Interest Rates

Since last month, the yield curve has flattened slightly, with very little movement except at the long end. The 3-year, 3-month spread stands at 96 basis points (b.p.), and the 10-year, 3-month spread is at 131 b.p., both above their long-term mean. Since the beginning of last year, however, the curve has become noticeably steeper. At the long end, 30-year rates have risen nearly a point, while at the short end, the 2-year, 3-month spread has changed from a slight inversion of -2 b.p. to a more normal +26. The longer-term capital market rates continue to track changes in the 30-year Treasury bond closely.

Certainly the most exciting recent development in the bond market has been the introduction of Treasury Inflation-Protection Securities, or TIPS. The principal and coupon payments on these 10-year bonds rise (or fall) with changes in the Consumer Price Index. Besides potentially offering lower borrowing costs to the Treasury and long-term inflation protection to investors, TIPS are particularly intriguing because they may provide a direct measure of real interest rates and a better estimate of expected inflation.

Putting aside liquidity differences, the interaction between inflation and real interest rates, and the risk premium associated with inflation uncertainty, one can get a measure of expected inflation by subtracting the real interest rate observed from TIPS from the nominal 10-year rate on Treasury bonds. In terms of protecting investors, one desired result of the introduction of TIPS has already occurred—the private sector has begun to issue inflation-indexed bonds.