ANALYSIS-FX market weighs possible inverted yield curve

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By Gertrude Chavez

NEW YORK, July 29 (Reuters) - The increased prospect of an inverted yield curve in the U.S. Treasury bond market could stem the dollar's rally this year, as higher short-term rates signal looming economic weakness, analysts said.

"The economy is at risk if the Fed continues to raise rates, this could be a threat to the dollar," said Axel Merk, president of Merk Investments in Palo Alto, California.

Ashraf Laidi, chief currency analyst at MG Financial in New York, echoed Merk's sentiment, saying a negative yield curve would signal the Fed could pause raising rates and dim the attractiveness of some dollar assets.

Normally yields on long-term bonds are higher than on short-term maturities, reflecting investor desire for a higher return for tying up their money for longer periods.

But when a central bank is in the process of raising short-term interest rates to control inflation, as the Fed is currently, or when a recession is looming, sometimes short-term maturities offer higher yields than long-term bonds, a condition known as an inverted yield curve.

The U.S. Treasury bond yield curve is unusually flat currently, with the yield spread between two-year and ten-year notes falling to a new four year low of only 0.24 percentage points on Thursday, before edging up to 0.26 points on Friday.

Federal Reserve chairman Alan Greenspan has called the flat yield curve a "conundrum" as the U.S. economy is growing at a healthy pace, with no recession looming.

U.S. second quarter GDP rose by 3.4 percent, according to the U.S. Commerce Department on Friday.

Investment banks Merrill Lynch and Credit Suisse First Boston, in recent research notes, have both suggested the U.S. yield curve could invert, provided there is no near-term surge in inflation.

But currency market analysts, who often look to the bond market for clues on the dollar's direction, are divided about the yield curve's impact on the dollar.

In 1989, when the yield curve inverted, the dollar weakened moderately, but in 2000, when the curve also inverted, the dollar rallied for over a year.

"It is not the yield curve that the dollar responds to -- but the Fed's response to the yield curve," Lara Rhame and Umberto Alvisi, vice presidents for Credit Suisse First Boston said in a research note.

"We continue to see the trend of higher U.S. interest rates and their attendant effect on relative U.S. yields as the driving support for the greenback," they said, even if the yield curve inverts.

GREENSPAN DOWNPLAYS YIELD CURVE

In his testimony to Congress last week, Fed chairman Greenspan argued that an inverted yield curve was not always a sign of impending economic slowdown, and said benign long-term inflation expectations and an excess in global savings have kept long term yields low.

Greenspan remained optimistic about U.S. economic growth, cementing market expectations for the fed fund rates to rise to around 4.25 percent from 3.25 percent currently.

Further, based on historical trends, the current Fed monetary policy tightening cycle implies a yield spread of about 130 basis between the two year and ten year U.S. Treasury notes, suggesting the ten year note yield needed to rise to about 5.25 percent from 4.30 percent on Friday, analysts said.

Further rises in short and long term yields would continue to support the dollar's rally, analysts said.

"An inverted yield curve doesn't necessarily mean a recession is coming. The dollar will still be influenced, as it has always been, by the Fed's pace of tightening," said Paresh Upadhyaya, currency analyst and portfolio manager, at Putnam Investments in Boston.

Upadhyaya expects a mild slowdown in the United States at some stage given how much interest rates have gone up, but he said the slowdown would not be as severe as it normally would under previous inverted yield curves.