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Top forecaster sees U.S. recession

By Joshua Krongold
Bloomberg News

The U.S. bond market's most accurate forecaster, who plies his trade 500 miles from Wall Street, says yields are sending ominous signs about the economy.

While economists at the biggest bond-trading firms wrongly predicted that the benchmark U.S. 10-year Treasury yield would end last year at 5 percent, a University of North Carolina, Chapel Hill, professor came a lot closer to getting it right.

"It was luck, partly," said James F. Smith, 67, who teaches finance at the school. "The other reason is the anticipation that inflation would be contained and that continued rate increases from the Federal Reserve would keep longer-maturity investors enthused about their returns."

Smith turned out to be the top forecaster in Bloomberg's January survey of 66 economists. He predicted the benchmark 10-year yield would end the year at 4.49 percent. At the time, the yield was about 4.27 percent and the median estimate was for it to climb to 5.04 percent by Dec. 31. It finished 2005 at 4.39 percent. Yields move inversely to bond prices.

"Those Wall Street gurus have bigger expense accounts than I have total income," Smith said.

Smith said the bond market is waving a caution flag on the economy. Two-year Treasury yields last week rose above those on 10-year notes, creating a so-called inverted yield curve for the first time since December 2000. An inversion preceded the past four U.S. recessions.

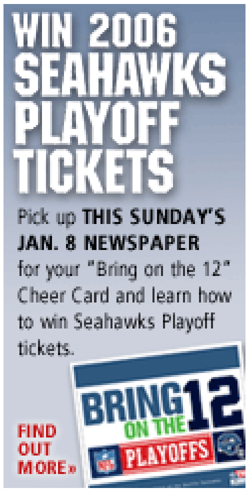
"When the curve inverts, run for the exits," said Smith, who served as an economist for the Fed from 1975-77. "It will stay that way until the Fed realizes it caused a recession in 2007. Investors should start planning for a recession."

The 10-year yield will climb to 4.53 percent this year, Smith predicts. His forecast is again below the median estimate of economists, which is for the yield to end 2006 at 5 percent, according to a survey from Nov. 30 to Dec. 8.

Core inflation, which excludes food and energy prices, "remains under control," he said, tempering any rise in yields. Inflation erodes the purchasing power of a bond's fixed payments.

Smith expects the Fed to raise its target rate for overnight loans between banks three more times, to 5 percent from 4.25 percent. The U.S. central bank has raised rates by a quarter-percentage point at every meeting since June 2004, when the target was at a 46-year low of 1 percent.

"That's three more times than we need," said Smith, who has also served as the chief economist for the Society of Industrial and Office Realtors since July 2002.



In the January survey, Smith expected the Fed to only raise rates to 3 percent last year, compared with the median estimate of 3.50 percent.

Prices for personal consumption expenditures excluding food and energy rose 1.8 percent in November from a year earlier, down from 1.9 percent in October, the government said. The Fed uses the PCE index in making its semiannual forecasts. In July, the central bank said it expected the core rate to rise 1.75 percent to 2 percent last year.

None of the economists surveyed by Bloomberg expects a recession, or two consecutive quarters of a decline in gross domestic product, this year. The economy likely will grow by 3.4 percent in 2006, based on the median of 71 forecasts in a survey conducted from Nov. 30 to Dec. 8.

Fed Chairman Alan Greenspan said Nov. 3 that the yield curve "used to be one of the most accurate measures we used to have to indicate when a recession was about to occur," though "it's lost its capability of doing so in recent years."

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