Contributed by

CI Funds™

PAY ATTENTION TO THE YIELD CURVE

In presentations to investors over the past year or so, the importance of the yield curve has frequently been discussed. Sometimes there have been some befuddled stares or severe cases of MEGO (my eyes glaze over) when this topic was addressed, so it might be useful to review why such a seemingly dull topic could be of great importance to investors.

A quick review of the yield curve is timely as well, since its current message about the prospects for the economy and equity markets is quite positive.

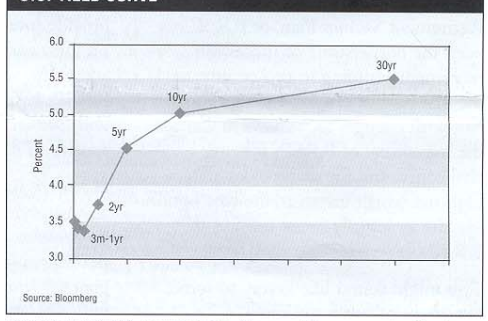
The yield curve is typically presented as a simple chart showing the annualized yield investors receive for loaning out their money for different time periods. The chart shows the yield curve in August for U.S. government securities, and it has a normal positive slope. That is, investors who are willing to part with their money for five or 10 years were receiving yields of 4.5% or 5.0% respectively, compared to a much lower yield of 3.4% for investments in three-month T-Bills. Generally, the slope of the yield curve is positive as investors typically demand more compensation in the form of higher yields for tying their money up for a longer term.

Occasionally, the yield curve inverts, meaning that the yield on longer-term bonds is lower than for shorter-term maturities. An inversion of the yield curve occurred from August 2000 to March 2001.

Historically, the slope of the yield curve – the difference between long-term and short-term yields – has been one of the best leading indicators of the economy. Moreover, it has been especially useful for warning about turning points in the economy, including coming recessions and recoveries.

Campbell Harvey, a finance professor at Duke University, has found that inversions of the yield curve have historically preceded recessions by several quarters, while positive yield curves have been associated with economic growth in subsequent quarters.

U.S. YIELD CURVE



The yield curve for U.S. government securities currently has a normal positive slope, with the yield on long-term bonds higher than the yield on short-term bills.

The yield curve's ability to forecast recessions has been impressive, with the curve having given no false signals over the last 40 years. There is no doubt that the yield curve was preaching caution about the economic outlook a year ago.

This predictive character of the yield curve is partly a result of central bank behaviour. When a central bank is concerned about inflation and economic overheating, it typically pushes short-term interest rates up. Other things being equal, that would tend to flatten or invert the yield curve at the same time that it chokes the supply of credit to the economy and produces an economic slowdown.

In terms of using the yield curve to predict the stock market, it's a little more complicated. Given that corporate profits and stock prices depend heavily on the strength of the economy, an improving economy should lead to higher corporate profits and stock prices.

Harvey's research shows that both economic growth and stock returns tend to be anemic following inversions of the yield curve. In the U.S., the broad market has tended to be flat following yield curve inversions – but has posted annual returns in excess of 13% during periods when the yield curve is normal.

At the time of writing, the yield curve had a normal, healthy, positive slope – pointing to economic recovery ahead. So while the news on job losses and falling corporate profits will continue to be dismal, a key forward-looking indicator is telling us that a recovery is on the way in coming months.

No indicator is perfect, but investing is never about certainty – it is more a business of assessing the odds and making reasonable decisions based on the odds. And history shows that the risk/reward tradeoff for stocks is much better when the yield curve is positive.

By: William Sterling, Global Strategist