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What's In A Curve?

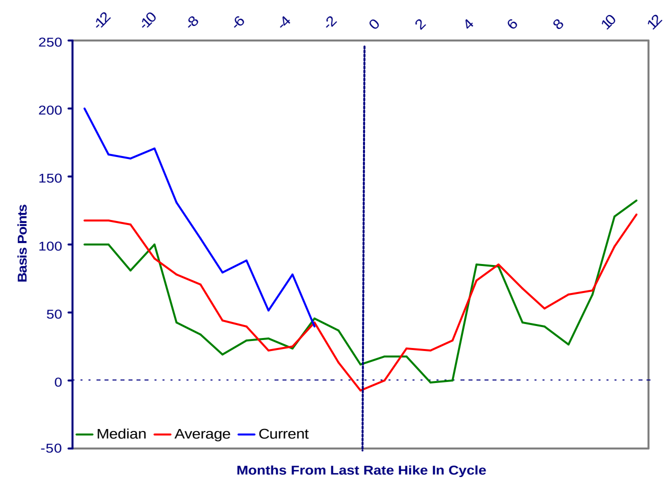
The word "curve" conjures up different images for different people. For some, a curve may signal a pending turn in a road. For students, and even some CFA candidates, a curve may offer hope of passing an exam. But for bond professionals, a curve means only one thing-a yield curve!

The yield curve is a line that connects the yields of all of the recently issued ("on-the-run") US treasury securities in maturity order from the shortest maturity to the longest maturity. A normal yield curve is positively sloped-meaning that the yield of longer maturity treasuries is higher than the yield of shorter maturity treasuries. In fact, over the past 50 years, the 10-year treasury yield on average was 133 basis points higher than the 3-month treasury yield. The implication is that investors usually require some extra yield to buy a bond with a longer maturity.

So, what's in a curve today? Not much. The yield curve has flattened significantly as the 10-year treasury yield is now only 18 basis points above the 3-month treasury yield. If current yield trends continue, the yield curve will soon be inverted, meaning that 10-year yields will be lower than 3-month yields. This is not "normal." Even more dramatic, the 30-year yield is only 37 basis points higher than the 3-month yield. The yield curve has "flattened" in response to the Federal Reserve increasing short term interest rates 13 times this current interest rate cycle.

Today's flat/inverted yield curve is now getting significant attention in the press. Everybody seems to be talking about it. In fact, even my allergist could not resist asking me about "this new curve!" While the press is portraying the flat curve as big news, it is not news to us. For the past two years we have positioned our portfolios for a flattening yield curve. Now, as the media chatter gets louder, we are beginning our analysis and preparation for the flattening to end and a steeper curve to follow.

Let's use history as a guide for the proper timing of a cyclical change. Our Quantitative Strategist, John Lohman, examined data for the past 50 years. He found that the yield curve has reacted to Fed policy in a remarkably consistent pattern. The following chart tracks the average yield spread between the 3-month and the 10-year over the course of the nine tightening cycles since 1955. As shown, the pattern has been one of dramatic yield curve flattening during times of tighter Fed policy, followed by equally dramatic curve steepening once the Fed has finished raising short-term interest rates. More specifically, the curve (as measured by the 3 month/10-year yield spread) has flattened an average of 125 basis points in the 12 months prior to the Fed's final rate increase and steepened an average of 130 basis points over the subsequent 12 months.



Thus far, the current interest rate cycle has closely followed this script. Now, many economists are forecasting March 2006 as a stopping point for the current tightening cycle. The curve has flattened substantially over the last 12 months and the difference between short and long rates is consistent with this point in the interest rate cycle.

Does this mean the yield curve will continue to flatten for precisely three more months, pause as the Fed completes its final interest rate increase, and then steepen with the 3 month/10-year yield spread increasing exactly 130 basis points over the subsequent 12 months? Mark Twain reportedly once said, "History doesn't repeat itself, but it does rhyme a lot." So, while history does not generally repeat with such precision, the probabilities are certainly in favor of such a general outcome! Thus, we at Davis Hamilton Jackson and Associates will be ready for what will soon be a new yield curve steepening cycle.

For our bond portfolios, this means we will gradually take off the "barbell" trade that we have enjoyed for almost two years. Our barbell trade led our portfolios to be positioned with large percentages in shorter maturities and longer maturities while having little exposure to the middle of the curve. This worked well as the yield curve flattened. Now, we will gradually extend the shorter maturities and reduce the longer maturities in favor of securities in the middle of the curve. We will implement this move over the coming months in anticipation of a curve steepening in the second half of 2006.

On the equity side, the scenario is a little different. Stocks usually have a difficult time through the last bit of tightening. Therefore, we believe the equity market will remain generally range-bound for the first half of the year. In fact, there could be a downward bias in the first quarter, as sentiment has become overwhelmingly bullish again. Some sort of pullback is in order. If the yield curve forecast plays out as anticipated, we are very optimistic about stocks in the second half of the year. Best wishes for a happy, healthy, and peaceful New Year.

Gilbert A. Garcia, Principal
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A copy of our Form ADV, Part II is available upon request.
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