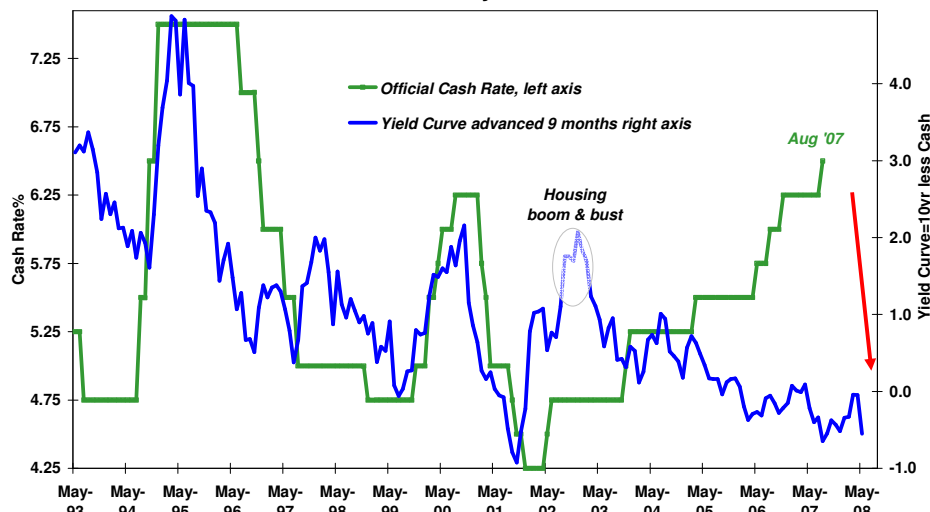


**Red Moon****28 August 2007**

Centuries ago a red moon, caused by a lunar eclipse, helped refute the theory of a flat earth. As the Earth's shadow passed across the surface of the moon the spherical outline gave a clue that the Earth was round not flat. Clues to problems can come from unusual places. Generally the official data from the ABS is the main source used to describe the economic landscape. However it's been a quiet two weeks data-wise – the data drought ends Friday with July's Retail Sales data and the RBA's Credit data. But there are other sources that help you paint the scene if you care to cast your gaze beyond the horizon. One of those alternative places is the price data from the bond market or the yield curve. Now I am not sure if the yield curve is as spectacular as a red moon but it is also exhibiting some interesting behaviour that investors should take notice.

**Yield curve tends to show the way ahead for the official cash rate**

You may recall that the yield curve can be a guide to the economy and monetary policy although for some it may be less obvious than a red moon. As economic activity starts to accelerate, the demand for credit also rises which tends to put upward pressure on market determined interest rates (like bond yields). However, if the central keeps its cash rate target unchanged, then it will have to print more money (create more credit) to prevent short-term interest rates from also rising. The central bank's cash injections will accommodate faster growth in economic activity. The yield curve thus steepens (long-term interest rates rise relative to short-term rates) and this steepening indicates a more accommodative monetary policy. In contrast, suppose the net demand for credit falls, putting downward pressure on long-term interest rates. In order for the central bank to prevent a fall in short-term rates, it would have to extinguish some credit it had previously created. This would lead to a slowdown in the growth of money and economic activity. In this case, a flattening in the yield curve (or inversion with long-term yields below short-term yields) would be indicative of more restrictive monetary policy.

Earlier this month the central bank increased the cash rate again and the yield curve inverted even further making monetary policy even more restrictive. In the process that increased the risk of an economic slowdown. The longer part of the yield curve pulls the shorter part and the cash rate along with it. If an economic slowdown is to be avoided, the central bank will be forced to cut the official cash rate. If it doesn't cut rates or even hikes rates yet again, then along with the moon, financial flags should also be starting to turn red.

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