



INVERTED YIELD CURVE AFFECTS ON FIXED INCOME PORTFOLIO STRATEGY

Financial media has questioned the impact of a recently inverted yield curve. Normally in the bond market, long-term securities earn a higher yield than short-term securities. Recently, that condition reversed where short-term securities yielded more than their long-term counterparts. Hawk seeks to understand the so-called inverted yield curve in formulating investment strategy for its clients.

Fixed income securities – most corporate, government, and municipal bonds – earn that name from the fixed coupon rate investors receive so long as the issuers don't default. This aspect of fixed income securities differs from common stock investments that pay dividends based on the issuer's success or failure. The real value of that fixed income resides in exceeding future inflation that eats away fixed incomes. Unpredictable future inflation helps explain normally higher yields for long-term securities.

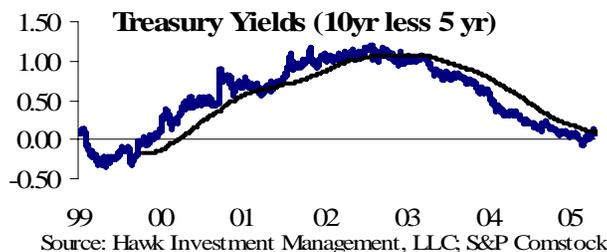
Analytical processes of constructing the fixed income portion of investment portfolios provide a rational response to the inverted yield curve. Hawk Investment Management, LLC uses a three-factor model to construct its fixed income portfolio strategy.

Duration estimates bond price sensitivity to changes in market yields. The most significant factor in determining bond performance is mostly affected by length of time to maturity. Longer time increases duration making bond prices more sensitive to changing market yields. Consider that bond prices move inversely with interest rates (i.e., bonds lose value when rates rise). If market yields are expected to fall, one expects bond prices to rise and should rationally increase portfolio duration. The opposite also holds true.

Presently, Hawk is hawkish about interest rate trends, and our duration target is shorter than normal.

Maturity Structure refers to the strategy of weighting portfolio securities across the spectrum of available maturities in order to attain the desired portfolio duration. Three generic strategies are called ladder, bullet, and barbell. Ladders invest equal amounts along the entire maturity structure. Bullets invest mostly near the target duration. Barbells invest at extreme short and long ends of the maturity structure.

Relationships beyond the scope of this writing explain that the three generic strategies perform differently when the yield curve shifts. Specifically, bullets perform better than barbells when long-term yields are expected to rise (fall) faster (slower) than short-term yields. Again, the opposite holds true.



The chart at left presenting 10-year treasury yields versus the 5-year treasury yields illustrates the recent yield curve inversion. At points below 0, the 10-year yield was briefly less than the 5-year yield for the first time since 2000. The move above our indicator (the smooth line), predicts wider yield spreads justifying a bullet strategy.

Credit Quality serves to direct portfolios into high-yielding securities when economic conditions are expected to improve. Yields tend to contract when economic conditions improve. Thus, rates on risky high-yield bonds fall more rapidly than rates on less risky bonds. As discussed with falling yields, high-yield bonds would experience more rapid price appreciation.

In the past, an inverted yield curve foretold economic calamity caused by declining investor demand for long-term credit. The inverted yield curve fails to compensate investors for the normally higher yields demanded from long-term securities. The S&P 500 3.5% rise since the curve inverted shows stock investors don't share that view. Similarly, Hawk's economic forecast remains confident despite a briefly inverted yield curve.



445 HUTCHINSON AVE
SUITE 800
COLUMBUS, OH 43235
WWW.HAWKIM.COM
(614) 410-3366 OFFICE
(614) 785-6496 FAX
(614) 657-7797 MOBILE
RCLEMENS@HAWKIM.COM

By: RICHARD A. CLEMENS

President/Principal and Founder
Hawk Investment Management, LLC

CFA Charter holder

Certified Public Accountant

15+ years experience serving clients

