CANADIAN INVESTORS' COURSE

Session 3 – Introduction to Equities

Commentary

Introducing a Key Signal in the Fixed Income Markets that Affects Equities

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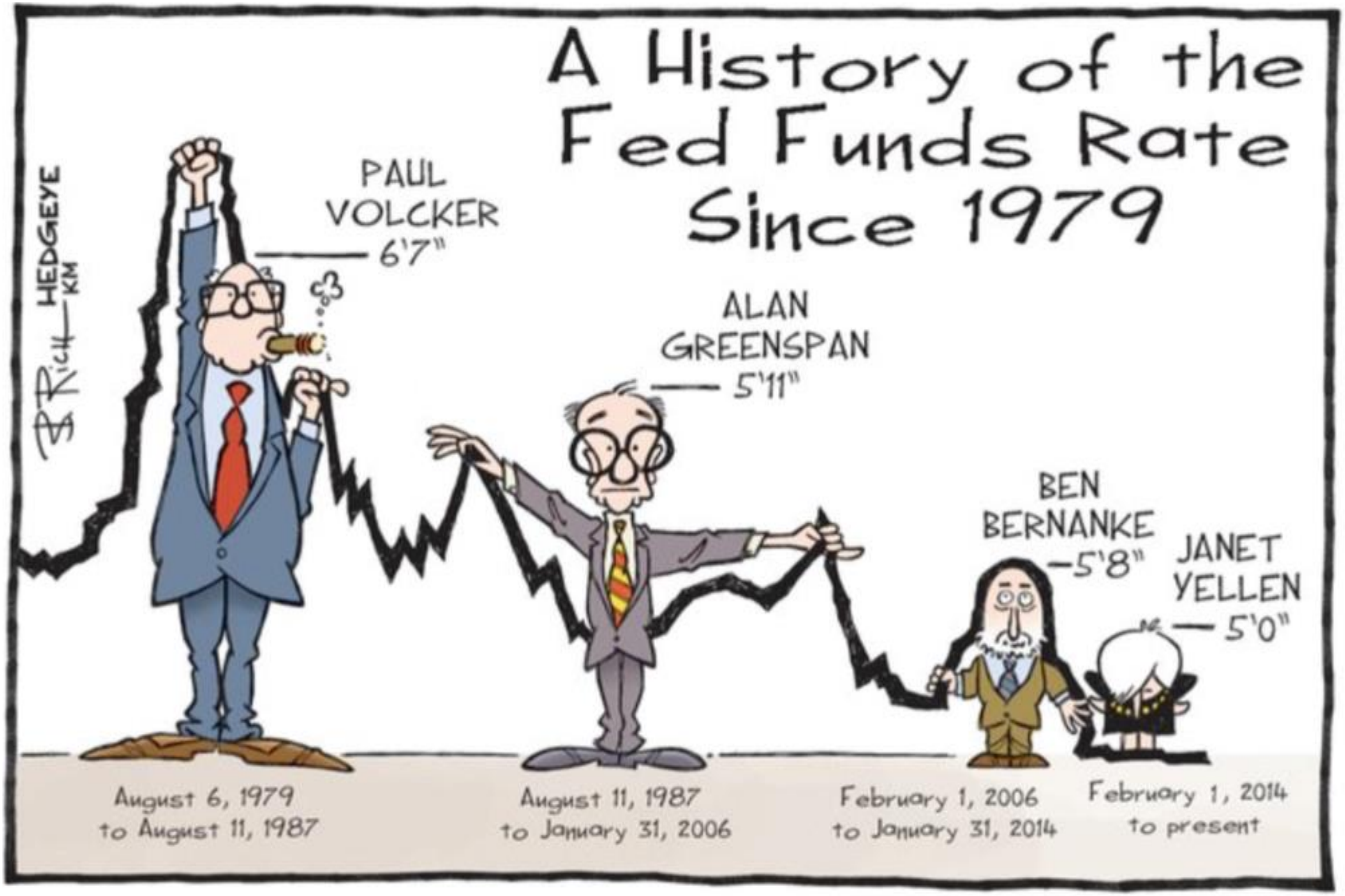


This Session concentrates on the two ends of the fixed income yield curve:

