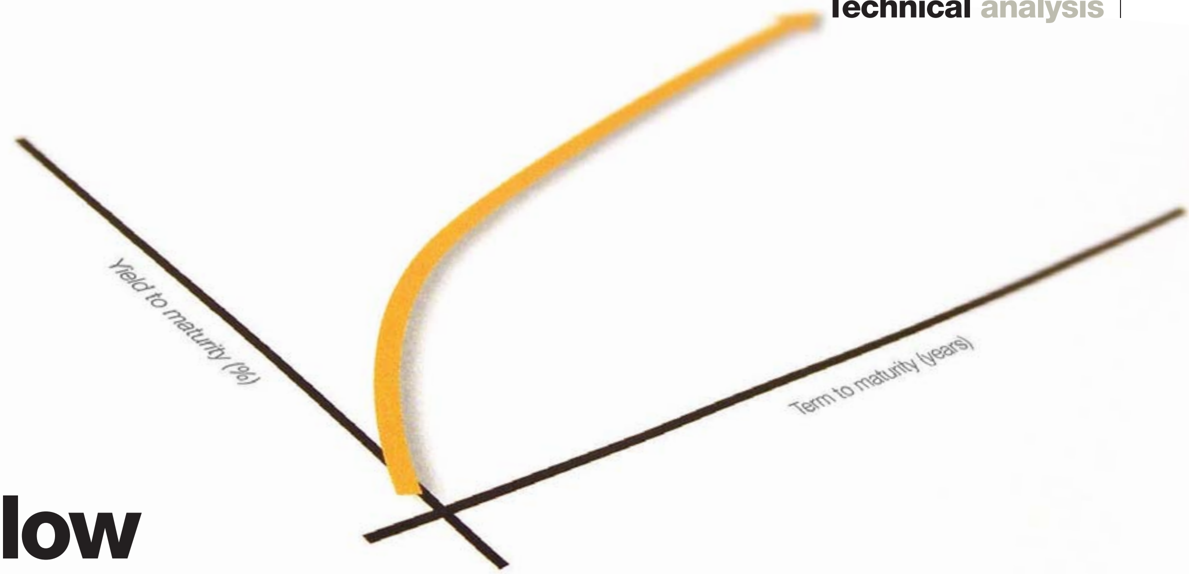

Follow the money in 2006

By Theodore Chen

Giving sound financial advice requires knowledge of individual opportunities and an awareness of the macro environment in which they operate. The yield curve is one indicator of the financial markets' expectations for the economy.

Professional accountants are frequently asked by their clients to provide advice on suitable investment strategies. As expert financial analysts, accountants can provide invaluable advice on the financial health of individual companies or investment opportunities. It is usually the jurisdiction of the economists to consider the investment climate of capital markets and to advise on the best timing for market entry.

Economists rely on a number of indicators, including interest rates, currency fluctuations and political risks, to form their view on the market. Accountants would be remiss to overlook this macro perspective, as it will directly affect the performance of most companies. What then, can the accountant use as an economic indicator?

The yield curve

The yield curve plots the interest rate, or yield to maturity, against an investment's time remaining to maturity. Most governments or central banks use short-term interest rates as a tool of monetary policy, to control inflation and protect their currency. But they have little control over longer-term rates, which respond to sentiment in the bond market.

When bonds are transacted at yields above the short-term rates set by the central banks, the market is signalling that the economy is healthy and that rates will either stay put or rise. A steep upward curve promotes bank lending, as banks borrow at the lower short-term rates and lend out at the higher longer-term rates. This process is known as the carry trade.

Bond yields may, on occasion, fall below the short-term rates. This inverted yield curve is a warning that the economy is contracting. Inverted yield curves not only indicate economic downturn, but contribute to one, as banks start curtailing their lending activities and calling in loans. Inverted yield curves preceded the recessions of 1981, 1991 and 2001.

What next?

The United States' Federal Reserve has indicated that its current rate rising cycle may be coming to an end. But many governments will need to make further increases, to counter high energy and commodity prices, overcapacity, rising wages and high global money supply. All these inflationary signs can be curtailed by higher interest rates. The recent flattening of yield curves in many countries provides a warning that economic growth may have to slow.

Cash cannot be a long-term investment holding. However, in one of every five years, cash beats stocks and bonds. If inflation is to be kept under control by raising short-term interest rates, a flat or inverted yield curve may wipe out a lot of the value of bonds. If you are concerned about capital preservation then it's worth staying liquid: Now is a good time to be tracking the yield curve.

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