-term bond portfolios.
- 3) The heavy accumulation of US Treasury obligations by foreign monetary authorities has helped to lower long-term US Treasury rates. This is very plausible given the burgeoning size of the US trade deficit with China, but unfortunately such purchases do not explain why yields on long-term non-US sovereign debt instruments are so low.
- 4) The breakup of the Soviet Union and the integration of China and India into the global trading market have permitted more of the world's lower-cost productive capacity to be tapped to satisfy domestic demand for goods and services. Greater integration of financial markets has meant that a larger share of the world's pool of savings is being deployed in cross-border financing of cost-reducing investments. The enlargement of the global market for goods and services and finance has contributed significantly to the favorable inflation performance that we are witnessing in so many countries.

The chairman did not emphasize one hypothesis over another, but he did say that lower long-term interest rates across many industrialized nations were causing private equity funds and hedge funds to seek out higher-yielding investments. He said that by continuing to seek above-average returns, hedge funds could create risks for which compensation is inadequate, and thus returns would shrink and so would the size of the hedge funds.

We must admit that our favorite explanation for low long US interest rates is the last one: globalization. This hypothesis asserts that the opening up of China and India has unleashed a supply of lower-cost productive capacity that is keeping a lid on inflation. (And it fits with our deflationary boom thesis of strong growth, low inflation, and low interest rates.) These phenomena last occurred prior to World War I, when multilateral trade agreements and global trading were as liberal as they are now. Unfortunately, the result was disaster as nationalism and protectionist sentiments brought the period to a close in the disarray and chaos of war.

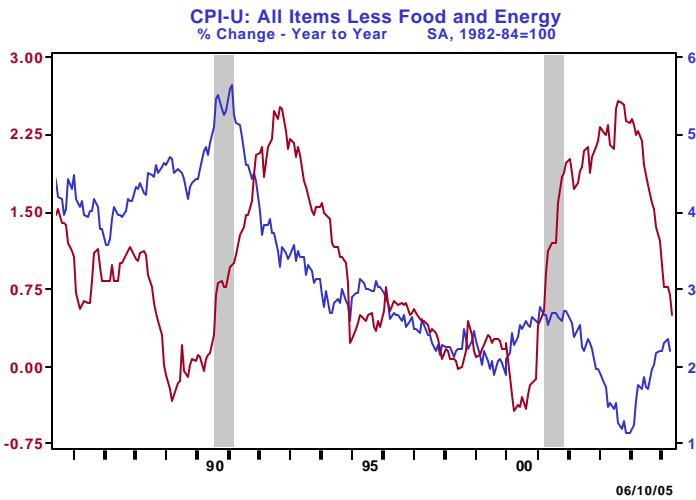
At the end of his Beijing speech, Greenspan made a reference to what is currently going on in the world. He said, "The economic and financial world is changing in ways that we still do not fully comprehend. Policy makers accordingly cannot always count on an ability to anticipate potentially adverse developments sufficiently in advance to effectively address them.... Policy makers need to be able to rely more on the markets' self-adjusting process and less on officials' uncertain forecasting capabilities.... The recent emergence of protectionism and the continued structural rigidities in many parts of the world are truly worrisome. In the end, I trust that we will all recognize our common interest in fostering global and domestic arrangements that promote the prosperity of our citizens." This is not the first time the chairman has mentioned this. Assuming that history does not repeat itself and that this period does not end (according to the textbook version of Kindleberger) in international contagion, we can all reap the benefits of growth, low inflation, and low interest rates.

If we pause for a moment and think a bit about what this means for the yield curve, we come to the following conclusion: *The yield curve may stay flat for an extended period of time.* The chart at the top of the next page illustrates this quite well. Following the last tightening cycle in 1994, the yield curve — as measured by the spread between two years and 30 years — stayed around 50 bps for four and a half years. (Hopefully this will be a similar extended period of prosperity.) The chart further below gives us pause. Core CPI was around 2.5% to 3% during this period — fairly

FCM30 - FCM2



FCM10 - FCM2



steady. One must wonder if core CPI won't do something similar this time around and settle in between 1.5% and 2%. If it does, the implication is low long *and* short rates.

As for next week's data, we look for continued evidence of economic strength in the May retail sales report and housing starts. Measures of manufacturing activity, such as the industrial production and Philly Fed reports, may continue to decelerate. The Q1 current account deficit, released on Friday, will be very large. We expect the Fed to raise interest rates by another 25 bps at their meeting at the end of the month.

Active investment managers should start to think through the implications of a flat yield curve on the structure of the fixed-income portfolios they manage. Likewise, equity managers should consider the consequences of low interest rates (both short and long) on overall equity valuations and asset allocations. Given our optimistic outlook for GDP growth this year, we expect the financial sector, industrials, energy, and IT to benefit most. Investors need to be aware that with the manufacturing sector now experiencing a deceleration in growth, profit prospects may not be nearly as robust as they were over the last two years unless companies find new and improved ways to increase productivity.

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