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STERLING'S WORLD REPORT

Why Should Investors Pay Attention to the Yield Curve?

In my presentations to investors over the past year or so, I have frequently talked about the importance of the yield curve. Sometimes I have seen some befuddled stares or severe cases of

MEGO (my eyes glaze over) when I have addressed this topic, so I thought it might be useful to review why such a seemingly dull topic could be of great importance to investors.

I also believe that a quick review of the yield curve is timely as well, since the yield curve's current message about future growth and equity market prospects is quite positive at the moment – in great contrast to much of the doom and gloom currently being served up by the financial media. We all know the global economy has slowed and that current profits are awful – that's already reflected in market prices. The key is

where the economy and profits will be headed in the future, and that's where the yield curve comes in handy.

Using a question-and-answer format, I will start with the basics and then discuss what the yield curve is telling us now.

Q. What is the yield curve?

A. The yield curve is sometimes called the term structure of interest rates, and is often presented as a simple chart showing the annualized yield investors receive for loaning out their money for different time periods. These can range from overnight to as long as 30 years in the case of some government bonds. Most often, analysts look at the yield curve in terms of government securities, since there should be (in theory) no problems with credit quality that could distort the picture.

Chart 1 shows the current yield curve for U.S. government securities, and it has a normal positive slope. That is, investors who are willing to part with their money for five or 10 years currently receive yields of 4.5% or 5.0%, respectively, compared to a much lower yield of 3.4% for investments in three-month Treasury bills. Most of the time, the slope of the yield curve is positive because investors typically demand compensation in the form of higher yields for tying their money up for a longer term.

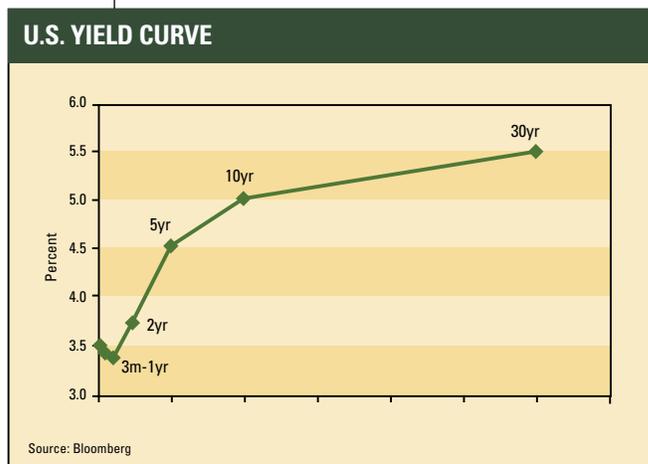


Chart 1. The yield curve for U.S. government securities currently has a normal positive slope, with the yield on long-term bonds higher than the yield on short-term bills.



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Occasionally, however, the yield curve inverts, which means that the yield on longer-term bonds is lower than on shorter-term maturities. An inversion of the yield curve, measured by the difference between five-year U.S. Treasury bond yields and three-month Treasury bill yields, occurred last August and lasted until March this year.

Q. Why should equity investors care about the yield curve?

A. There are several reasons equity investors should pay attention to the yield curve. Obviously, if the entire curve is moving up and interest rates are rising, that can be bad news for stock market investors. That's because money market funds and bond market funds will then offer attractive rates of return that may draw money out of stocks. So stock valuations have tended to be low when interest rates are high, and vice versa.

But the slope of the yield curve – the difference between long-term and short-term yields – can also be extremely important to stock investors for a simple reason. Historically, the slope of the

yield curve has been one of the best single leading indicators of the economy. Moreover, it has been especially useful for warning about turning points in the economy, including coming recessions and economic recoveries.

Campbell Harvey, a finance professor at Duke University (www.duke.edu/~charvey), has done extensive research into the yield curve's power as an economic forecasting tool. His research has found that the yield curve provides more accurate forecasts than most professional forecasting services that rely on detailed computer models of the economy based on hundreds of equations and thousands of hours of analysts' labour. To my former economist colleagues: Sorry about that.

