

What do different yield curve shapes mean?

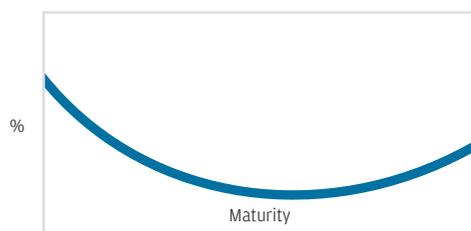
Bonds are issued with different maturities, ranging from the very short term (less than a year) to the very long term (up to 30 years). Bonds of different maturities but the same credit quality, issued by a single issuer, will have different yields, reflecting the perceived risk of investing in them. In general, the longer the maturity of the bond, the higher the risk to the investor, and so the higher the yield. The yields of bonds of equal credit quality but different maturities can be plotted and joined up into a curve. Investors often use the yield curve of a country's government bonds to tell them how the economy of that country is expected to behave.



NORMAL

The market expects the economy to function at normal rate of growth:
No significant changes in inflation or available capital. So, investors who risk their money for longer periods expect higher yields.

e.g. Dec 1984 - middle of longest postwar expansion in the US; GDP growth rates at a steady 2-5%.



INVERTED

The market expects the economy to slow down and interest rates to drop in the future. Long term investors want to take the opportunity to lock in interest rates before they fall even further.

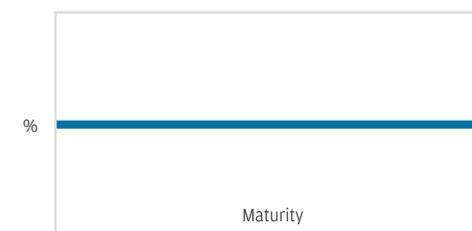
e.g. Recession in the early 1980's. Has become permanent in UK due to excess demand from pension funds.



STEEP

Long-term bond holders expect the economy to improve quickly in the future. Long-term investors fear being locked into low interest rates so therefore demand greater compensation more quickly than the more liquid short-term rate holders.

e.g. Apr 1992 - spread between long and short term treasuries was 5bps. The economy followed, with GDP rising 3% in 1993.



FLAT

The market is at the point of inflection, preceding either a recession or an economic pick-up.

e.g. Nov 1989 - the curve flattened. The economy was in recession by 1991.

Interpreting the yield curve

The yield curve is often viewed as a leading indicator, providing an early warning on the likely direction of a country's economy - for example, the yield curve has historically become inverted 12-18 months before a recession. This is because the slope and shape of the curve reflects investors' expectations about future interest rates, and, by extension, about economic growth.

It's important to remember, though, that there are limitations on what can be gleaned from looking at the yield curve. Yield curves reflect not only interest rate expectations, but investors' attitude to risk and their need for different maturities of bond. In the UK, for example, demand from pension funds for long-dated bonds to match their liabilities means the yield curve has become permanently inverted.

Comparing the yield curves of two different government bond markets is therefore not a reliable way to gauge the potential performance of one economy versus another - particularly when used on its own. But knowing what's normal for the markets in which you invest can help to make the yield curve a more useful tool.

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