CALAMOS INVESTMENTS

When a Yield Curve Inverts

Transcript of a video recorded 10/17/19

MATT FREUND
Co-CIO, Head of Fixed Income Strategies, and Senior Co-Portfolio Manager

The yield curve has been getting a lot of press over the last two or three quarters. Now, let's just define what it means first: the yield curve is a depiction of yields from very short or overnight rates, all the way out to 30 years.

In general, a positively shaped yield curve, where long rates are higher than short rates, is a sign of a well-functioning economy, where there is a profit motive throughout, not just for the users of capital, but the providers of capital.

When the yield curve gets very flat or gets inverted, when short rates are higher than long rates, it shows, we think, that there's a lot of pressure building in the economy.

And here's why. The yield curve is a rough approximation for the cost of capital and the return on that capital for businesses. If the yield curve is flat or inverted, it shows that your return on the capital is very close to the cost, and in that sort of environment there's not a lot of need to expand.

At the same time, if you are a provider of capital—so you're a bank or an insurance company—when you are borrowing and lending off the same rate, it's very hard for financial intermediaries to make an adequate profit.

When you have a flat curve, when you have an inverted curve, that implies that the folks who are demanding capital (think businesses), as well as the institutions that are providing that capital, both have an incentive to slow down, to be less dynamic, and when that occurs, the economies tend to stutter.

Again, the shape of the yield curve doesn't mean we have to have a recession, but it does show there are significant pressures building in the economy.

Video recorded 10/17/19.

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Fixed income securities entail interest rate risk. High yield securities are also subject to increased credit risk and liquidity risk.

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Calamos Financial Services LLC, Distributor
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | www.calamos.com | caminfo@calamos.com

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