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## Don't Fret Inverted Yield Curve; Economic Outlook Solid

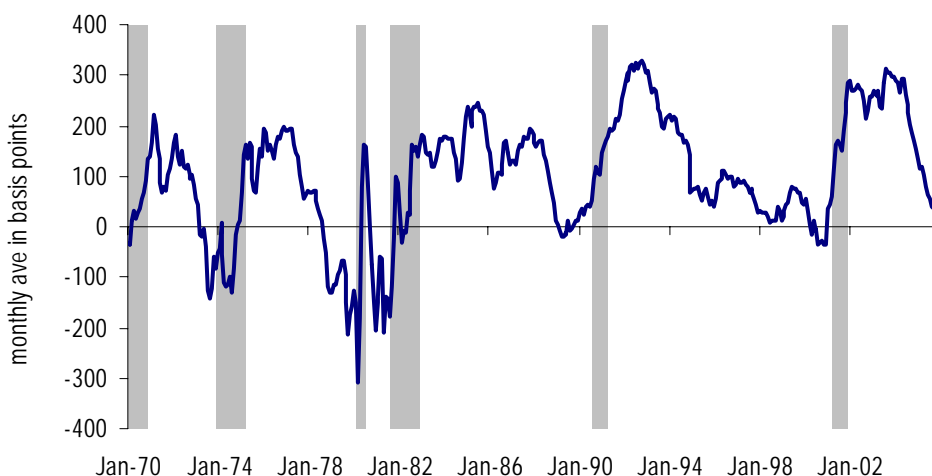
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Equities weakened on Tuesday and bond yields fell further, pushing longer-term yields below shorter-term yields.

- Some are expecting lower bond yields on the view that the U.S. is going to slow down substantially in the first half of 2006 due to interest rate increases, a housing slowdown and higher energy prices. We disagree. Like 2004 and 2005, we think 2006 will see relatively strong economic growth, a further decline in the unemployment rate, and more rate hikes than expected.
- We think low bond yields, rather than signaling a slowdown, reflect ample liquidity globally, contained inflation thus far, and the Fed's unusual commitment to limit the size of each rate hike.

### U.S. Yield Curve (10-Year Treasury Minus 1-Year Yield)

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Source: Haver; Bear, Stearns & Co. Inc.

- We think the economy is relatively well insulated from interest rate hikes. The household sector is a big net creditor, so rate hikes to date haven't slowed consumption growth. The Fed itself believed monetary policy through November was "accommodative", meaning stimulative and additive to the growth outlook. Regarding energy costs and the consumer, we emphasize the bigger role played by the unemployment rate. We expect some moderation in new home construction after a record 2005. We think this will make economic growth more balanced, not slow it down. In terms of economic output, a slowdown in home construction will soften this sector's demands on labor, management, and materials, benefiting many other sectors. In terms of consumption, we think the benefits from falling unemployment are more important than asset price fluctuations. We expect home equity extraction to slow, but note the much bigger pools of financial resources available to the consumer in net household financial assets.

## **Yield Curve Inversion**

We disagree with the view that a flat yield curve is a negative sign in the outlook.

- Low longer-term yields reduce the cost of capital for new investments and improve the outlook for housing.
- The Leading Economic Indicators were fully revised in August to downplay the significance of the flattening yield curve (see our July 21 piece *Upward Revisions Keep Coming*). An inversion, if it persists and becomes deep as in 1981, would be a negative indicator. For now, the yield curve is barely inverted and other market-based signals – equities, credit spreads, commodities -- don't point to weakness.
- Past instances of flat yield curves and inversions occurred at much higher interest rates. For example, the yield curve was flat at 6.4% in May 2000, versus flat at 4.3% today, a big difference in impact. Real interest rates are also about 2% lower now: CPI was 3.2% in 2000 versus 3.5% today, and core CPI was 2.4% versus 2.1% today.
- Fed Chairman Greenspan addressed the prospect of an inverted yield in some detail in a November 28 letter, finding: "A flattening of the yield curve is not a foolproof indicator of future economic weakness. For example, the yield curve narrowed sharply over the period 1992-1994 even as the economy was entering the longest sustained expansion of the postwar period."
- We expect the yield curve to remain relatively flat in 2006 as growth continues, the Fed pushes short-term rates higher, and long term rates move in parallel. If core inflation rises, the curve would steepen. We don't expect a material inversion until we're closer to the next recession.

## **Economic Outlook Solid**

The key factors in our constructive outlook for the first part of 2006 are the low level of interest rates relative to inflation and economic growth, the reservoir of liquidity left over from 1% interest rates, signs of continued business innovation and profit growth, the falling unemployment rate, and the strength of the corporate balance sheet and household balance sheet (the world's biggest net creditor, with a record low percentage of its debt short-term.)

- The U.S. should enjoy continued healthy growth in business profits, along with substantially higher interest rates and bond yields (this applies to Japan and Europe too). It's not a goldilocks scenario for equities, which don't like rate hikes. Still 2006, like 2005 and 2004, should show equity out-performance over bonds and cash.
- We emphasize the unique nature of this rate-hiking environment, the world's first major-economy experience with a floating exchange rate after a deflation. As Fed Chairman Greenspan has suggested, the Fed will probably have to overshoot neutral in order to find it. The Bank of England spent 12 months at 4.75% before cutting to 4.5% in August, and the U.S. will probably need higher levels given its faster growth, higher inflation, stronger household balance sheet, greater return on investment, and long period of negative real interest rates in 2003 and 2004. A key variable is how much the core inflation outlook deteriorates due to the halving of the dollar's commodity value between 2001 and 2005.

We stick by the durable expansion with higher rates view expressed in our June 21, 2004 piece: *Top Reasons Rate Hikes Won't Cause a Slowdown*:

- The level of interest rates probably matters more than the change in rates.
- The positives from job growth will offset some of the impact of the interest rate hikes.
- Foreign economies are strengthening, offsetting some of the effect of U.S. rate hikes.
- U.S. households are sizeable net creditors with long-maturity liabilities, so rate hikes will add to disposable income.
- Firms have unusually strong cash flows and liquid asset positions to finance new investment.
- Bond losses from higher interest rates will be widely disbursed to U.S. and foreign holders.
- Futures markets have already priced in significantly higher interest rates.
- Rate hikes will probably be gradual.
- There have been two stress tests already (this referred to the bond sell-offs in 2003 and 2004).
- The distribution of interest rate risk has improved in a pro-growth way (a reference to the household sector's shift toward longer-term debt and increased financial assets).

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