

Concept Corner

Yield Curve

Yield Curve

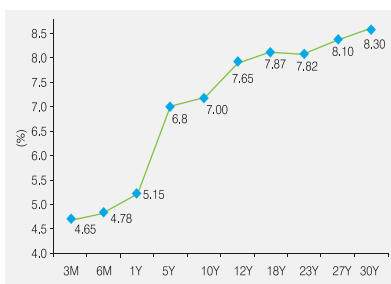
You have heard the fund manager talk about it, you have heard it mentioned on your favorite business channel, but you might not have understood what it really was. It is important to know how to read a yield curve as it can give you insights on where the interest rates are headed in the near future.

At first let's understand, what is meant by 'Yield' of a fixed income security. In simple terms, Yield is the interest income which you receive on a debt instrument and is expressed in percentage terms on an annual basis. Let's say your savings bank pays you an interest rate of 3.5% per year. It simply means that your savings bank account pays you 3.5% yield. To extend this further, a yield curve is nothing but a graphical representation of bond yields of same credit quality but with different maturities as the one seen below.

Period	Yield to Maturity	Period	Yield to Maturity
3 Months	4.65%	12 Years	7.65%
6 Months	4.78%	18 Years	7.87%
1 Year	5.15%	23 Years	7.82%
5 Years	6.80%	27 Years	8.10%
10 Years	7.00%	30 Years	8.30%

A Graphical Representation of Yields

Yield curves are more commonly used by fixed income analysts, who analyse bonds and are looking for trading opportunities. The most commonly used yield curve is the one plotted using yields of Government Bonds of different maturities (as shown in the above table).



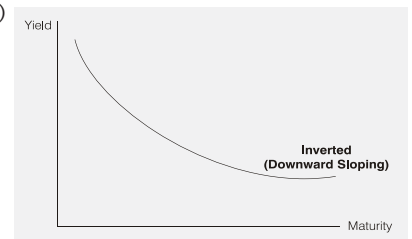
Normally, yield curves are upward sloping which means that as you go higher on tenure, you get a higher yield. Simple explanation for this is; an investor who locks his investment amount for a longer tenure carries

higher risk, hence may be rewarded by a higher return. From an economic perspective, it means the positive growth of the economy and rise of interest rates in the near future.

Besides the normal upward sloping yield curve, the yield curve graph can also be downward sloping, Steep or Flat / Humped.

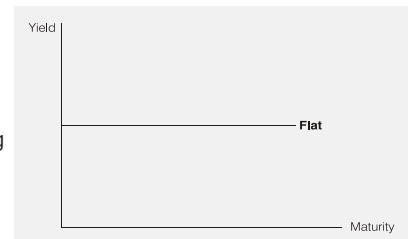
Downward Sloping Yield Curve

A downward sloping (inverted) yield curve occurs when long-term bonds yield less than short term bonds. An inverted yield curve indicates worsening of the economic situation and fall of interest rates in the near future.



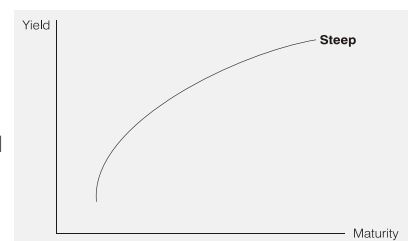
Flat Shaped Yield Curve

A yield curve is called flat when there is little difference between the short and long term rates and medium term yields are higher than the long and short term yields. It indicates uncertain economic conditions.



Steep Yield Curve

A yield curve is called steep when the long term bonds yield much more than the short term ones. The slope of the curve is greater compared to normal yield curve. It is an indication of revival of the economy and as demand returns to the market, it also tells us that the market expects interest rates to rise in future.



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