

Yield curve

The alignment of interest rates over time.

On a piece of graph paper, draw a horizontal axis and a vertical axis. Along the horizontal axis, mark down intervals of time, 24 hours to 30 years. Along the vertical axis, mark down yields, from the federal funds rate to the 30-year bond. Connect the dots. Voila! You have constructed a yield curve.

Notice that—as of springtime 2013—the curve is upward sloping, i.e., longer-dated securities fetch more than shorter-dated ones do. This positive slope is said to be the norm. And it is the norm for the modern age of paper money.

In the years leading up to the founding of the Federal Reserve in 1913, however, the conventional slope of the yield curve was negative. Money-market interest rates were volatile, but usually pitched higher than long-term bond yields.

A positive-sloping yield curve facilitates borrowing short and lending long. The ability to fund long-term assets with short-term debt lubricates credit formation and speculation. For this reason, among others, an upward-sloping yield curve is associated with expanding economies, a flat or negatively sloping curve with contracting ones.

In the early 1980s, Galen Blomster, an economist with Northwestern National Bank, proposed that the shape of the yield curve was a powerful predictor of real final sales over an 18-month horizon.

In a 1991 paper published in *The Journal of Finance* and entitled, “The Term Structure as a Predictor of Real Economic Activity,” Arturo Estrella and Gikas A. Hardouvelis agreed that the shape of the yield curve does have something to say about the future. “The slope of the yield curve,” they held, “has extra predictive power over and above the predictive power of lagged output growth, lagged inflation, the index of leading indicators and the level of real short-term interest rates.” Still, they judged, the yield curve’s forecasting potency was only relatively superior to that of the other indicators cited: “[O]ne should not lose sight of the fact that the absolute forecasting ability is not great.”

Not since 1953 has the American economy entered a recession while the curve, as measured by the difference between the two-year note and the 30-year Treasury bond, was positively sloped. A question that time alone will answer is whether these trusty rules of thumb still pertain in a monetary regime of zero-percent funding costs and massive central bank purchases of longer-dated securities.

Yield curves can be ridden as well as deconstructed. To “ride the curve” is to buy a security with the intention of selling it before it matures. The idea is to capture the capital gain implicit in an upward-sloping curve. If a three-year note yields more than a two-year note, for instance, that yield differential has embedded within it a price differential. One could buy the three-year security and sell it a year hence, capturing both the coupon and the capital gain, rather than, say, buying and holding a 12-month security in which one would earn the coupon but no capital gain. Of course, the capital gain is hypothetical until it is realized. Nothing says that the yield relationship on which one is speculating has to stand still.

Associated Articles

Jan 13, 2006: Yield curve, where is thy sting?