

Financial Update—U.S. Banks' Quarterly Interest Rate Review

## Non-U.S. Buying of Treasuries Explains Inverted Yield Curve

Long-Term Yields Could Rise Despite Slowing Business Activity

Despite year-end 2006 consensus forecasts that anticipate an early 2007 easing move by the Federal Reserve's Open Market Committee to stimulate a softening U.S. economy, lower interest rates are far from a certainty. Even with weakening business activity, inflation and dollar difficulties have the potential both to frustrate a Fed easing as well as to push long-term interest rates higher. This is particularly true given the distortions to normal credit market dynamics from heavy non-U.S. buying of U.S. Treasury securities.

Evidence commonly cited for a pending recession includes the inverted yield curve, with 10-year Treasury yields running about 40 basis points below the three-month Treasury bill. The Conference Board uses the yield curve as one of its leading economic indicators, with a negative slope (short-yields higher than long-term yields) taken as a signal for recession. The theory goes that the money markets will trade to an inverted yield curve when they begin to sense an economic downturn.

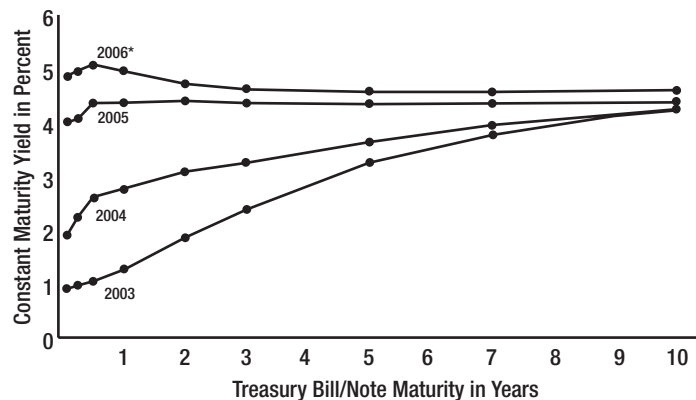
While that often is true, and where real (inflation-adjusted) annual growth rates in a number of indicators such as retail sales and money supply (M2) are consistent with a possible looming recession, other factors have dominated the current yield inversion.

As shown in the graph of year-end yield curves for the past four years, the short-term rates have moved higher by about 400 basis points, based on Federal Reserve tightening that began in mid-2004, but the 10-year yield is little changed, up about 30 basis points for the same period.

*This report was written by Khanh Vuong, senior managing financial analyst, and John Williams, senior business analyst, with A.M. Best. Co.*

Exhibit 1

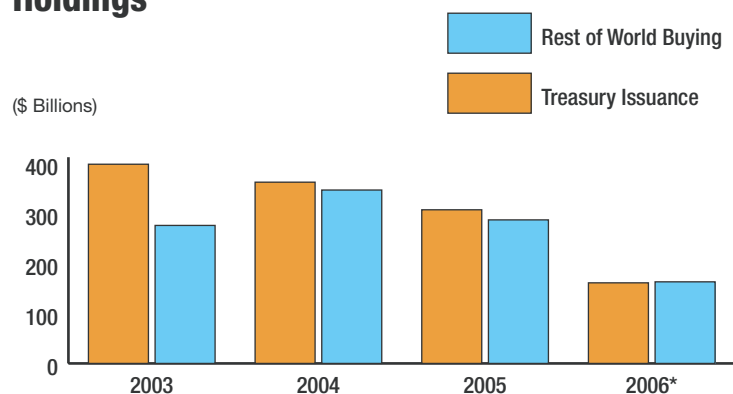
### U.S. Treasury Yield Curve At Year-End 2003 to 2006



\*2006 is as of Dec. 14.  
Source: Federal Reserve Board

Exhibit 2

### Treasury Net Debt Issuance vs. Change in Foreign Holdings



\*Seasonally adjusted annual rate for 3Q06.  
Source: Federal Reserve Flow of Funds



Market fears of recession have not held long-term rates in check as short-term rates were pushed higher. The economy has been reported as booming in recent years. Similarly, a lack of inflation has not held down rates, since average inflation in 2005 was, and 2006 CPI inflation is on track to be, the highest since 2000. What has contained long-term yields is strong demand for Treasuries, based on an extraordinary influx of liquidity into the U.S. credit markets from outside the United States.

The ever-burgeoning U.S. trade deficit has sent a continual stream of excess U.S. dollars into global commerce. Much of that has been returned to the United States through "rest of world" buying of U.S. Treasury securities, as shown in the quarterly flow of funds accounts published by the Federal Reserve. As detailed in the accompanying graph, the latest numbers show roughly 87% of net Treasury debt issuance of the past four years being funded from abroad, often through purchases by central banks holding excessive dollar reserves.

Herein lie the risks to the consensus forecasts of lower rates in 2007. First is inflation. The effects of the explosion in oil prices over the past year or two still are working their way into nearly all aspects of economic activity. Cartel-controlled commodity price inflation does respond readily to a weakening economy, because it is not demand driven.

The second risk is a selloff in the U.S. dollar and declining willingness of investors outside the United States to hold Treasury paper.

With both inflation and the dollar offering upside market pressure on interest

rates, the Federal Reserve could find itself having to raise rates to defend the greenback and/or to fight inflation, despite a less-than-robust economy. The upside pressure on long-term yields could be enough to shift the yield curve to a more normal positive slope.

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**A.M. Best Company**

Ambest Road  
Oldwick, New Jersey 08858  
Phone: (908) 439-2200  
Fax: (908) 439-3296  
[www.ambest.com](http://www.ambest.com)

**A.M. Best Europe Ltd.**

12 Arthur Street, 6th Floor  
London, UK EC4R 9AB  
Phone: (44-20) 7626-6264  
Fax: (44-20) 7626-6265  
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**A.M. Best Asia-Pacific Ltd.**

Unit 5707 Central Plaza  
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