Q. Can the yield curve predict recessions?

A. As shown in Chart 2, inversions of the yield curve have historically preceded recessions by several quarters, while positive yield curves have been associated with economic growth in subsequent quarters.

Indeed, the yield curve's ability to forecast recessions has been quite impressive, with the curve having basically given no false signals over the last 40 years. Even though the jury is still out on this particular economic episode, there is no doubt that the yield curve was preaching caution about the economic outlook a year ago, precisely when many corporate managers were still talking about outstanding "visibility" for future profits based on their bulging order books.

Q. Why should the yield curve have any predictive power?

A. There are two reasons – one based on central bank behaviour and the other based on investor behaviour.

Short-term interest rates are highly influenced by central banks. When a central bank is concerned about inflation and economic overheating, it

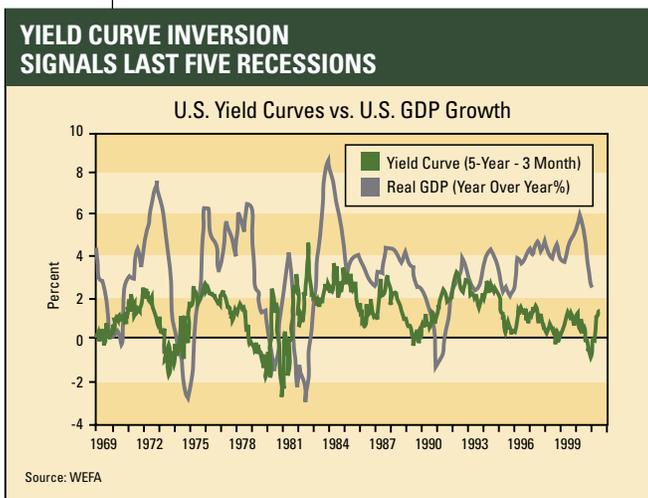


Chart 2. Inversions of the yield curve have almost invariably preceded recessions or significant economic slowdowns.



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typically tightens monetary policy and pushes short-term interest rates up. Other things being equal, that would tend to flatten or invert the yield curve at the same time that it chokes the supply of credit to the economy and produces an economic slowdown.

Long-term interest rates are determined more directly by investor behaviour. If investors are risk averse (and I don't know too many who are not), they tend to flock toward the safety of bonds when they sense that an economic downturn is on the horizon. That tends to push long-term interest rates below short-term interest rates when a recession is approaching.

Essentially, this makes the bond market a round-the-clock forum on whether the economy is likely to accelerate or decelerate, one that is based on the interaction between powerful central banks and millions of investors who have real money at stake. The yield curve is therefore a simple tool for reading the collective mind of the market, which has done a surprisingly good job at spotting downturns on the horizon.

Incidentally, Prof. Harvey and other researchers have found the stock market to be much less

reliable as a leading indicator for the economy than the yield curve, leading to the joke that "the stock market has predicted nine of the last five recessions."

Q. Can the yield curve predict the stock market as well?

A. That's a trickier question. If the yield curve were a perfect leading indicator for the stock market, there would be a lot more millionaires around than Regis Philbin could imagine.

But if the yield curve can predict the economy, it should be of some use in gauging the overall risk/reward potential of the stock market as well. That's because both corporate profits and stock prices depend heavily on the strength of the economy. So if the economy is likely to improve, so too should corporate profits and stock prices.

As shown in Charts 3 & 4, Prof. Harvey's research shows that economic growth has tended to be anemic following inversions of the yield curve. Not surprisingly, stock returns tend to be anemic as well following yield curve inversions. In the U.S., for example, the broad market has tended to be flat following yield curve inversions but has posted annual returns in excess of 13% during periods when the yield curve is normal.

This is no guarantee that stocks will do well during periods when the yield curve has a normal positive slope, but recent research does suggest that the risk/reward tradeoff for stocks is much better during periods when the yield curve is positive.

