

RISK AND RETURN

The Yield Curve

A yield curve shows yields or interest rates along a time axis of comparable bonds with the same credit rating but different maturities.

Governments – next to other issuers, such as corporates – place bonds in the capital markets with different maturities for good reasons: This strategy accommodates demands of different investor clusters with different investment horizons, stretching from very short- to very long-term.

Let's take a brief look at one of the largest sub-segments of the global bond markets: Fixed income securities issued by the United States of America. To be more precise, they are actually issued by the country's Treasury, de facto its Ministry of Finance: Bonds issued by the Treasury - called Treasuries – are classified along different maturities: Treasury bonds or T-bonds have the longest maturity (more than 10 years), T-notes are medium term (2, 3, 5, 10 years maturity) and T-bills are short term (a year or less). Other than T-bonds and T-notes, T-bills do actually not pay an interest but are issued at a discount and redeemed at face value at maturity (so the interest payment is actually paid with redemption of these notes).

Now, the yields offered for T-bonds, T-notes and T-bills differ: Most of the times, longer-dated T-bonds offer a higher yield than, for example, T-bills. The plot of the yields offered by Treasuries along different maturities is called a yield curve. - Such a yield curve exists for any bond issuer of any credit quality who has bonds with different maturities outstanding.

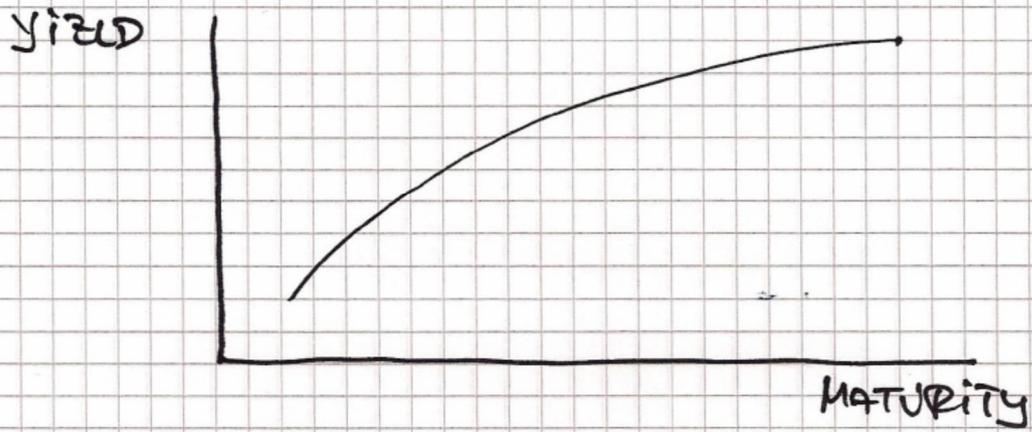
The fact that the yield curve usually slopes upwards along with longer maturities seems to

make perfect sense from an investor's perspective: Even if you believe that the United States Government seems like a credible borrower and will eventually redeem the funds borrowed, there is still a tiny risk that the issuer may not fulfill its obligations. And this risk certainly increases with the length of the maturity of a bond: Who would be able to forecast the state of the world or the U.S. economy in 30 years from today when investing in a 30-year T-bond?

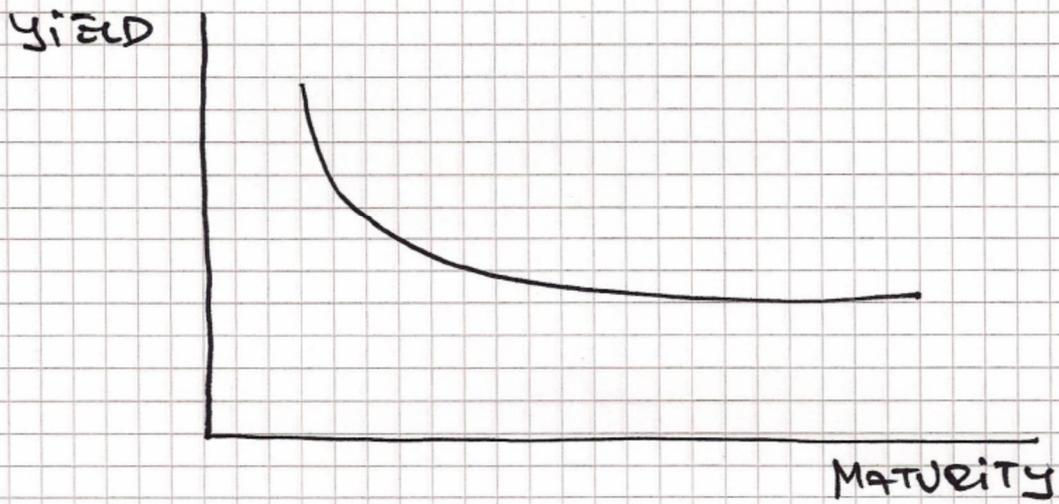
However, sometimes constellations occur, when the shape of a yield curve is flat or even curved downwards. Latter is referred to as an inverse yield curve. - Such unusual patterns are due to the fact that a major part of the risk included in the yield of a bond addresses future, expected interest rate scenarios: If, for example, investors expect overall interest rates to fall substantially over the next years, then a yield curve may even slope downwards.

Downward sloping - or inverse - yield curves can be also be observed in situations when a national bank intervenes in circumstances of a currency having come under pressure. This can have various reasons: For example, the national bank may want to address the issue that investors sell the local currency. This may be because they think that the local currency has become a bad investment. Or they have lost trust in it and therefore exchange it for safer, foreign currencies. Then the national bank may step in by substantially increasing short-term interest rates and by buying the local currency (for which they have various tools available). This will result in an increase in the short end of the yield curve, possibly even in an inverse yield curve. – Having stabilized the market with interventions successfully, eventually the shape of the yield curve should over time get back to normal again.

NORMAL YIELD CURVE



INVERSE YIELD CURVE



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