Chartwell Consulting

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Interest Rate Risk

The inverted yield curve has traditionally been the harbinger of a weak economy, which is hardly good news for investors. But, a flat or even inverted curve makes current fixed-income investment decisions much easier.

A flat or inverted yield curve doesn't happen that often — the last truly flat one was in 1989, and the last inverted curve was in 1981. It is an economic anomaly because it assigns little or no risk premium to the passage of time, since short-term investors reap the same or higher coupon returns as do long-term investors. Ordinarily the passage of time carries risks – of defaults, of rising interest rates (i.e., falling bond prices), of political instability — all of which logically "should" be compensated for with higher yields. Traditionally, only when investors feel the economic future is likely to be worse than the present, *and market interest rates lower*, will they readily accept flat or lower yields today for a longer term commitment of their money.

This makes the current flat yield curve even more anomalous, because interest rates are already low by most standards. If you're willing to accept low long-term rates because you believe the economy will be so weak that yields will fall even further, then just how low do you think they'll go? It's one thing to buy into a flat or inverted yield curve when long-term rates are 10% or more, as they were when the yield curve inverted in 1981. But with 10-year yields at about 4.4%, it's hard to imagine them dropping much more. The 10-year Treasury briefly touched on 3.11% in the summer of 2003, but before that you have to go all the way back to 1962 to find 10-year rates below 4%. Do you really feel the need to lock in today's low yields for the next 10+ years?

There's something else peculiar about today's fixed-income market: The yield differential between risk-free Treasury bonds and higher-risk alternatives has generally never been narrower. This is true of not just junk bonds, but investment-grade corporate bonds, emerging-market debt, various forms of real-estate investment trusts and even energy partnerships. Some market strategists make the case that every category of yield-oriented assets is either highly overvalued or overvalued by historical standards, with the possible exception of municipal bonds.

Our suspicion is that today's bond buyers aren't making any prediction about the future health of the U.S. or global economy, which actually looks fine at the moment. The creditor nations, China foremost among them, have simply shown a voracious appetite for U.S. debt securities, and appear to be all but indiscriminant in their buying, both in terms of duration and quality. Perhaps their bond portfolios are now so massive and diversified that it doesn't really matter. They can hold everything to maturity, easily absorb a few defaults, and plow fresh billions into new offerings should interest rates rise.

For the rest of us, this actually simplifies our lives rather dramatically. Last week I needed to rebalance my portfolio and add some fixed income to the mix. Never has the task been easier. I simply bought a ladder of one- two- and three-year certificates of deposit. The rate difference was marginal: 4.2% for the one-year, 4.5% for both the two- and three-year CDs. Such short maturities will fluctuate very little in market value each quarter, and effectively carry no risk of default. With the flat yield curve I gave up virtually nothing in current yield.

How does this relate to institutional investors? Directly, we think. Institutions increasingly need to be very careful allocators of risk budgets. Each investment portfolio must offer sufficient relative return potential in exchange for its contribution to overall program volatility. Today, the portion of your fixed income portfolios invested in 10+ year paper is capturing very little current return premium in exchange for 2-3 times the potential price volatility (i.e., much higher duration). That's only a good bet if the price "risk" is all to the **upside**.

A focus on the shorter end of the yield curve has cost about 25 basis points of total return this year, due to what Alan Greenspan refers to as the conundrum of rising short-term rates and flat or falling long-term ones. We see that scenario as temporary, and ripe for reversal. Someday the curve will steepen, spreads will increase, and our investment options will again be far more complicated. For now, shorter-term bonds earning a virtually risk-free 4.5% current return look pretty good.

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