The "Term Premium" Meme

This is Ben Bernanke in March 2006 on *Reflections on the Yield Curve and Monetary Policy*:

> However, if the behavior of long-term yields reflects current or prospective economic conditions, the implications for policy may be quite different—indeed, quite the opposite. The simplest case in point is when low or falling long-term yields reflect investor expectations of **future economic weakness**.
>
> Suppose, for example, that investors expect economic activity to slow at some point in the future. If investors expect that weakness to require policy easing in the medium term, they will mark down their projected path of future spot interest rates, lowering far-forward rates and causing the yield curve to flatten or even to invert. **Indeed, historically, the slope of the yield curve has tended to decline significantly in advance of recessions**.
>
> **What is the relevance of this scenario for today?** Although macroeconomic forecasting is fraught with hazards**, I would not interpret the currently very flat yield curve as indicating a significant economic slowdown to come, for several reasons**. First, in previous episodes when an **inverted yield curve was followed by recession, the level of interest rates was quite high, consistent with considerable financial restraint**. This time, both short- and long-term interest rates—in nominal and real terms—are relatively low by historical standards. **Second, as I have already discussed, to the extent that the flattening or inversion of the yield curve is the result of a smaller term premium, the implications for future economic activity are positive rather than negative.**

Twelve years later in May 2018, Lael Brainard writes *Sustaining Full Employment and Inflation around Target*:

> **The Yield Curve**
> Even though longer-term Treasury yields have moved up, on net, since the beginning of the year, there has been

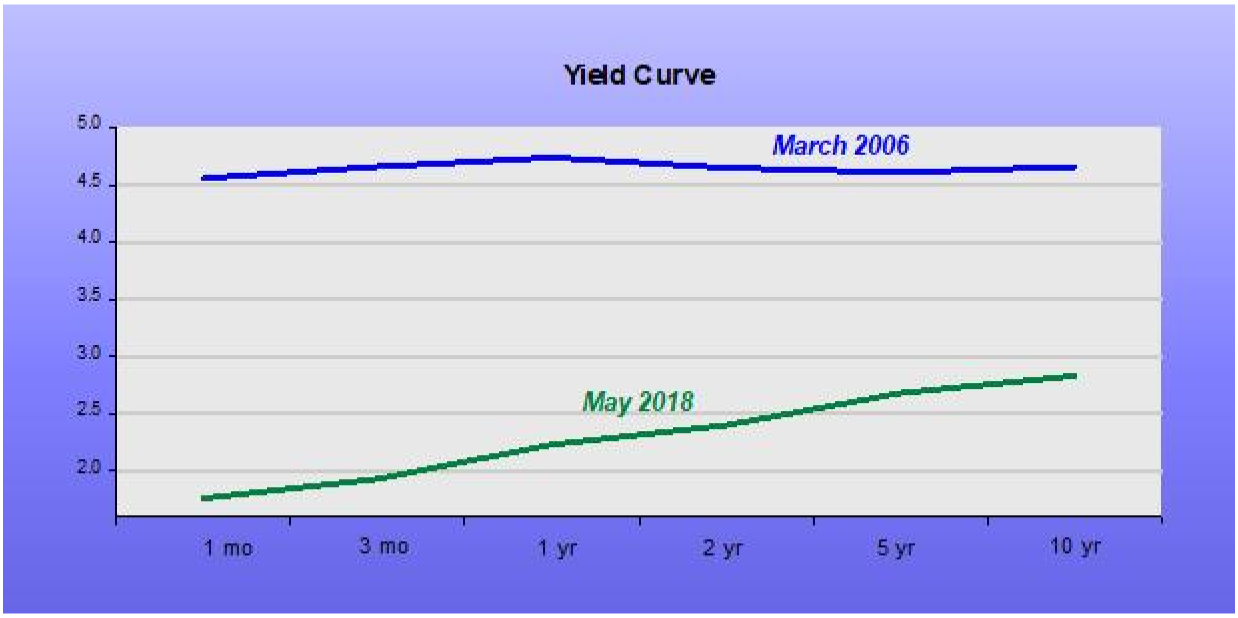
> growing attention of late to the possibility of an inversion of the yield curve—that is, circumstances in which short-term interest rates exceed long-term interest rates on Treasury securities. **Historically, yield curve inversions have had a reliable track record of predicting recessions in the United States**.
>
> As we try to assess the implications of this flattening of the yield curve, it is important to take into account the **very low level of the current 10-year yield by historical standards**.
>
> For the 20 years before the crisis, the 10-year Treasury yield averaged about 6-1/4 percent, compared with recent readings around 3 percent. One reason the 10-year Treasury yield may be unusually low is that market expectations of interest rates in the longer run may be unusually low. **A second reason may be that the term premium—the extra compensation an investor would demand for investing in a 10-year bond rather than rolling over a shorter-dated instrument repeatedly over a 10-year period—has fallen to levels that are very low by historical standards**.
>
> Other things being equal, a smaller term premium will make the yield curve flatter by lowering the long end of the curve. **With the term premium today very low by historical standards, this may temper somewhat the conclusions that we can draw from a pattern that we have seen historically in periods with a higher term premium.** With a very low term premium, any given amount of monetary policy tightening will lead to an inversion sooner **so that even a modest tightening that might not have led to an inversion in the past could do so today.**

