The yield curve on Treasury securities—which describes rates of return at different maturities in ascending order—has flattened dramatically since the third quarter of 1994. At the end of December, the difference between the 10-year Treasury yield and the effective federal funds rate was less than 20 basis points (a basis point represents 1/100 of a percentage point). To provide some perspective on this difference, the spread has averaged nearly 100 basis points in nonrecession years since 1954.

Based on past experience, this decline in the rate spread between short-term and long-term interest rates has raised some concern about the prospects for the U.S. economy over the coming year. Nearly all post–1950s recessions were preceded by significant declines in the difference between, for instance, the 10-year Treasury rate and the federal funds rate. In all but one instance, this spread was actually negative prior to the downturn. Thus, although the magnitude and timing of so-called yield-curve inversions have differed before the onset of recessions, conventional wisdom holds that negative, or very low, interest-rate spreads are harbingers of tough economic times.

Changes in long-term less short-term interest rates depend, of course, on the behavior of rates at each maturity. Before becoming too (continued on next page)
alarmed at the messages read from yield-curve tea leaves, it is instructive to examine the components of rate spreads more closely.

The recessions of 1973–75 and 1981–82 are typical of most downturns in the past 35 years. In both of these episodes, the 10-year Treasury/funds-rate spread fell precipitously and inverted some months before the recession began. These declines occurred even though long-term rates were steady or rising. The sinking rate spreads, therefore, were largely a result of fairly steep increases in the federal funds rate.

A similar pattern can be found before the 1960–61, 1970, and 1980 contractions. A notable exception was the 1990–91 recession. Not only was the yield inversion smaller in magnitude and longer in lead time than during earlier episodes, but the negative 10-year/funds-rate spreads had disappeared six months before the downturn began.

With the possible exception of this latest contraction, the current fall in rate spreads is unlike the declines that preceded earlier recessions. In contrast to constant or rising 10-year yields combined with a rising funds rate, last year witnessed a slightly falling funds rate combined with significant declines in longer-term rates.

Being doomed to repeat history does imply that history repeats itself. A deeper look into the recent yield-curve declines suggests that the source of similar behavior in the past—behavior that did not ultimately bode well for short-term economic growth—may be absent in the current environment.