How to Understand the Yield Curve

**MANISHA THAKOR:** The Federal Reserve has signaled that interest rates will eventually rise. It may be tempting to conclude that, with diligence and perseverance, you could uncover a way to profit from this knowledge. If you find yourself enticed by this possibility, the question you need to ask is, “What do I know about what the Fed will do that the market doesn’t?” If you’re being completely truthful, you will answer, “Nothing.”

The beauty of the market is that it already incorporates all of our collective expectations about the Fed’s likely future actions in the current yield curve. What is the yield curve? It is a visual depiction of the interest rates at various maturity dates for bonds of the same credit quality. The curve can be upward or downward sloping. (Historically, an inverted yield curve has predicted an economic slowdown.) Unless you’re positive that you are smarter than the market, the yield curve is your best guide for what interest rates will be in the future.

What is the yield curve telling us presently? It’s saying that one year from today, the one-year Treasury rate will rise by 74 basis points.

BAM Alliance Director of Research Larry Swedroe explains it like this: “Today, the one-year Treasury is at 0.25%. The two-year Treasury is at 0.62%. Let’s suppose you think rates will rise, so you decide to keep your exposure short by buying one-year Treasuries with a yield of 0.25%. Alternatively, I decide to buy two-year Treasurys, which currently are yielding 0.62%. After that first year is up, you will have to roll the proceeds from your matured bond into another one-year bond. Forgetting compounding, the math is as follows. Over that two-year period, I will have earned 1.24% in interest (0.62 x 2 = 1.24). By contrast, you have earned 0.25% in interest in year one. To match my 1.24% over the same two-year period, you would need to buy a new one-year bond yielding 0.99% (1.24 – 0.25 = 0.99). So, even if one-year Treasury rates rise by 50 basis points or even 73 basis points, I’d still be ahead given the breakeven point (0.99 – 0.25 = 0.74). The typical investor doesn’t think that way.”

So what is an investor to do? The logical response is to weigh the twin risks of reinvestment and inflation by building out bond ladders with a four-  to five-year maturity. While we expect the Fed to raise rates, our guess of when and by how much is no better than anyone else’s. In fact, the research shows that active managers trying to time bond markets fail with great persistence.

Bottom line, the only way to prosper in a rising-rate environment by staying short is if rates rise faster than the collective expectation. The yield curve tells us precisely what the expected increase is at any point in time. So, unless you have certain knowledge that the Fed will be raising rates faster than the implied collective expectation (in which case the regulators would dearly like to speak with you), rather than spend your time guessing what the Fed will do and when, invest in a carefully constructed bond ladder that reflects your specific liquidity and risk needs