Q. Does the U.S. yield curve matter for overseas markets as well?

A. Yes, and to a surprisingly powerful degree. Because the dollar is the key currency of the global financial system, U.S. Federal Reserve policy has a powerful influence on stock markets around the world. This is especially true for small

STOCK PRICE PERFORMANCE NORMAL VERSUS INVERTED YIELD CURVE

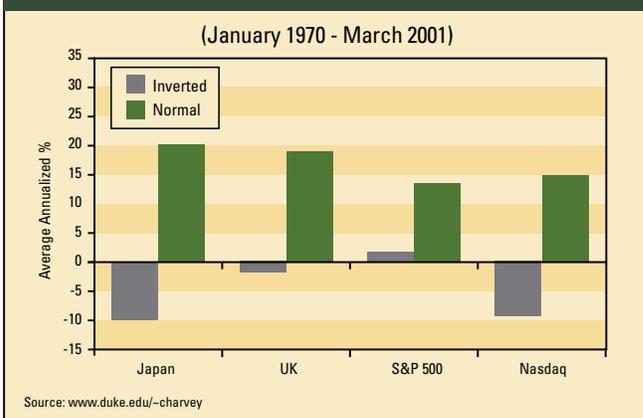


Chart 3. Major market stock indices have tended to provide anemic or negative returns following inversions of the yield curve.



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markets like Hong Kong that are heavily dependent on trade with the U.S., but it also applies to other major markets like Japan and Europe where international economic linkages continue to matter as well.

Q. So what is the current message of the yield curve?

A. Despite the financial media's current fixation with gloomy news about corporate profits and layoffs, the current message from the yield curve is quite positive. At the time of writing, the yield on three-month U.S. Treasury bills is 3.45%, while the yield on five-year U.S. Treasury bonds is more than one percentage point higher at 4.52%. That means that the yield curve has a normal, healthy, positive slope and points to economic recovery ahead.

According to a model developed by Harvey, the positive indication from the yield curve that came earlier this year is pointing to a likely recovery in the economy beginning around the end of the current quarter. In Harvey's opinion, the key message from the yield curve is that the current slowdown is likely to be short-lived.

So if history is any guide, the worst of the economic slowdown and slump in profits is probably over by now – even if the view out the rear-view mirror is ugly. And with the Fed widely expected to ease one or two more times in coming months to ensure that a recovery takes hold, the message from the yield curve should continue to be positive for quite some time to come.

To be sure, no indicator is perfect and “this time could be different.” But investing is never about certainty – it is more a business of assessing the odds and making reasonable decisions based on the odds.

We think a reasonable view at the moment is that the world is not coming to an end. We expect that the next six to 12 months will bring an economic recovery and positive stock returns. We also believe that the global economy will recover, with the U.S. economy leading the way. And we are positioning our funds accordingly.

I hope this discussion yields some useful insights. Enjoy the rest of the summer and I look forward to seeing many of you in the fall.

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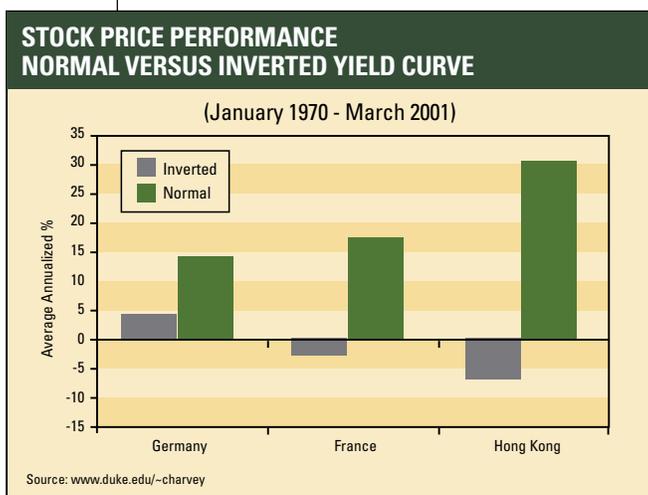


Chart 4. International markets have also been heavily influenced by the U.S. yield curve, with inversions of the curve tending to lead to poor stock market returns.