TEVIS
INVESTMENT MANAGEMENT

What is the yield curve?

Over the last several years, rising interest rates have added a layer of stress and uncertainty to many financial decisions. One day you're taking out a mortgage at 2.5%, two years later that rate tops 7%.

While these changes feel stressful, they can also tell us a lot about the state of the overall economy, especially when you look at rates on what's known as a yield curve.

Before we do that, let's quickly recap how the Fed influences interest rates. (You can also read the full article explaining this if you want a more in-depth refresher.)

The Federal Reserve and interest rates

When the Fed raises rates, what they're really doing is raising their target for the federal funds rate—the rate at which banks lend each other money overnight.

When the Fed hikes the target for this rate, they essentially make banks less likely to lend money, or to lend it at a higher rate of interest. Most interest rates are based on this core lending rate, so interest rates tend to increase across the board on things like mortgages and credit cards.

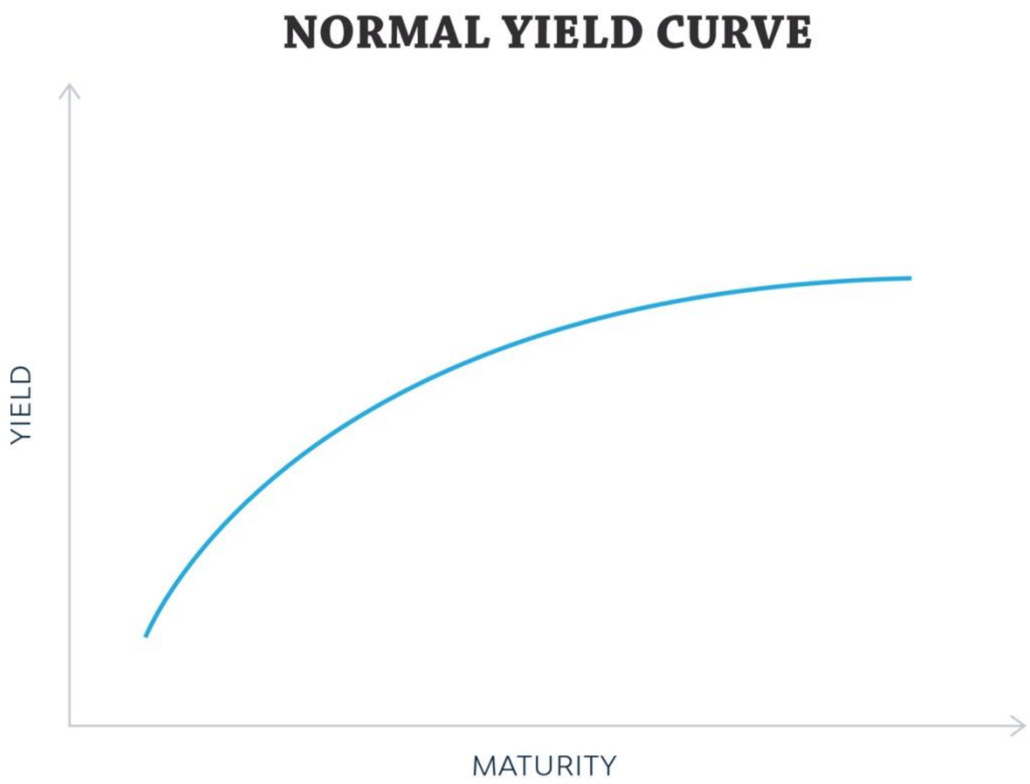
When that happens, folks are less likely to spend money and it can help slow inflation. Higher rates also affect investors. In particular, we're going to look at how rising rates affect the bond market.

Duration and yield, risk and return

In a normal world, shorter-term debt tends to have the lowest interest rate, or yield payment. As the term of the bond increases—from six-month Treasury Bills to 2-year

Treasuries, 10-year Treasuries, all the way up to 20- and 30-year Treasuries—the interest payment, or yield, changes.

