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Righting The Yield Curve

The so-called Treasury yield curve (see above chart), a chart which tracks the percentage yields of treasury bills and bonds from 3 months to 30 years, has righted itself. This is important because it shows an economy pointing to a longer-term recovery, in spite of the current credit crunch.

Banks do most of their borrowing from the U.S. Treasury, their depositors, and/or bond markets on the short end of the yield curve; say 3 months. Today that rate is slightly above 2 percent. But it lends money at longer term rates; say a 30-year mortgage that is now between 6-6.5 percent.

The difference in yields between what banks borrow and what they lend is their profit. Over most of the past 2 years—before the Fed began to lower its short-term rates (2.25 percent to date)—short-term rates were higher than long-term rates. For instance, the 3-month rate was about 5.25 percent, while the 10-year bond fluctuated between 4 to 5 percent.

That meant banks' costs were higher and profits lower, so they went looking for riskier investments, such as more subprime mortgages. The search for higher returns was in fact a direct result of the Federal Reserve credit tightening, after holding down interest rates too long in its attempt to fight the phantom of a Japanese-type deflation that enfeebled Japan's economy for more than 10 years.

The 4.25 percent increase in the Fed's short-term rates over 17 consecutive FOMC meetings under Alan Greenspan from 2004 to 2006 helped to provoke the current credit crisis, in other words. Not only did the Fed's actions reduce bank profits, but jacked up adjustable rate mortgage indexes too high, resulting in a 50 percent increase in foreclosures (from 1 percent to 1.5 percent of outstanding mortgages).

It is because the Fed's tightening proved to be too much for both banks and consumers, that the Fed has been trying to undo the damage it wrought. Righting the yield curve by continuing to lower short-term interest will do just that—increase banks' profits and capital base over time. The question is how much time it will take for the banks to recover, and so ultimately unfreeze the credit markets.

There are already signs that housing may recover this year. Both the National Association of Builders sentiment index and housing starts have begun to slowly revive.

NAHB INDEX--Builder confidence in the market for new single-family homes edged marginally higher in February as traffic of prospective buyers through model homes improved considerably, according to the latest NAHB/Wells Fargo Housing Market Index (HMI). The HMI rose a single point to 20 in February, though still close to its recent historic low reading of 18 (the series began in January of 1985).

Housing Starts

January new-home construction also edged up slightly to 1.01 million annualized units, after being flat since November. This was the first rise since the fall from its 2 million unit high peak in April 2006. This is another sign that customers are returning to the market.

The current credit crunch will be over when banks are assured that profits (and the value of their stocks) will rise again. Once credit becomes more readily available, consumers and homebuyers will increase their spending. The righting of the yield curve should assure banks and other lending entities that this will happen in the not too distant future.