6.7: The Yield Curve

The Yield Curve refers to a graph of interest rates on securities with different times to maturity. The Yield Curve is designed to illustrate the difference between long-term and short-term interest rates. From our discussion above on determinants of interest rates, we know that the two factors that are likely to be different on bonds with different maturities are the maturity premium and the inflation premium. The longer the time to maturity, the greater the maturity premium will be. The inflation premium will depend on inflation expectations. The normal shape of the yield curve is upward sloping (due to the maturity premium). If we see a steep upward slope (more than a 1-2% yield difference between short-term and long-term bonds), that indicates that investors anticipate rising inflation (and, in turn, interest rates) in the future. If we see a flat or declining yield curve, that indicates that investors anticipate declining inflation (and interest rates) in the future. Since inflation typically slows in a recession, a downward sloping yield curve is an indicator of a potential recession. However, we must be careful. The economy is very complex and depends on hundreds of different influences. While a downward sloping yield curve is an indicator of a potential recession it does not mean there WILL be a recession – only that a recession is more likely than it would be if we had an upward sloping yield curve.

Another thing to stress on the yield curve is that things like the default risk and liquidity risk should be held as constant as possible along the yield curve. In other words, you would want to draw a yield curve entirely with Treasury bonds or entirely with BB-rated corporate bonds, but not with a mix of these bonds.

To view the current yield curve, see the following link:

Vanguard Funds Bond Yield Chart