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Curves (part 3) – peaks and troughs

Johann Griener



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Investing for the long or the short term? This is the question bond investors ask. In this blog, we will have a look at German government bonds with a remaining time to maturity of two years (2Y; short) and ten years (10Y; long). More specifically, we are interested in the yield differential between the long- and the short-term interest rates. The technical term here is the “slope of the yield curve”.

German government bonds – slope of the yield curve, long-term assessment

The chart shows the yield for German government bonds with a remaining time to maturity of 10Y (dark blue) vs. those with 2Y (light blue). In addition to the absolute yield, the yield differential is particularly important. In the chart below, this manifests as “peaks and troughs”.

Chart: yield German government bonds 2Y vs 10Y (above); yield differential (below); observation period 20 years. deutsche
Source: Datastream, as of 17 April 2017

The chart clearly indicates that the yield differential (10 Y minus 2Y remaining time to maturity) is not constant over time.

- If the yield for 10Y is clearly above 2Y, the yield curve is referred to as steep – in the chart, this is illustrated by a peak.
- If the yield differential is very low, the yield curve is referred to as flat – in the chart, this is illustrated by a trough.
- If the yield of the short maturity is higher than that of the long maturity, experts call the scenario an inverse yield curve. However, this is a very rare phenomenon and actually never happened during the observation period.

The reason for the changes in the slope of the yield curve:

The slope of the curve is calculated as the difference of the yield for the respective remaining time to maturity of 2Y vs. 10Y. This means a change can come from either end – from the long and the short one.

Usually, different factors affect the two parts of the yield curve:

- The long end of the curve (10Y) is the classic segment of long-term investors such as for example (pension) funds. Fundamental concerns like inflation development and economic performance crucially affect the yield.
- The short end (2Y) is used to a large degree to “park” money. This segment tends to be affected much more strongly by the central bank policies.

Investors usually expect a higher interest rate for longer periods of investment. This is why the yield curve is largely steep (i.e. normal) throughout the observation period.

The lower part of the chart (“Peaks and troughs”) clearly illustrates at what point something extraordinary occurred on the financial markets, because at those times the slope of the yield curve would change drastically. The most recent events happened in 2000/01 (technology bubble, stock market crash) and in 2008 (Lehman bankruptcy, stock market crash). In both cases the short-term interest rates increased rapidly (triggered by the central banks), and indeed more so than the long-term interest rates (i.e. flattening of the yield curve).

As another example in this context, this chart illustrates the yield curve of June 2008:

Chart: yield curve German government bonds, 2-10Y; as of 17 June 2008
Source: Datastream

The yield was almost the same across all maturities on 17 June 2008. So that yield curve really was flat.

Why do investors need this information?

The steeper the yield curve, the bigger the compensation for future risk (especially inflation). In other words, if the yield curve is steep (normal), there are no significant strains in the market, i.e. the asset markets are calm. If the curve flattens a lot, this may be so for several reasons. If the flattening happens quickly, it suggests stress in the financial markets. At these moments, investors prefer to "flee" into cash. (Although very often the best investment opportunities present themselves during stormy times.)

Conclusion:

Peaks and troughs are crucial concepts in the analysis of yield curves. The historical development should also always be taken into account. Interest markets are very efficient, because a large number of market participants with different goals meet in the market place. The slope of the yield curve can offer a very good insight into the status quo of the financial markets.

Yield curve management is part of the active management of the funds of Erste Asset Management.

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Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of Erste Asset Management GmbH and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The "1x1 of Investment Funds" that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on "banks" and "securities". After completing his master's degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: "Only a day with laughter is a good day"