Put Down the Barbell and Choose Your Bullet
Strategies for a Changing Yield Curve

As I write this article, the US Treasury yield curve sports a higher yield for short three-month paper than it does for a ten-year commitment. The inversion is not great, but it does exist. A key prop to bank earnings — borrow short, lend long — is now of no benefit. Rather than bemoan the fact, this article explores the options available to profit from the next change in the curve.

Since the spring of 1953 (the extent of the data available from the Federal Reserve), the spread between the ten-year Treasury and the three-month Treasury has been negative for only 78 months or roughly one-eighth of the time. The longest stretch of inversion was from late 1978 to early 1980 during the inflationary blow-off related to the Iranian hostage crisis. Most episodes lasted a year or less. This suggests that the current flat to inverted yield curve is likely to steepen by the end of 2006. The question: how to position the portfolio for the expected movement.

Of Ladders, Barbells, and Bullets

The classic approach to community bank investment portfolios is to build a ladder with some maturities short (up to one year), some intermediate (two to five years), and some long (seven to 15 years). The average life (or duration if you prefer) of the entire portfolio usually ranges between two and four years, depending on how bullish or bearish the portfolio manager is. A ladder of this type is neutral on the shape of the yield curve. The underlying assumption is that all interest rates, regardless of maturity, will move by roughly the same amount.

What if you believe that the yield curve will not move in a parallel fashion? Two options are available. If you feel the curve will flatten or invert, the correct choice is a barbell. A barbell would place portfolio assets short and long but stay away from the intermediate term. That way, the bank would profit from reinvesting cash at rising short rates while being anchored by the higher starting yield afforded by long rates. This was the perfect strategy to employ starting in mid-2004 as the Federal Reserve began to tighten.

Were you to predict a steeper yield curve, a different approach would be needed. This is where a bullet strategy works best. A bullet strategy targets an intermediate maturity, both avoiding the expected decline in short rates and the rise in long rates that is implied by a steeper yield curve. If interest rates were to reverse course and return to late 2004 levels, a three-year maturity would benefit both by a higher coupon and some modest appreciation. Maturities less than one-year would be forced into reinvestment at less than current rates, and long-term choices would face possible market value deterioration.

Bull or Bear: Where Is the Pivot Point?

Once one decides that the yield curve is likely to steepen, a key decision on how the steepening is expected to unfold presents itself. There are three ways that we could find a steeper yield curve a year down the road. First, the Fed could reverse course and begin to aggressively ease based on a weaker economy and the impending election cycle. In this case, intermediate rates would begin to fall while long rates would stay range-bound. Second, the Fed could ease modestly while long-term rates rose. And finally, the Fed could stop tightening while the market changed its view and pushed up intermediate and long rates in response to a shock like a weaker dollar or a terrorist attack that shut down oil production, etc.

