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The Treasury Bond Yield Curve

CBS Market Watch commentator and economist Irwin Kellner has been noting certain signs that the U.S. economy is slowing down, contrary to remarks by both Federal Reserve and Bush Administration officials that robust growth will continue for the rest of 2005. One sign of it, he said, is "the yield curve—that is, the term structure of interest rates—has become less steep over the past month. This, too, is a sign that slower growth lies ahead."

What is the yield curve? It is a graph of interest rate yields for Treasury securities due from 3 months to 30 years. Now, interest rates tend to rise the longer the term of the bond…or loan. A 30-year fixed rate mortgage has a higher interest rate than one for 15 years, for example. The so-called curve then reflects that yield or interest rate for each term. Today's 30-year Treasury bond is yielding 4.48 percent, for instance, whereas it was yielding more than 5 percent just last fall. Today's 3-month Treasury bill is close to 4 percent, in line with the 3.75 percent fed funds rate.

So a graph with the vertical arm showing percentage yields and horizontal arm the term, or time frame, will be rising the longer the term. Now, it is the degree of slope of that curve that Dr. Kellner is describing. During the recession it was very steep, as short-term rates fell first. The Federal Reserve had been holding short-term rates at 1 percent, while making noises that deflation was a greater concern than inflation.

If short-term rates should rise above long term rates, says Dr. Kellner, a recession could follow. Why? Because banks finance their loans with short-term money and lend at longer-term rates. It is the difference between short and long-term interest rates that generates their profits. So, when the cost of money is as much as what they can earn in interest, then they can no longer be in the lending business.

The yield curve was last inverted in 1999, just before the last recession. The fed funds rate was 6.5 percent then, and 30-yr Treasury Bond slightly above 6 percent. The 2001 recession followed. Our conclusion? If the Federal Reserve Open Market Committee continues to raise their fed funds overnight rate above 4 percent—and they have 2 more meetings this year in which to do so—then we could see at least a flat yield curve and slower growth next year.

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