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## Inverted yield curve, slow housing market hurt



**RICHARD  
TODD**

**PERSONAL  
FINANCE**

**T**he current fed funds rate of 5.25 percent is almost 0.5 percent higher than the 10-year Treasury yield. It's rare to have short-term rates higher than long-term rates (an inverted yield curve), and that's happened just three times in 20 years. Historically, this has meant trouble ahead for the economy.

In 1989 and 2000, the yield curve inverted roughly 10 months before the economy plunged and was a catalyst for the Fed cutting short-term interest rates. In 1998, yield curve inversion was followed by the Russian debt crisis and volatility in the emerging markets.

Why does an inverted yield curve signify a recession or a financial market slowdown? An important factor is that an inverted yield curve creates a disincentive for banks to lend money. Banks borrow money "short" and lend "long" to capture the normal spread between short rates and long rates. When the yield curve inverts, the spread is negative and banks have much less incentive to risk their capital.

Today, many believe that the dynamics of the U.S. economy are more asset-based, and the changes in stock markets, real estate markets and commodities have a larger impact on our economy than interest rates. That's why the combination of an inverted yield curve and a dramatically slowing housing market is a difficult economic formula.

It's estimated that a significant portion of our GDP gains were related to the housing market. New home sales are down sharply and housing starts are at a three-year low. This means fewer jobs in the construction and housing markets.

Consumers drive roughly two-thirds of U.S. economic growth, and the American consumer isn't in great shape. The slowing housing market is no help.

But corporate America, which drives about one-third of the economic growth, is in excellent condition. Balance sheets are arguably in the best shape in 20 years and corporate cash on hand is still near record levels.

It will be interesting to see if corporate America can carry the load and keep the U.S. economy in positive territory.

How does this relate to stocks?

Data from the U.S. mutual-fund industry and Lehman Brothers indicate a net sale from the international markets in July. The Middle East crisis and economic slowdown are most likely the culprits.

In the last 20 years, there have been eight similar occurrences when the international flow of funds was negative. Examining stock-market results shows stocks were up almost 20 percent 12 months later and were positive in seven of eight years. The year following 9/11 resulted in stocks being down more than 20 percent -- the only time when stocks were negative.

Equity valuations are fairly decent, and the market is making new highs. It'll be interesting to see how the economy and stocks weather an inverted yield curve and a housing slowdown.