The Federal Open Market Committee’s August 13 statement indicated that the balance of risks for the economy tilted toward economic weakness, a change from its previous statement that economic weakness and inflation were evenly balanced. How do the financial markets view the current balance of risks? Put another way, do market participants see a 1.75% federal funds rate or an M2 growth rate of more than 5% as a sign of inflation?

Over the long term, the answer seems to be no. One market measure of expected inflation, the spread between yields on 10-year nominal Treasury bonds and 10-year Treasury inflation-indexed bonds, has fallen. In late May, the spread implied expected inflation exceeding 2%; it now implies values closer to 1.75%. In the short term, the answer again appears to be no. A measure of expected inflation over the next 30 days, derived from surveys and Treasury bill rates, suggests a rate of only 2.4%.

A less favorable indicator of inflation risk comes from the gold market, where prices have increased 21% since April 2001 and 12% since the beginning of this year. However, the price of gold is not an infallible sign of inflation because often it is...
affected by specific market factors such as central bank sales or jewelry demand.

A rise in gold prices often reflects a flight to security when the economic or political outlook becomes uncertain, but other measures of risk in the financial world do not point to uncertainty. The TED spread, the yield difference between eurodollar deposits and Treasury bills, often picks up on such concerns because it measures credit risk at international banks without reflecting exchange rate risk; it remains very low. In the domestic market, the yield spread between 90-day commercial paper and three-month Treasury bills also remains quite low.

At the lower end of the credit spectrum, things look less rosy. Spreads over Treasuries of both high-yield and BBB-rated bonds have increased substantially in recent months. Thus, credit concerns seem to be growing, at least for lower-rated borrowers. Such borrowers become more important if we turn from rates to ratings. In any given year, some firms get stronger and others get weaker, but a good measure of the overall trend is the ratio between ratings upgrades (receiving a higher—that is, better—rating, which suggests the company has become less risky) and downgrades. Not only have
A classic measure of risk in the economy is the term structure of interest rates coming out of the Treasury yield curve. The yield curve has moved little since last month, although it has steepened noticeably since this time last year, mainly because short rates have fallen. For most of 2002, however, short rates have held steady, with longer-term rates dropping 120 basis points since late spring.

In the past, a steep yield curve indicated robust economic growth. Plotting the 10-year, 3-month spread against GDP growth for the year ahead shows that the yield curve has been a fairly reliable signal since 1960, although periods of high growth occasionally are accompanied by a low spread. A negative spread (inverted yield curve) reliably indicates recessions, although, like many other signs, it was confused by the 1967 mini-recession. Thus, while the present steep yield curve may not guarantee a strong recovery, it suggests a low likelihood of a “double-dip” recession.