Yield Curve

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

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

For instance, one of the largest sub-segments of the global bond markets are fixed income securities issued by the United States (actually by the Treasury, its de-facto Ministry of Finance). Bonds issued by the Treasury (i.e. Treasuries) are classified along maturities: Treasury bonds or T-bonds have the longest maturity (more than 10 years), T-notes are medium-term (2, 3, 5, 10 years) and T-bills are short-term (1 year or less). Other than T-bonds and T-notes, T-bills do actually not pay interest but are issued at a discount and redeemed at face value at maturity (so interest is paid with redemption of these notes).

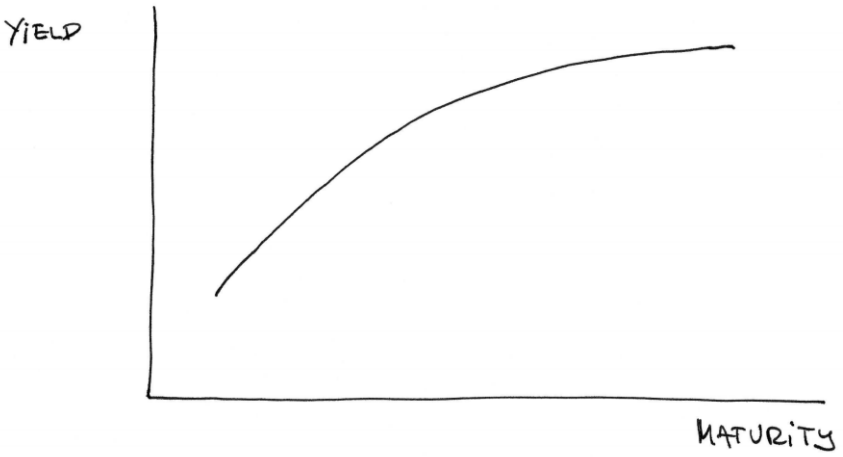
Now, the yields offered for T-bonds, T-notes and T-bills differ: Most of the times, longer-term T-bonds offer a higher yield than, for example, T-bills. The plot of the yields by Treasuries along different maturities is called yield curve. Whereby a yield curve exists for any bond issuer of any credit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

The fact that the yield curve most times slopes upwards along with longer maturities appears to make sense from an investor´s perspective: Even if one believes that the United States Government seems like a credible borrower and will eventually redeem the funds borrowed, there is still a slight risk that the issuer may eventually not fulfill its obligations. Besides, the risk of higher future inflation than current levels (and therefore higher interest rates) may also increase with the length of maturity.

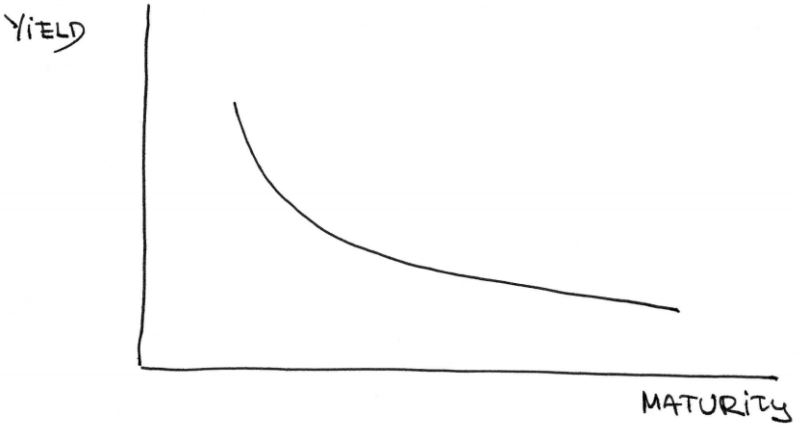
Sometimes, though, the shape of a yield curve is flat. And, even less frequently, it is curved downwards, then referred to as an inverse yield curve. – In almost all cases, such unusual patterns are due to investors expecting interest rates to fall over the years.

In even rarer cases, downward sloping (inverse) yield curves can be the consequence of central banks intervening to support a local currency having come under pressure: Such pressure may have been caused by investors (suddenly) selling a currency, as the respective country and along with it its assets, among them stocks or bonds, are viewed a bad investment. Or, even worse, investors have simply lost trust, as they exchange local currency for safer, foreign ones. In such constellations, the central bank may step in by radically raising short-term domestic interest rates whilst simultaneously also buying local currency (for which various tools are available). These measures to protect the local currency will cause an increase, perhaps even a (steep) hike in the short end of the yield curve, resulting in an inverse shape. – Having stabilized the market successfully, eventually the shape of the curve should get back to normal again.

NORMAL YIELD CURVE



INVERSE YIELD CURVE



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