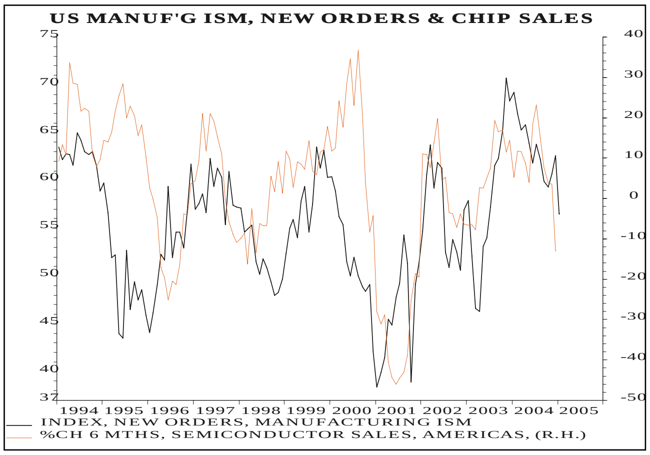
GFC ECONOMICS

DAILY COMMENTARY

THE YIELD CURVE AND A US SLOWDOWN

Curve flattening trades appear to have run their course for now, with ten year maturities significantly underperforming the short end of the curve last week. That said, incipient signs of a economic slowdown, softer credit growth and a Fed still determined to raise rates suggest 10-year yields may dip below 4.0% again over the coming weeks. Signs of a downturn in technology demand suggest the recent fall in some leading indicators may not be an aberration. Furthermore, the US administration's budget plans should not be dismissed lightly. Fiscal policy is going to be much tighter than in the first term of President Bush. That in turn, should help underpin the long end of the curve. But ultimately, a sustained fall in yields is not going to materialise until the FOMC is forced into dealing with the burgeoning shortfall on the current account. Rates will have to go higher to brake credit growth decisively and bring the deficit down to manageable levels. Once that happens, 10-year yields may be ripe for a drop to new secular lows.



A Modest Slowdown?

Ever since the summer of 2003, the FOMC has gone out of its way to elucidate a coherent strategy to financial markets. This was partly in an attempt to forestall the sort of frenzied speculation that saw bond yields fall sharply, in anticipation of the Fed introducing some form of quantitative easing. The policy has paid dividends, as the volatility within the bond market has certainly diminished. However, FOMC member Jack Guynn did not manage the same degree of clarity in a press interview last week. He was trying to shed light on the Fed's intentions, and suggested the FOMC might want to drop any reference to "measured" rate hikes. But he was far from clear whether that implied rate hikes should accelerate, or decelerate from here. As he pointed out, "it's not quite clear how much we need to do from here". The Fed seems no more certain than the bond market, which is trapped midway between the prospect of accelerating inflation and incipient signs of economic slowdown.

The evidence of a deceleration in economic activity is admittedly sketchy. But recent business surveys have thrown off some signals, which may just be the start of a trend. The new orders index within the manufacturing ISM survey fell sharply in January to 56.5, its lowest level since June 2003. The slowdown in the manufacturing ISM report has been mirrored by a drop in the overall and new orders indices within the Philadelphia Fed surveys, which fell to 13.2 and 9.8 respectively in January. The level of these indices is not particularly low, especially in the case of the ISM survey. But for the bond market, these drops could still potentially be significant. Recent research from the Federal Reserve suggests that the underlying trend in productivity may be running somewhere between 2.6% y/y and 3.2% y/y, depending upon the precise rate of technological progress. By extension, the various indicators of economic activity do not have to fall quite so far to trigger a drop in yields, if the potential growth path for the economy is running in excess of 4.0%.

In this respect, the recent unveiling of a new computer chip by IBM, Toshiba and Sony is quite intriguing. It underlines the possibility that productivity growth will remain towards the top of the range suggested by the Fed. The Fed's researchers identified the ability of semiconductor manufacturers to double chip power as the key variable driving the pace of technological development, and that was measured by the power of computer chips. The latest "supercom-

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puter on a chip" runs at speeds between five and ten times faster than current processors. Suggestions that this new chip would "revolutionise communications, multimedia and consumer electronics" may not be quite so far fetched. These are precisely the technological developments, which the Fed study suggested could imply the economy will be able to sustain 4% growth rates without triggering a secular pick-up in inflation risks.

It is quite ironic, therefore, that the technology industry should be leading the downturn in some of the leading indicators. According to the Semiconductor Industry association, chip sales have fallen sharply in recent months, with December's data showing a drop of 16.9% from the 2004 high-point. In mitigation, chip sales have not always been that useful as a leading indicator. Signs that the dotcom bubble was starting to unravel became apparent some time before the semiconductor industry started to turn down in 2001. But in more recent times, the fortunes of this industry have provided quite a good guide to the turning points in the economy. And there are good reasons to suspect the drop in chip sales is for real. The data on durables goods orders has suggested for some time that technology demand was very robust. Spending accelerated sharply during the early months of the economic upswing. Computer and electrical orders rose by an impressive 16.5% during the first three-quarters of 2003. Since then, demand has fluctuated - dropping back in the early months of last year, then accelerating as companies rushed to take advantage of the tax depreciation allowances, before tapering off again. Orders were up 1.2% q/q in Q4 last year, but in the three months to December were down 6.1%. Durable goods orders are not that weak, but they are soft enough to have caught some companies out, forcing chip sales to be pared in order to reduce inventories.

Of course, the technology industry no longer drives the wider economy, and there are plenty of other indicators that suggest the US economy is not slowing. The recent jobless claims data have been notably strong. More significantly, consumer demand was very buoyant towards the end of 2004. Spending on autos did boost the December numbers, but it made little difference to the Q4 data, which showed consumer demand expanded by an annualised rate of 4.6%, with and without motor vehicles included. Of course, since then, some of the borrowing number have slowed a touch, and since employment growth remains sluggish, incomes are not rising quickly enough to take up the slack. Mortgage applications have fallen 9.7% compared during the first 6 weeks of the year, compared with the last 6 weeks of 2004. The rise in consumer credit outstanding during November and December was also quite modest, although these numbers are very prone to revision. And the recent slowdown in the growth of revolving home equity loans remains intact (see chart).

In truth, these are modest pullbacks from the historically very strong growth rates in consumer borrowing witnessed last year. There is no reason to believe the economy is going to brake sharply in the first half of this year. The risks lie further out, should the Fed continue to ratchet rates up, in response to a perceived inflation threat, and/or because the US$ starts to slide again. The recent price action in the currency markets has been quite significant in this respect, following what was essentially another poor trade report. Closer reading of Mr Greenspan's Kirkcaldy speech might suggest the Fed Chairman is all too aware of the risks that the shortfall on the current account could carry on climbing this year. Ultimately, it is the requisite policy response to an unsustainable external deficit that is likely to precipitate a more significant economic slowdown.