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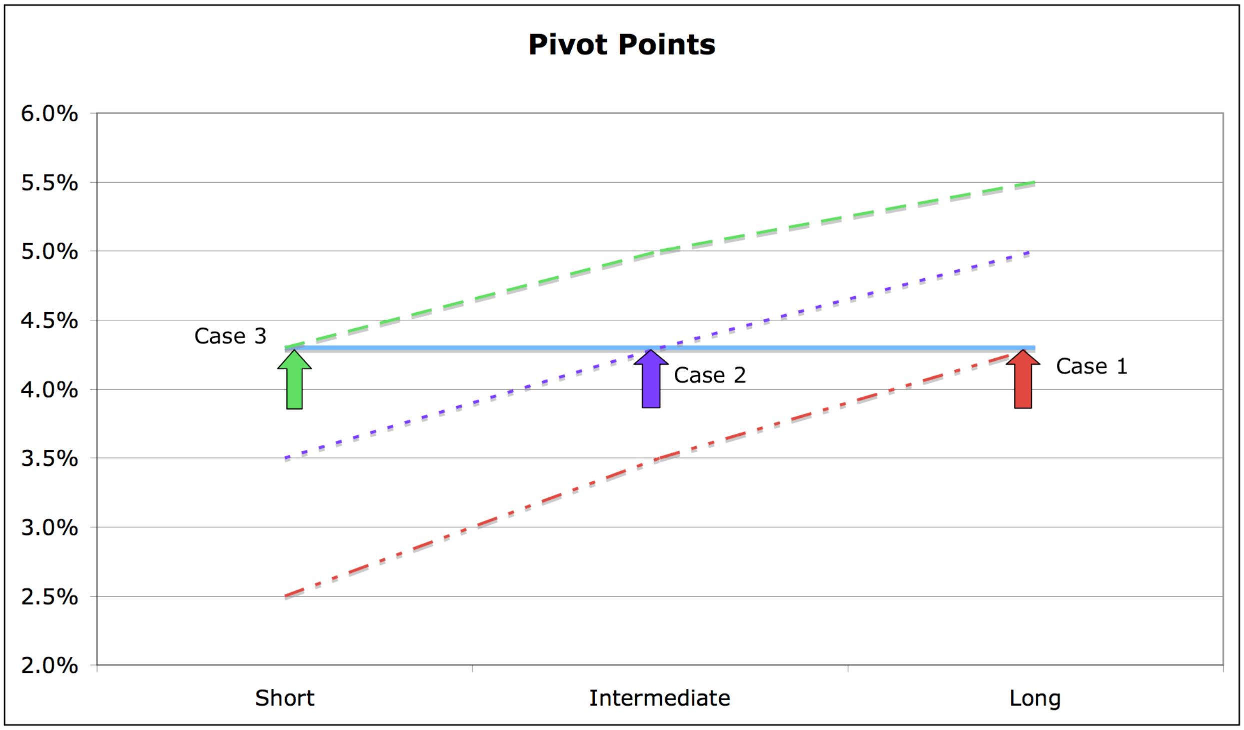

The pivot point of the change in the yield curve would be different in each case. In the first case, the long-end stays the same; in the second, the intermediate portion of the curve is stable while in the latter, short rates hold the line. Let's consider the returns available in each scenario over a one-year timeframe.

Pivot Point	Federal Funds	Three-year	Ten-year
Case 1: Long	Poor	Best	Good
Case 2: Intermediate	Good	Best	Poor
Case 3: Short	Best	Poor	Terrible

If you believe that the Federal Reserve will stop tightening too soon, allowing inflation to gain traction (case 3), shortening maturity is necessary. Long-term investments should be sold if possible, and overall duration should be moved to the shortest acceptable level.

If, however, you expect the Fed to reverse course due to normal economic developments, then moving dollars from both long and short into the intermediate portion of the curve is the winning strategy. The odds in either case 1 or 2 favor concentrating dollars in the three-year maturity range. This maturity collects coupon income while holding the possibility for some price appreciation as it rolls down the curve.

<u>Other Considerations</u>

When you get down to executing the strategy of buying three-year investments, there are some additional issues to consider. First, there is the starting yield. Assuming that the Federal Reserve increases rates at the end of January to 4.50% (and the risk of a further move to 4.75% in March), it seems as though the starting yield should be at least 4.75%. This knocks Treasury securities out of the game and puts non-callable agencies almost out of reach. The latter could be acquired opportunistically. The tax-equivalent on municipal securities can achieve the hurdle as can discount callables (price of 98 or below). MBS and par callables do not work as well because they turn into reinvestment cash if short rates head downward. By and large, the bullet strategy requires a good deal of call protection and minimal if any cash flow before maturity.

The last thing to consider is the chance of being wrong. Maybe the curve does not steepen but inverts and stays that way. Maybe rates rise across the board. Or maybe, the rest of the balance sheet performs poorly. All this means that any actions should be balanced against the cost of being wrong, and outright sales to reposition should be analyzed thoroughly before any action is taken.

A wise man (Mark Twain I believe) once observed, “History may not repeat itself, but it does rhyme.” And based on history, a change in the shape of the yield curve is likely. This being the case, the best risk/reward over the next year involves putting down the barbell and choosing the bullet approach.

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