That's the yield curve: It maps how bond yields change based on their duration, or time to maturity. A normal yield curve reflects lower rates on short-term debt and higher rates on long-term debt. It looks like this:



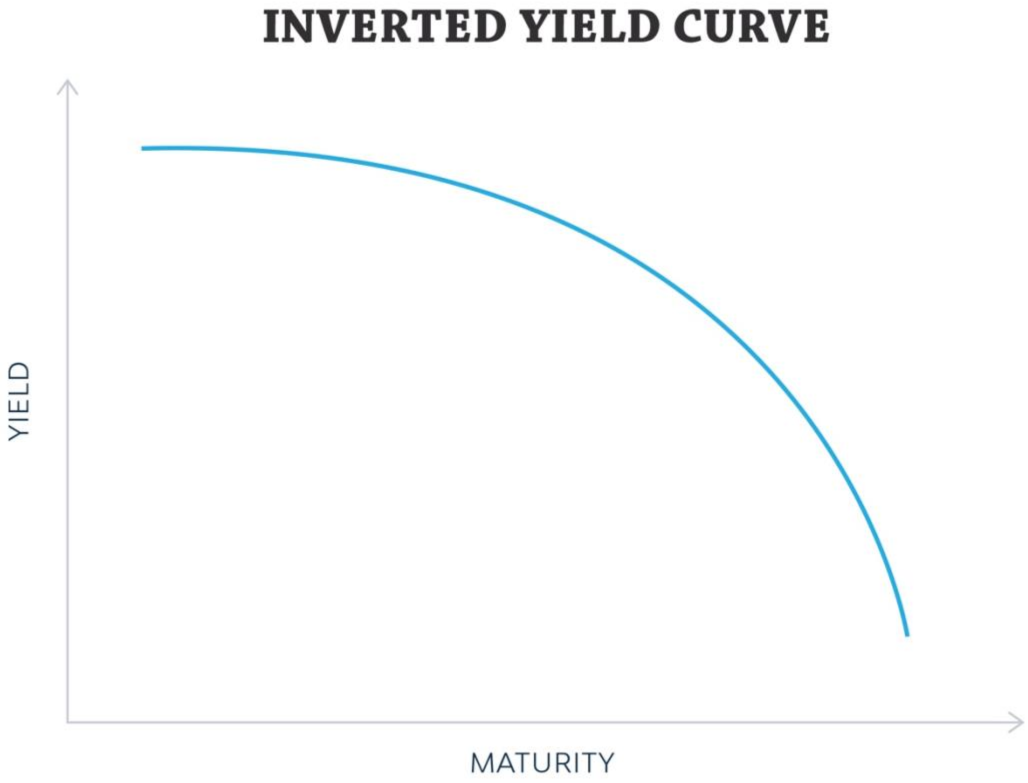
Think about it this way: All else equal, bonds with shorter maturity are considered "safer" because there's less time for something to go wrong. As the duration, or maturity, of the bond increases, higher yields reflect the greater risk involved.

Inverted yield curves: How to predict a recession

Every so often, the yield curve inverts, usually when the Fed is hiking rates. As we mentioned, rate hikes start at the shortest end of the spectrum: overnight lending. This can create a situation where the rate charged on short-term debt jumps. This can make cash equivalents particularly appealing if they're generating a higher yield than normal. (We wrote about that in depth last month.)

However, a rising-rate environment often feels risky for investors, who may seek the safety of longer-term bonds. Buying a longer-term bond is, in a sense, betting that the economy may be rocky for a time but will be better in the future. As more investors buy long-term bonds on the secondary market, the demand drives the price of those bonds up and the yield down.

These factors combine to create an inverted yield curve, where yield on short-term debt is higher than long-term debt. It looks like this:



The way the yield curve inverts can tell us a lot about what issuers, investors, and economists are thinking about the future of the economy. In fact, an inverted yield curve has forecasted every economic recession since the 70s.

Consider 2006: The yield curve inverted and just two years later, the Financial Crisis drove the economy into the Great Recession. The yield curve also inverted in 2018 as the Fed hiked rates, and in 2020, the economy hit a technical recession.

The yield curve inverted again in 2022, and the inversion got steeper in early 2023, leading many economists to predict a recession ahead. Still, even if an inverted yield curve is an accurate indicator for economic trouble, it doesn’t necessarily tell us how soon that trouble might hit or how severe it might be.

While uncertainty nearly always creates stress, downturns happen, and we prepare for that when building your investment portfolios. For now, we recommend staying the course. Reach out if you have any questions or concerns.