1. Short end of the yield curve – 2 years or less
2. Long end of the curve – 10 year to 30 year bonds

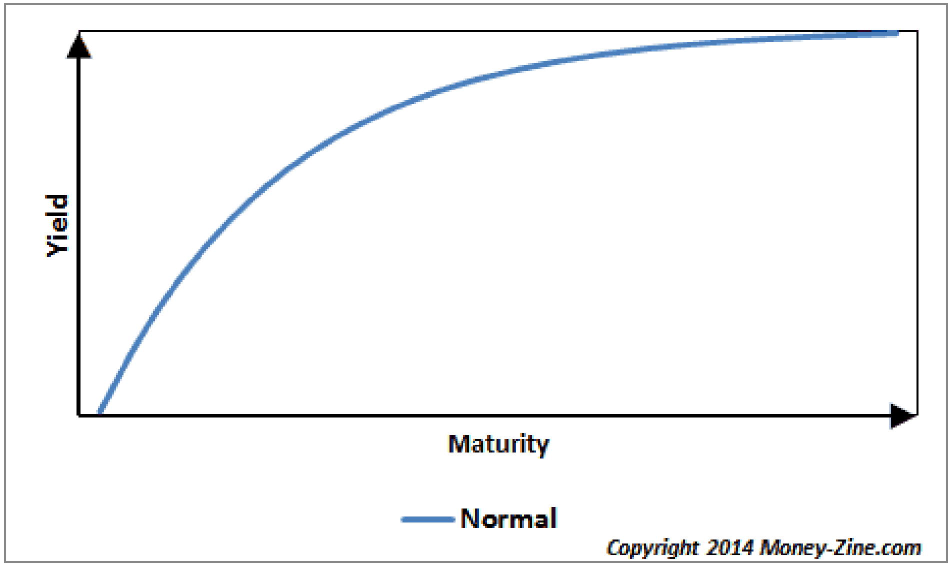
Note: If you haven't taken Session 2, please do so, understanding the bond market is crucial to managing a stock portfolio.

The Extreme Ends of the 'Yield Curve'

These 2 extremes are driven and influenced by different forces.

1. the short end is highly influenced by the Federal Reserve, AKA the Central Bank
2. the long end is more influenced by the market made up of investors.

Chart of the Yield Curve



- In Canada, the Bank of Canada governor determines interest rates of maturities 1 year or less. The Bank of Canada Rate is related to 90 day interest rates.
- In the U.S., the Federal Reserve chairman determines the Federal Funds Rate which deals with interest rates less than one year.

'Yield Curve' continued

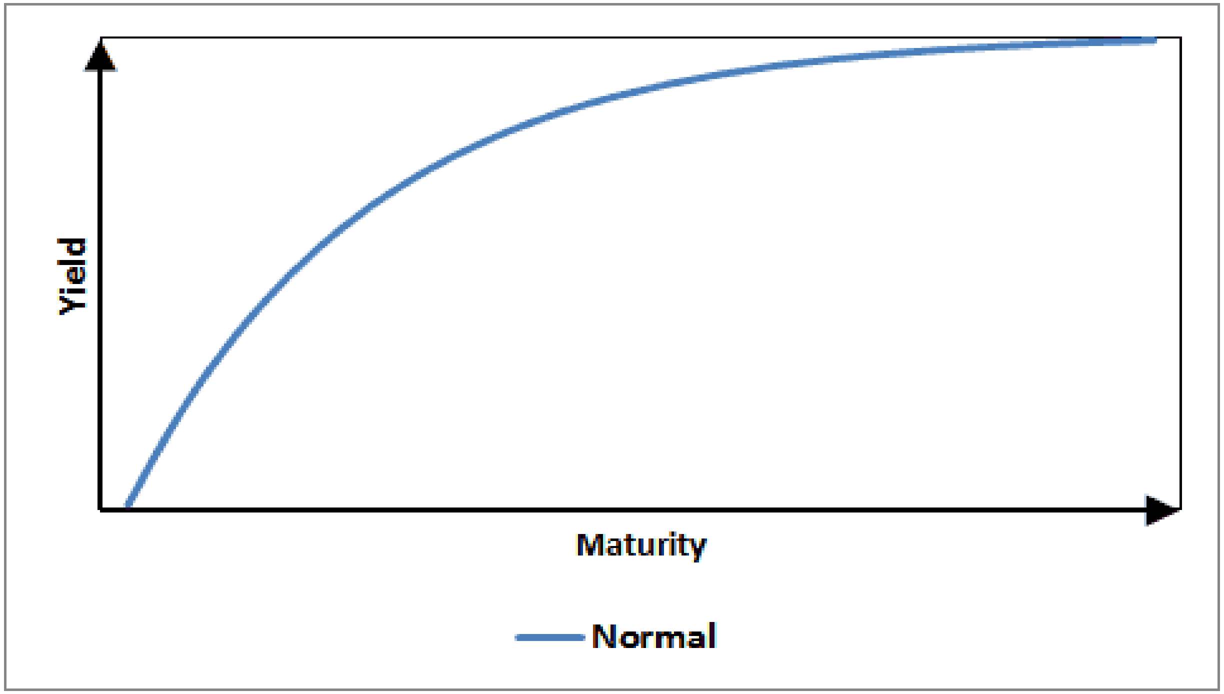
- The Long end of the yield curve in both countries or the rest of the world is made up of 10 to 30 year bonds
- Please review Session 2 of how Bond prices are influenced by changes in interest rates
- The question is what influences the changes in interest rates