What both are saying is “I´m not too worried about a yield curve inversion”.

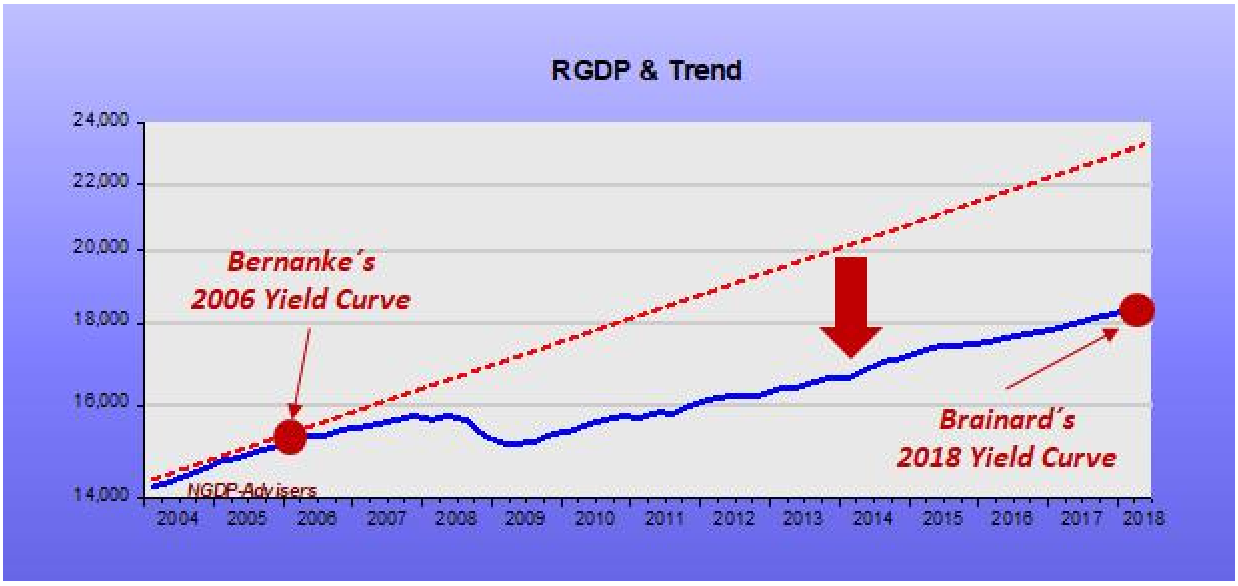
Now, look at what happened one year after Bernanke showed “optimism”.

The yield curve “flipped” and inverted. The rest is history. Some months later, the economy entered a recession and monetary policy, focused on “saving” financial institutions, “killed” the “peasants”, making the recession “Great”.

The chart compares Lael Brainard’s May 2018 yield curve with Bernanke´s March 2006 curve. Bernanke´s was significantly flatter, but also significantly higher. If in 2006 the yield premium was very low, how do you describe it now?



Or, does the low yield curve level reflect a much-weakened economy, as the chart indicates?



Over the coming months, the Fed is sure to give us an answer. After Powell´s show of “humility” yesterday, this is likely, to borrow Charles Plosser´s favorite expression, to come “sooner rather than later”.