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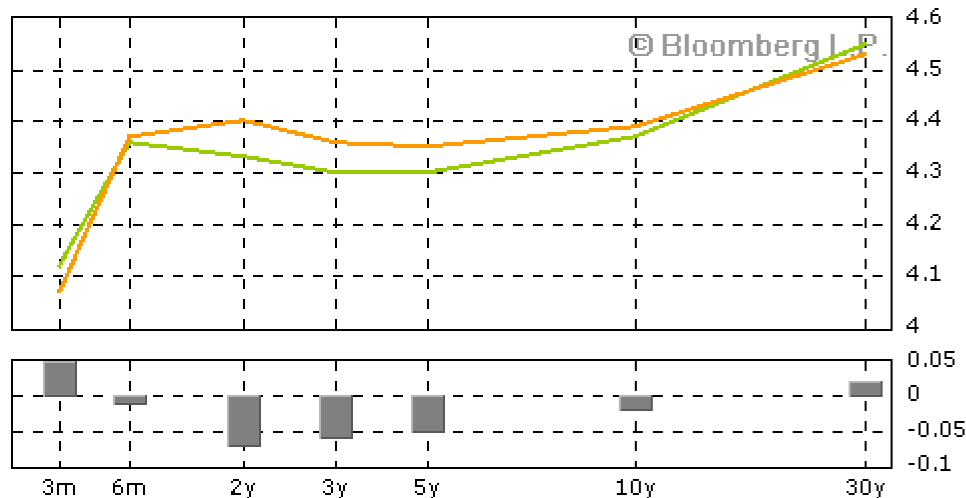
InvestmentST.com

A picture tells a thousand stories. The one below from Bloomberg.com paints the yield curve as of 1/3/06. (You may see an update at Bloomberg.com)



As you can see, parts of it are inverted (6 months out to 5 years), which may be a warning of a potential recession within the next 4-6 quarters.

A normal yield curve would swing smoothly from left to right, increasing as it went along, so that all along as you increased the duration, the yield would increase also. But the current picture shows an inversion in the curve, which means that certain short-term rates are yielding more than certain longer-term rates.

Historically, inversions have been one of the best predictors of a recession. Since 1960, every recession has been preceeded by an inverted yield curve. If a recession is ahead, stocks will begin to decline roughly six months in advance on average. The time to buy is when the recession is fully announced and felt and you are worried.

Looking ahead and to simplify the curve's message, I would continue to monitor the relationship between the 3 month and 10-year rates, which is what most economists consider when speaking of an inversion, as opposed to other maturities. This relationship is not quite inverted at this time.

So, the news today that the "number of rate increases left may not be large", to use the Federal Reserve's wording, helped stocks and parts of the bond market get off to a positive start for the New Year. If the Fed were to raise rates even two more times, however, the main relationship would invert, if nothing else changes. Caution would then be fully warranted as the probability of a recession is nearly guaranteed.