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Throwing Curves at Us

What the heck is the "yield curve" and why is everyone talking about it? Not long ago, no one beyond a select group of economists or investment bankers understood much about the yield curve. Today, it's all the rage: the "flat" yield curve we have and the possibility of an "inverted" yield curve yet to come.

So, what is it? The basic yield curve is simply a graph of the yields currently available on US Treasuries for various maturity dates. Bear with me while I run some numbers. A U.S. Treasury maturing in three months (June 2006) currently yields 4.4%. The six-month treasury is 4.79%, one year 4.84%, two-year 4.78%, five-year 4.82%, 10-year 4.9%, 20-year 5.01%, 30-year 4.89%. If you graph these points and connect the dots, you have the current yield curve for US treasuries. The differential between 4.4% in three months and 4.8% in 30 years constitutes the flat yield curve. Other instruments—CD's, government agency notes, corporate bonds—generate somewhat more generous curves because they carry more risk than a U.S. Treasury security.

If this is a flat yield curve, what is normal? Well, folks, with all due respect, this is economics, and normal is a moving target. We might expect something more akin to the current corporate bond picture that starts just below 5% and moves to 6.2% for the 20-year maturity. Thus, you get a 1.3% increase over 20 years. An increase of 2% would be a lot but it is not unheard of. The point is, we are supposed to have a yield curve. We are supposed to get more yield when we put our money at risk for a longer time.

Why is it flat? Partly, it's because the Federal Reserve controls only two factors touching on interest rates: the fed funds rate and the money supply. (We'll talk about money supply on another day.) The funds rate is the rate banks are charged to borrow money overnight from the Fed. The Fed has increased this by a quarter of a point (.25%) 15 times in the last couple of years. It cannot set or change the rate on the one-year, five-year, ten-year or any other bond. A change in the Fed funds rate would, under normal circumstances, effect a corresponding change throughout the entire yield curve. But then there's the other part: supply and demand. Investors control the rates of the other maturities by buying or selling.

What does a flat yield curve mean? Depends on whom you listen to. Economists, it has been said, share only one thing: a difference of opinion. A flat yield curve has preceded most recessions in the United States since 1950. Since it doesn't look like we are on the edge of a recession, there must be another school of thought. Fed Chairman Bernanke makes the case (and he is the one in charge) that we are in a time of stable inflation and reduced economic volatility. The stage is set, he thinks, for stronger economic activity in the months ahead. Which means: Guard against inflation. And that's no curve ball.

Want to know more? Try this: www.investopedia.com/articles/03/122203.asp