

THE YIELD CURVE TELLS ALL

THE YIELD CURVE CHARACTERIZES THE RELATIONSHIP BETWEEN THE INTEREST RATE ON DEBT AND TIME TO MATURITY. IT IS SEEN BY ECONOMISTS AS AN IMPORTANT TOOL TO FORECAST ECONOMIC OCCURRENCES. SO WHAT DOES IT LOOK LIKE RIGHT NOW?

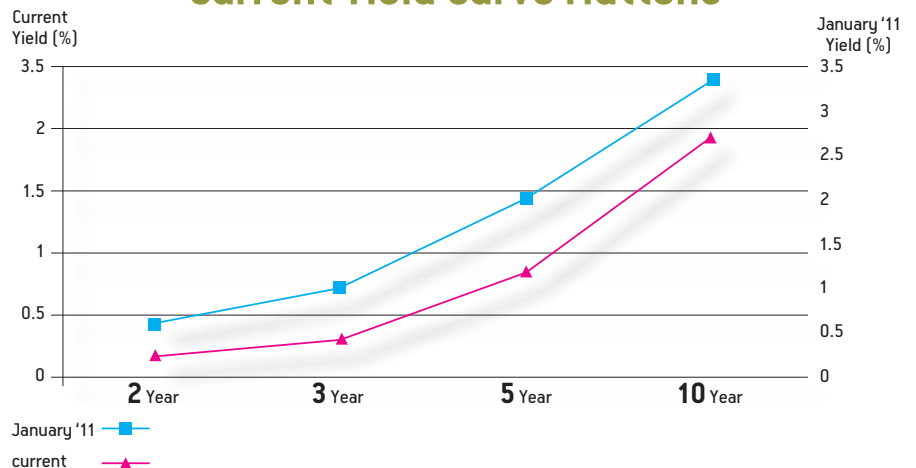
By Persella Ioannides

In a healthy economic environment the yield curve should typically be upward sloping to signify that, as the future economic environment trends favourably, inflation tends to increase. Central Banks can then be expected to increase interest rates on longer-term debt in an attempt to tame inflation. A flat yield curve, where yields on short-term debt are level with those of long term debt, insinuates an uncertain outlook as the curve's slope could revert either positively or negatively. Lastly, an inverted yield curve, where short-term rates are higher than longer-term, signifies a downturn as a deteriorating economy will urge Central Banks to lower short-term rates to spur growth. Since the 1970s, every recession has been preceded by an inverted yield curve, although not every curve inversion has been followed by a recession. To name two recent examples, there were inversions both in 2006 prior to the sub-prime crisis and in 2000 prior to the burst of the dotcom bubble.

So what is the current picture? Positively, the yield curve is upward sloping with the spread between 2 and 10 year debt at around 1.8%, a spread of

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Current Yield Curve flattens



“THE FEDERAL OPEN MARKET COMMITTEE INTENDS TO PURCHASE, BY THE END OF JUNE 2012, \$400 BILLION OF TREASURY SECURITIES WITH REMAINING MATURITIES OF 6 YEARS TO 30 YEARS AND TO SELL AN EQUAL AMOUNT OF TREASURY SECURITIES WITH REMAINING MATURITIES OF 3 YEARS OR LESS.”
BEN BERNANKE, CHAIRMAN



above 2% is typically considered to be steep. The curve has flattened though, as the yield on 10 year treasuries approached the lowest level in six decades as investors became convinced that declining equities and the eurozone debt crisis would prompt the Federal Reserve to enact a new programme of bond purchases (this would have the effect of increasing bond prices, thus lowering yields as yields and bonds prices are negatively correlated). At the time of writing, the expectations are that the Fed will embark on a so-called “Operation Twist” (OT), originally tried during the Kennedy administration in the 1960s, where short-term treasuries are sold and the proceeds used to purchase longer-term debt.

Such a policy will not be seen as boosting the size of the Fed’s balance sheet. This operation will be conducted in the hope that the lowering of longer-term rates, which affect US mortgage and corporate borrowing rates, might

stimulate borrowing and thus also economic activity. It would be performed through two auctions, with the first being a sale of short dated securities and the second the purchase of long dated securities and is seen to be as big as QE2.

The impact, of the Fed’s forecasted action is quite controversial however. Firstly, the operation was considered to be unsuccessful in the 1960s, although the magnitude of the purchases was not significant enough to enable concrete conclusions. Secondly, it is considered to damage the already struggling banks as a positively sloping yield curve is beneficial for banks’ lending activities by borrowing on the short end of the curve and lending on the longer end. If the operation turns successful, however, and loan volume picks up, the banks will be able to benefit from increased volume and will eventually charge higher fees. Thirdly, we are currently experiencing an unprecedented economic environment

engaged by numerous disparate but correlated factors; it is thus very hard to accurately predict the success of such an action. Fourthly, although the magnitude of OT may be on par with QE2, the cash flows will be sterilized and it will effectively have a more muted bearing on economic activity. Lastly, the Treasury must support the policy of the Fed by concentrating on issuance of shorter maturity debt as opposed to long term bonds.

Nonetheless, central bankers and politicians alike need to be inventive, to act fast and to show investors that they still have the appropriate tools to deal with the issues that are tormenting the financial markets. US unemployment still lingers above 9%, the US housing market has yet to pick up, Japan’s economy is struggling and the eurozone is undergoing a critical debt crisis. OT may be one such inventive and proactive move to help revitalize the global economic recovery. **G**

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