

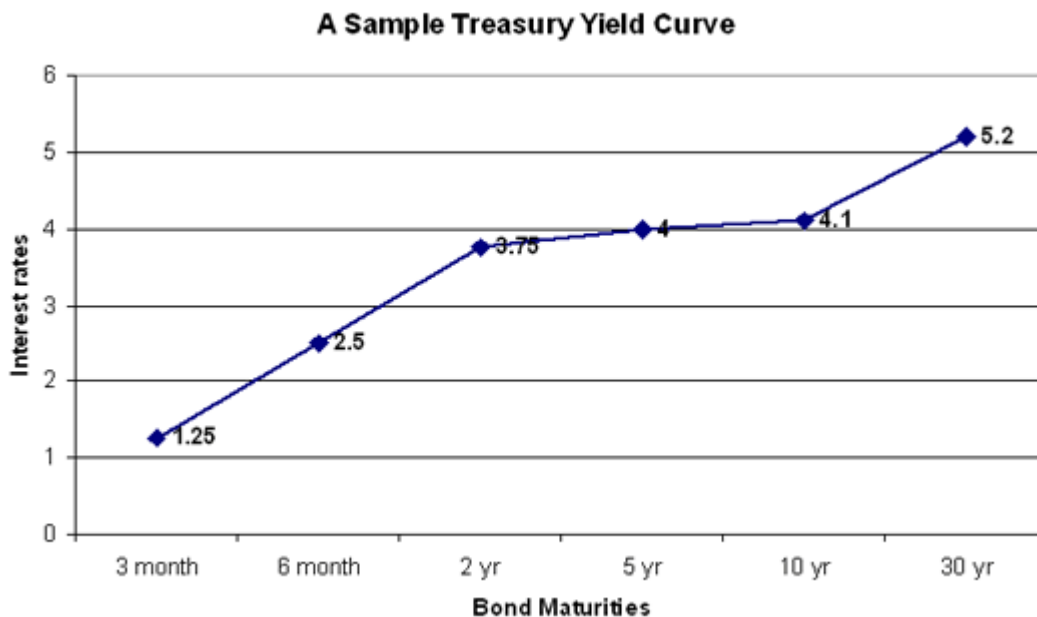
Watching the Yield Curve

What is a yield curve?

Bond maturities and their yields are related. Typically, bonds with longer maturities pay higher yields. Why? Because the longer a bondholder must wait for the bond's principal to be repaid, the greater the risk compared to an identical bond with a shorter maturity, and the more reward investors demand.

If you were to draw a line on a chart that compares the yield to maturity and time to maturity for similar fixed-income securities, you would typically see a line that slopes upward from left to right as maturities lengthen and yields increase. The greater the difference between the yields on, say, 3-month T-bills and 30-year bonds, the steeper that slope.

Yield curves can be plotted for many sectors of the bond market. However, one of the most widely used yield curves is the one that uses Treasury securities, because they have virtually no credit risk and a wide range of maturities.

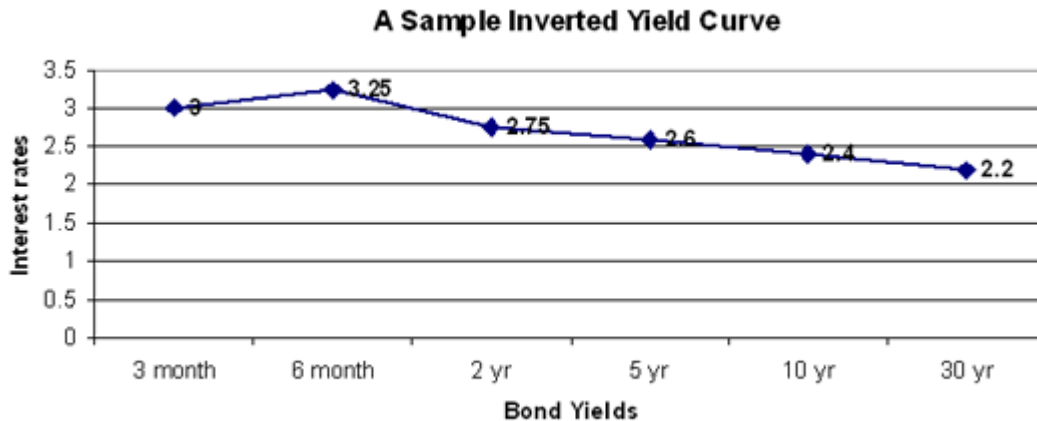


This hypothetical example is not intended to represent actual returns and is intended only as an illustration.

Watching the Yield Curve, cont'd

How the yield curve varies

Though the yield curve typically slopes upward, that's not always true. When there is very little difference between short and long maturities, the yield curve is said to be flat. And sometimes the yield curve can actually become inverted; in that case, short-term interest rates are higher than long-term rates. For example, in 2004 the Federal Reserve Board began increasing short-term interest rates; however, long-term rates didn't rise as quickly and an inverted yield curve resulted.



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The shape of the yield curve reflects not only on how much risk premium investors are demanding for longer maturities, but also investor sentiment and expectations about the direction of interest rates. The shape can change from month to month.

When interest rates for all maturities change by roughly the same amount, a parallel shift in the yield curve is said to occur. The curve's position relative to interest rates moves up or down, but the curve itself does not change shape.

Why is the yield curve important?

The yield curve is often used as a leading indicator of the economic situation. A steep yield curve often occurs when investors expect a faster-growth economy and rising interest rates that would help combat inflation. Because of those expectations, they want greater compensation for tying up their money for longer periods. By contrast, a yield curve that remains inverted for a period of time is believed to indicate a recession may be about to occur. Investors may be willing to settle for lower long-term yields if they believe rates will be headed even lower in the future in an attempt to stimulate the economy. A flat yield curve often signals a transition between economic cycles or economic projections that are relatively stable.

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