Factors that influence interest rate changes:

1. Inflation
2. Strong economy (low unemployment, strong GDP growth)
3. Deficits
4. Credit ratings
5. Currency movement (weak or strong)

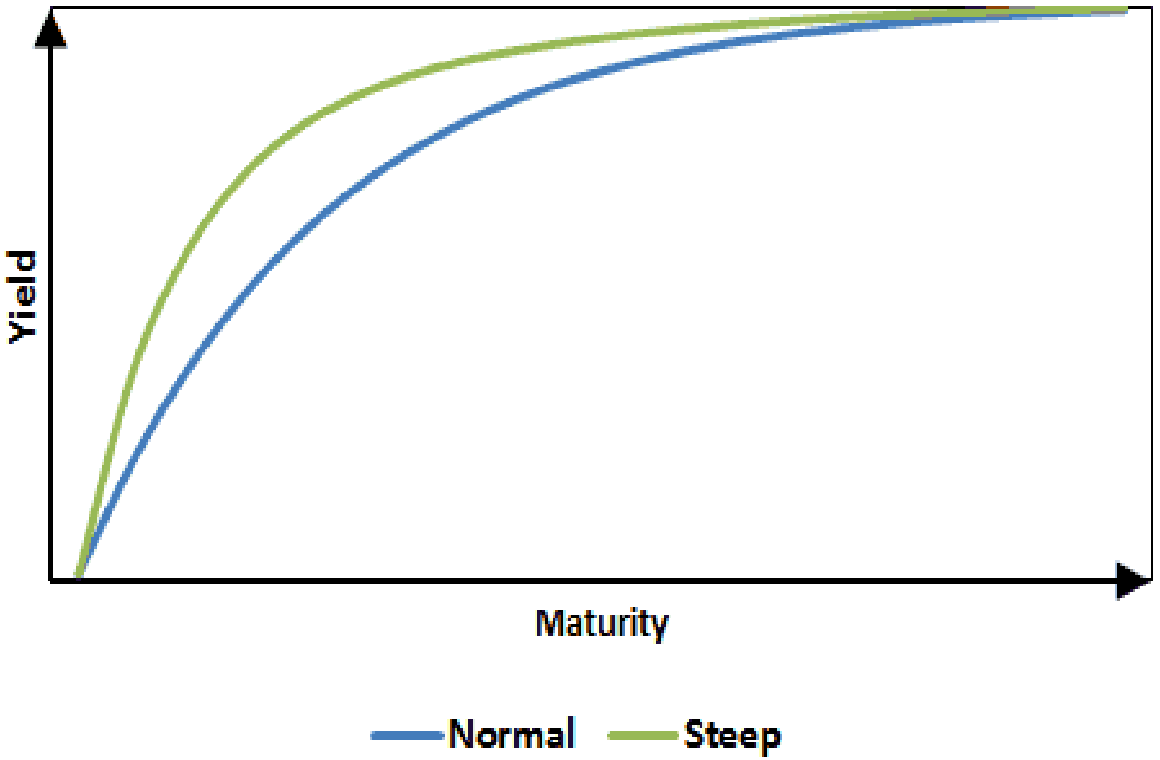
The Central Bank will raise or lower rates on the short end of the yield curve based on the same factors as above. They raise rates to cool off the economy, and lower rates to stimulate.

Yield Curve Formations - 1



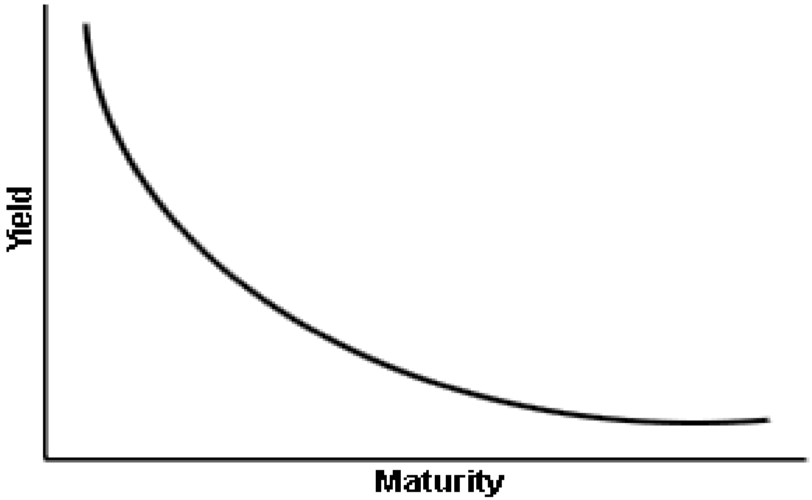
Normal yield curve

Yield Curve Formations - 2



<u>Steep</u> yield curve – very simulative

Yield Curve Formations - 3



Inverted yield curve – slows economy

- Further discussion of yield curve formation is contained in future Session(s)

