

## Yield Curve

**A yield curve depicts returns across the maturity spectrum of comparable bonds by the same issuer.**

Governments – next to other, major corporate issuers – place bonds in the capital markets with different maturities for a good reason: This strategy accommodates requirements by different investor clusters focused on 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).

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

The fact that most of times yield curves slope upwards along longer maturities makes sense from

an investor's point of view: Even if one expects that the United States Government – as a credible borrower - will eventually redeem funds borrowed, a slight risk remains that - nevertheless - the issuer may default. Besides, the risk of a scenario with higher inflation at some time in future as compared to current levels (also driving interest rates up) may increase with length of maturity: Also for this reason a yield curve sloping up make sense.

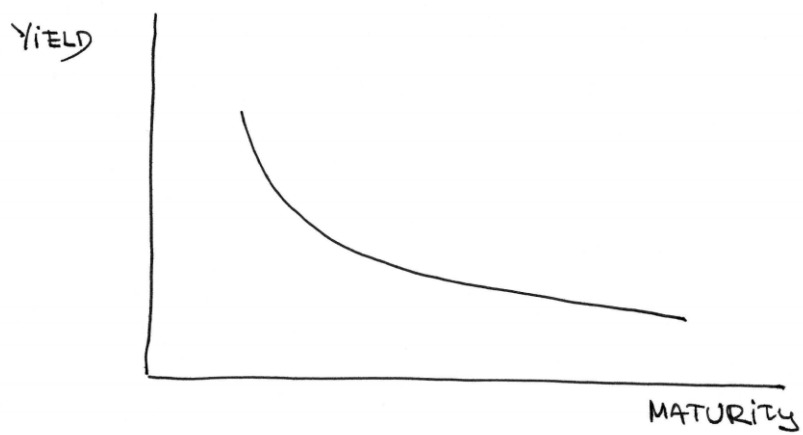
However, by times the shape of a yield curve can actually be flat, and, less frequently, even slope downwards (referred to as: inverse yield curve). – In almost all cases, such patterns are due to investors expecting interest rates to decline over the years.

In rare cases, a downward sloping (i.e. inverse) yield curve is the result of a central bank intervening with the aim to support a local currency which has come under pressure: This may have been caused by investors (all of a sudden) massively selling a currency, due to the respective country - and along with it its assets, among them stocks or bonds - being viewed a bad investment. Or, as may be the case, investors have simply lost trust, as they exchange local currency for safer, foreign ones. In such or similar constellations, a 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 – all aiming to protect the local currency - will lead to an increase, perhaps even a (steep) hike in the short end of the yield curve, in consequence to an inverse shape. – Having stabilized the market successfully, eventually the shape of the curve should get back to normal again.

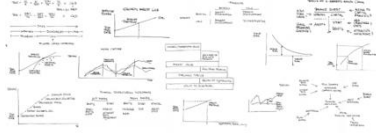
### NORMAL YIELD CURVE



### INVERSE YIELD CURVE

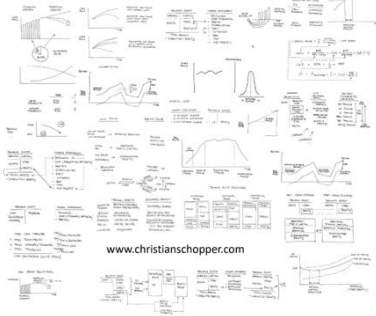


For more concepts click on:



### Corporate Finance Concepts

Christian Schopper



COPYRIGHT [www.christianschopper.com](http://www.christianschopper.com) - NOT COPY OR PASTE