

# The Yield Curve - Part I

## What is the Yield Curve ?

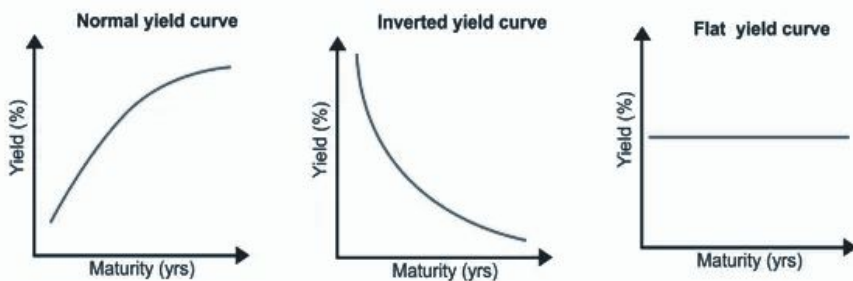
The **Yield Curve** is an important market tool to understand current market conditions and predict future market conditions.

It is the graph between the yields to maturity of different bonds and their respective time to maturity.

When Equity Markets go up we say Markets/ prices have gone up but when Debt Markets go up we say the yields have come down, conversely when the Equity Markets fall we say Markets/ prices have fallen, in the Debt Markets when the markets move down we say the Yields have risen. There is an inverse relationship between bond prices and yields. Bond prices and yields move in opposite directions.

There are 3 main types of **Yield Curve** :

1. **Normal Yield curve** - The **Yield Curve** typically slopes upward because investors want to be compensated with higher yields for assuming the added risk of investing in longer-term bonds.
2. **Inverted Yield curve** - On rare occasions when a **Yield Curve** flattens to the point that short-term rates are higher than long-term rates, the curve is said to be "inverted." Historically, an inverted curve often precedes a period of recession.
3. **Flat Yield curve** - A flat **Yield Curve** indicates very little difference between short-term and long-term rates for bonds.



### What are the factors that affect the **Yield Curve**?

- The shape of the yield curve is influenced by supply and demand
- Inflation
- Economic Growth
- Interest Rates
- Aggressive Monetary Policy

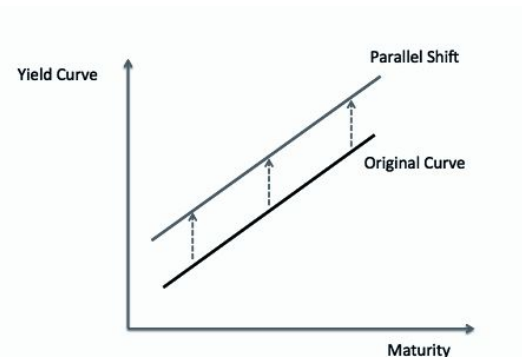
## What causes shift in Yield Curve ?

Sometimes shifts happen in the above basic types of **Yield Curves** due to some monetary policy stances like an accommodative stance to ease liquidity or an aggressive monetary policy to target factors like inflation. Shifts can be parallel or non parallel in nature.

**Parallel Shifts** : When rates across the maturity spectrum change by a constant amount and the slope of the yield curve remains consistent the shift is known as a parallel shift in the **Yield Curve**.

**Non Parallel Shift** : It can result in a **twist, positive or negative butterfly yield curves**.

### Parallel Shift



A **twist** in the slope of the **Yield Curve** refers to the flattening and steepening of the yield curve.

- When the slope of the Yield Curve decreases then it is known as **flattening** of the yield curve.
- When the slope of Yield Curve increases then it is known as the **steepening** of the yield curve.



**Butterfly Shift** : A butterfly shift is a change in curvature or humping of the **Yield Curve**.

- A **positive butterfly** shift occurs when short- and long-term interest rates shift upward by a greater magnitude than medium-term rates, decreasing the overall curvature of the yield curve.
- A **negative butterfly** is a shift in the yield curve where long and short-term yields fall more, or rise less, than intermediate rates.

### How Can an Investor Take Advantage of the Changing Shape of the **Yield Curve**?

Understanding the yield curve gives an idea of what the market thinks about where the economy is going.

Depending on yield curve movements fund managers plan different strategies like roll down strategy, a dumbbell or a bullet strategy to manage their portfolios. Fund managers try to take advantage of yield-curve arbitrage, a trading strategy in which a trader exploits relative mispricings along the yield curve due to high institutional demand for selected maturities, among other reasons.

## Coming UP in Part II ...

So coming up in our next knowledge series would be taking this further and discussing what some commonly used fund management strategies like a Roll Down strategy or a barbell strategy actually mean and how the yield curve helps to decide which strategy to use.