UNRAVELING YIELD CURVE

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Unraveling the 'Yield Curve'

- by Prof. *Simply* Simple

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- The yield curve is the relation between the interest rate and the time to maturity of the debt for a given borrower in a given currency.

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So what is ‘yield’?

- **The yield of a debt instrument is the annualized percentage increase in the value of the investment.**
- **For instance, a bank account that pays an interest rate of 4% per year has a 4% yield.**

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So what are the uses of the Yield Curve?

- **Yield curves are used by fixed income analysts who analyze bonds and related securities to understand conditions in financial markets and seek trading opportunities.**
- **Economists use the curve to understand economic conditions.**
- **The yield curve function Y is actually only known with certainty for a few specific maturity dates. The other maturities are calculated by interpolation.**

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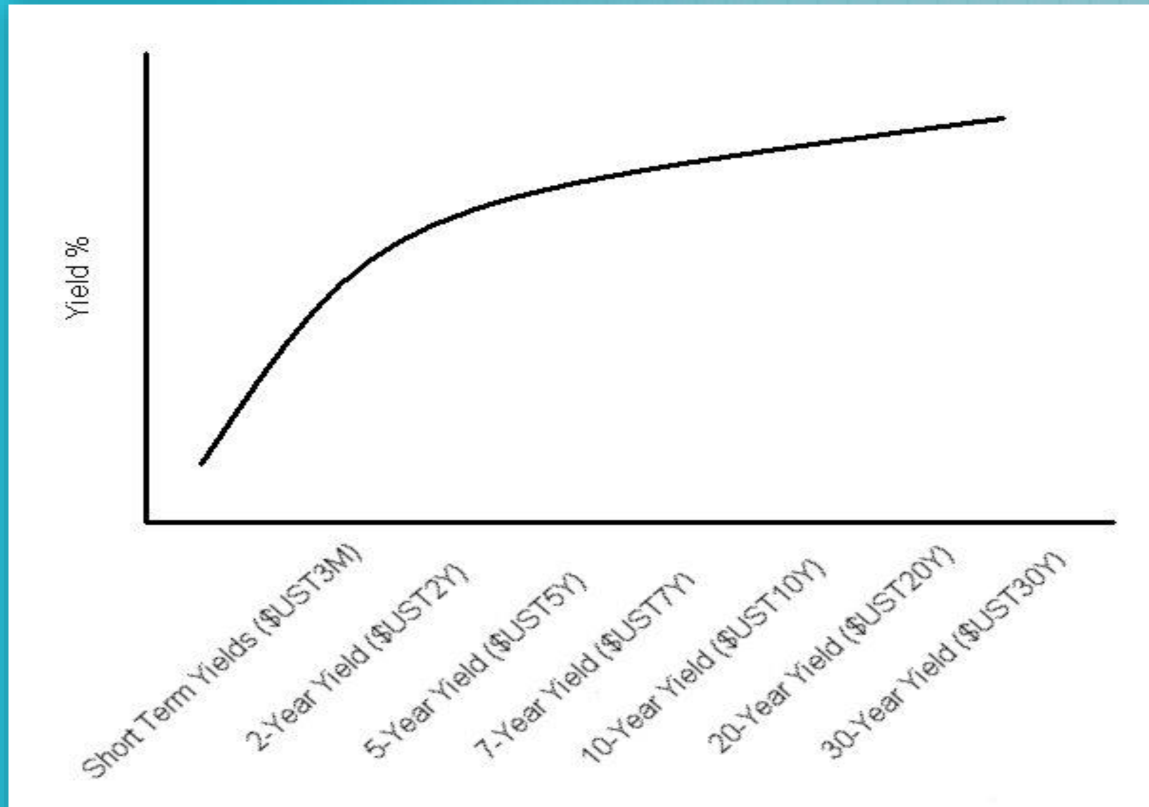
The typical shape of a Yield Curve



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Now…

Yield curves are usually upward sloping i.e. the longer the maturity, the higher the yield, with diminishing marginal growth (which means that after a point every increase in duration will bring lesser incremental return).

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This is because…

- **It is easier to predict the near term as against the long term.**
- **Hence, short term papers are usually held by the investor till its maturity.**
- **And long term instruments are usually traded in the market as their returns get affected by changes in interest rates, which occur regularly in an economy.**

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Also…

- **The yield curve can also be flat or even concave in shape where the short term yield is seen to be more than the long term yield.**
- **Yield curves move on a daily basis, reflecting the market's reaction to news.**

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Hope you have now understood the concept of Yield Curve

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