Implied yields on Eurodollar futures show that market participants expect a pause in policy tightening in 2006. They may believe that after the rate hikes anticipated for the remainder of 2005 and early 2006, the federal funds rate will be closer to a level consistent with a neutral policy.

Since the current round of tightening began in June 2004, the real (inflation-adjusted) federal funds rate has increased nearly 325 basis points (bp). This is in line with the FOMC’s stated desire to remove policy accommodation. The last few increases have brought the nominal federal funds rate closer to the levels suggested by the Taylor rule, which views the rate as a reaction to a weighted average of inflation, target inflation, and economic growth.

The yield curve flattened further in December. On December 27, the 10-year Treasury note yield fell 1 bp below the yield on the two-year Treasury. Situations where long-term rates dip below short-term rates are called “yield curve inversions.” The last one occurred on December 29, 2000, a few months before the 2001 recession began; indeed, the last six recessions have been preceded by yield curve inversions. However, inversions do not always signal a recession in the offing; the inversion of 1998, a case in point, was not followed by a downturn. Some analysts maintain that inversions’ predictive power has been... (continued on next page)
wanning. In a recent letter to the Joint Economic Committee of Congress, Federal Reserve Chairman Alan Greenspan stated that “a flattening of the yield curve is not a foolproof indicator of future economic weakness.” Furthermore, light trading in Treasury markets during the holidays means that recent yield data may reflect other factors.

Short-term rates have moved in step with increases in the federal funds rate. Since the current round of policy tightening began, short-term Treasury rates have moved up more than 250 bp at the short end of the maturity spectrum. Long-term rates have moved much less, which has resulted in the observed flattening of the yield curve.

Although long-term rates on conventional mortgages remain at historically low levels, they have increased more than 70 bp since the beginning of July 2005 and are near the levels observed at the beginning of the current round of policy tightening. Despite higher mortgage rates, new home sales and housing starts remained solid in November; however, sales of existing homes softened somewhat in October.

Risk spreads on corporate debt have been rising modestly. One measure—the spread between the yields on 90-day commercial paper and the three-month Treasury bill—is nearly 20 bp higher than at the beginning of September. Risk spreads on longer-term corporate debt have risen more modestly during the same period. Wider risk spreads may indicate that investors are less willing to take on risk and must receive greater compensation to do so. But even with these increases, risk spreads remain well below the levels observed a few years ago.

(continued on next page)
Despite modest increases in disposable personal income in 2005:IIIQ, the wealth-to-income ratio rose during the quarter. Higher home prices have been a major contributor to increases in the ratio this year. Stock market gains in late November may bolster the ratio further. Higher wealth-to-income ratios make households more comfortable with saving less. The personal saving rate in the U.S. stood at –1.8% in 2005:IIIQ, its second consecutive quarter in negative territory.

Outstanding consumer debt continued to rise at a robust rate in 2005:IIIQ; home mortgage debt showed the largest gains, with an annual growth rate exceeding 13%. However, recent data indicate that total consumer credit fell at a 4% annual rate in October, the largest percentage decline since 1990. A drop in nonrevolving credit outstanding was attributed to decreased consumer spending on automobiles in October. Nonetheless, levels of consumer debt remain elevated; they have not been associated with appreciable increases in delinquent loan repayment rates, however.

After plummeting in September and October following Hurricane Katrina, the Conference Board’s Index of Consumer Confidence rebounded in November and December. Most of December’s increase resulted from a rise in the present conditions component of the index, although the future expectations component also contributed. The University of Michigan’s Consumer Sentiment Index also rose in the last two months of 2005. Analysts attribute these gains to falling energy prices, rising equity prices, and November’s strong employment report.