- We feel this topic is extremely important to how an investment portfolio should be constructed

- The formation of an **inverted yield** curve leads to a recession and Bear Market over 90% of the time. The next chart reveals this

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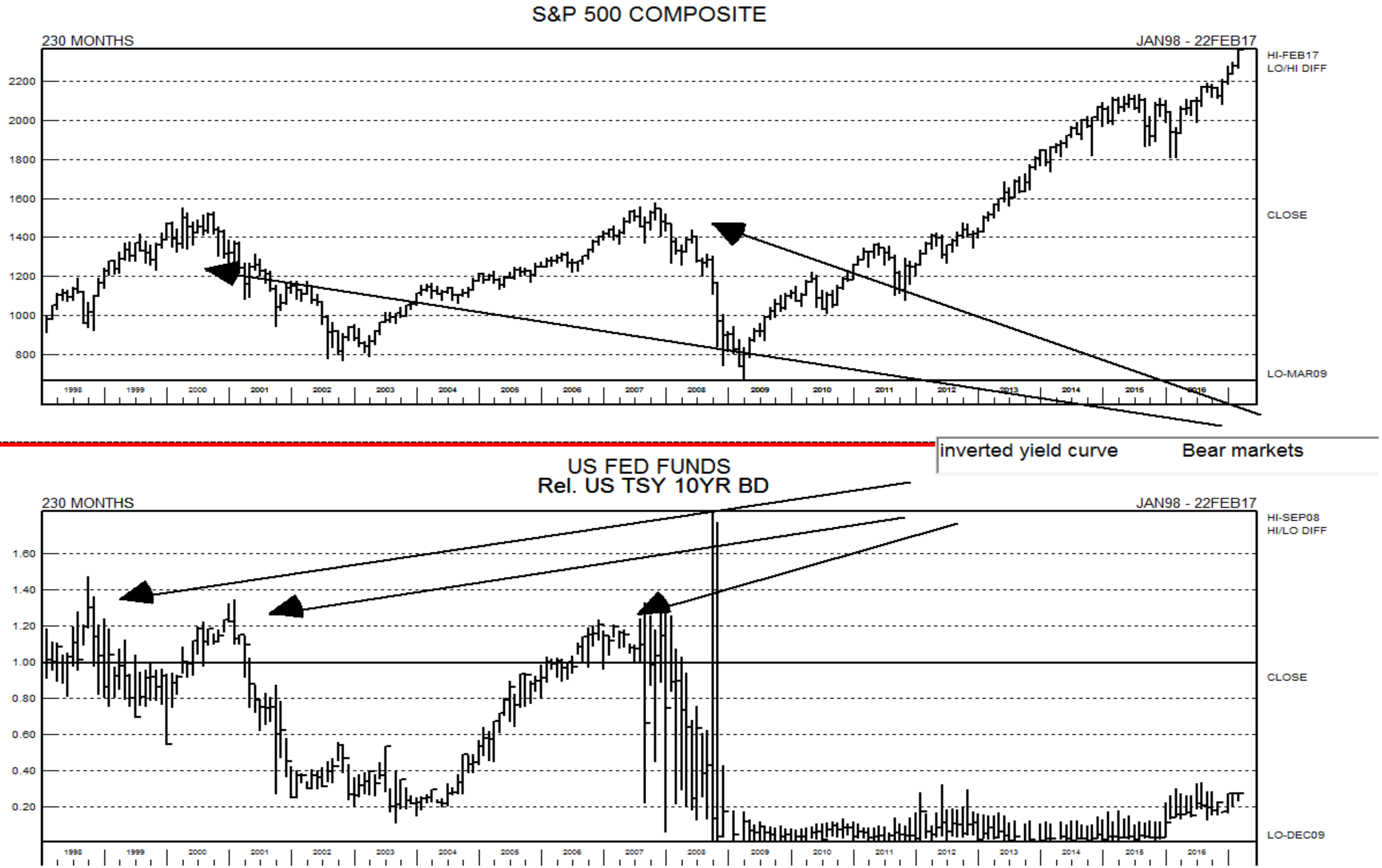

Inverted yield curve = SELL equities

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