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Bonds & the Yield Curve

By Ed Hynes, CFA

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The bond market is the center of attention these days. For starters, we have a new Chairman of the Federal Reserve Board, Ben Bernanke. He took over last week from the venerable Alan Greenspan, who held the post for over 18 years. Mr. Bernanke is respected and well known, so no one expects major changes. Nevertheless, Ben is not Alan - he has his own views and personality and it will take time for the market to get to know him. Chairman Bernanke's first public appearance is next week on the Hill.

Coincident with the change in leadership, the Fed's interest rate policy is less clear at the moment. Maybe Mr. Greenspan wanted to give his successor a free hand and not commit the Fed to actions after his departure. Whatever the reason, after a year and a half of the Fed clearly telegraphing its intentions, we are somewhat in the dark.

Another issue drawing interest is the bond market's yield curve as it flattens and moves to an inverted state. Understanding and interpreting yield curves is tricky business, so let's spend a little time discussing them.

The yield curve for U.S. government securities is a graph showing their maturities and yields. Generally, just a few maturities are plotted and you can often find a yield curve graph in The Wall Street Journal or NY Times. It is also on free web sites like Bloomberg.com.

To keep this discussion simple we will use just two maturities, 2 and 10 years. To graph a yield curve simply put years along the horizontal axis and yield on the vertical axis. Connect the dots and the result is a yield curve. If the 2-year's yield is 3% and the 10-year's yield is 4.5%, the line connecting the two points has a positive slope, which is considered normal.

Under normal conditions, interest rates are lower for short maturities and higher for longer maturities. Intuitively this makes sense, as it seems there is more risk lending money for 10 years than 2 years.

A yield curve is inverted when short rates are higher than long rates. The market can move from a normal to an inverted state in different ways. First, the curve can flatten or invert if short-term rates go up and long-term rates stay steady; second, if long-term rates fall without a decline in short rates or third, a combination of both.

The current flat yield curve is a result of increasing short-term rates and relatively steady long rates. The Fed has increased short rates from 1% to 4.5% over the past year and a half. These actions have slowly pushed up the yields of other short-term borrowing, but

the 10-year note has barely budged. Earlier this week, the 2-year note had a yield of 4.60% and the 10-year note yielded 4.58%, resulting in a slightly inverted curve.

The fact that the yield of the 10-year note has not moved higher is puzzling and frustrating for the Fed. Some investors may not realize the Fed only controls the Fed Funds rate, which is the overnight rate banks charge one another. It has very little influence over long-term rates. In this case, the Fed's attempt to move long-term rates higher has been like pushing on a string.

If long rates had moved higher, the Fed's raising of short-term rates would have had a greater impact on the economy. For instance, fixed rate mortgages would be higher and real estate would probably be slower. Even Mr. Greenspan is perplexed and called the situation a conundrum, which my dictionary says is an intricate problem requiring conjecture or guesses to understand.

Why do we care? Because inverted yield curves often signal recessions. Luckily, these signals are sometimes false positives.

Investors and policy makers are asking what it means if people will lend money for 10 years instead of 2 years without extra compensation. What do they know? This makes sense if there is little inflation or deflation, will that be the case? How is the yield curve impacted by the globalization of the bond market?

As the market sorts out the answers to these questions, I suspect it will be volatile and short-term rates might go higher than expected. Investors who are exposed to short-term interest rates due to credit card debt and/or adjustable rate mortgages/loans should monitor the situation closely.

Correction: In an article a few weeks ago about tax-qualified saving plans, I made a mistake. In the comparison of 401(k)s to Roth plans I incorrectly stated that 401(k)s were slightly preferable to Roth plans if one's tax rate does not change. In fact, if an investor's tax rate does not change the plans are equal. Vanguard published an excellent report "Tax Diversification and the Roth 401(k)" for readers looking for more information.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.

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