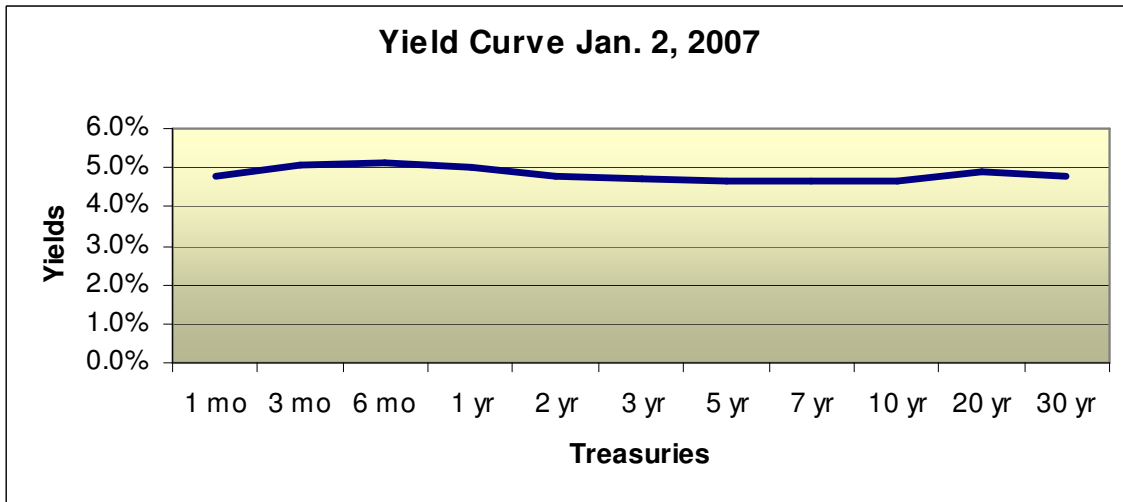


How to Read Yield Curve Tea Leaves

A yield curve shows the relationship between bond yields and maturity at a specific point in time.

You can draw a yield curve for any bond market, but it's typically done for U.S. Treasuries. Take today's yields, plot them on a graph, connect the dots and you have today's yield curve.

Here's one for the first trading day of the year - January 2, 2007:



(This graph shows Constant Maturity Treasury (CMT) rates based on the closing market bid yields on actively traded Treasuries in the over-the-counter market. Daily data is available at: <http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml>)

This chart is based on data obtained from the U.S. Treasury website: www.ustreas.gov

Who cares?

It's a reference, a benchmark, a quick snapshot of the bond market.

But wait... there's more.

For some people the world turns on yield curves.

For folks who analyze bonds, it's a quintessential tool. For economists, it's used to interpret and understand economic conditions. For financial prognosticators and soothsayers, it's used to predict the economy ahead.

For the rest of us... well, by the end of this article, you'll know more than just yield curve party trivia.

The Fed

Many folks believe the almighty Federal Reserve controls interest rates. Not exactly true. Though they do have a good bit of influence.

The "Fed" controls only one rate... the overnight lending rate or "Fed Funds rate". That one isn't available to you and me. It's the rate banks charge each other for overnight loans. Basically, it establishes the cost of money for banks.

(In truth, the Fed also controls another rate – the “Discount Rate” - which is the rate banks are charged to borrow emergency funds from the Federal Reserve. It’s like getting a cash advance on your credit card. Banks don’t often do that, so the Discount Rate has minimal impact under typical conditions).

Banks “mark up” money and lend it out. (Like a grocer buys loaves of bread at wholesale, marks them up and sells them). These are the rates you and I experience when we shop for a car loan and a home loan. They’re also the rates businesses experience when they borrow money from banks.

Bonds are loans. They’re competing in the market with bank loans. Thus, interest rates on bonds respond similarly.

In essence, interest rates are the cost of money whether it’s a bank loan or a bond.

Interest Rates Are Controlled By...

Ultimately, the market sets interest rates. If Bank A is quoting 7% for a home loan and Bank B is quoting 6% - all else being equal - where are you going to get your home loan?

For a bank, a loan is a product it sells. If Bank A doesn’t make any loans, they can’t pay their bills, certainly don’t make a profit and they go out of business. So there’s a dance of supply and demand and suppliers compete for the demand, in other words, business.

Back to our yield curve.

Would you agree that a 30-year home mortgage is different than a 5-year car loan?

Of course. They’re two different products. Just as bread and laundry detergent are two different products even though you may buy them at the same store.

If you’re shopping for a 30-year mortgage, you can’t string together six 5-year car loans. The products are not interchangeable.

Although on one hand, the Fed can increase the cost of money by raising the Fed Funds rate, you won’t always see rates increase equally from short-term rates such as a 30-day CD to long-term rates such as a 30-year mortgage. You may not see rates rise at all. You may see rates at some maturities increase and others not.

Which brings us back to supply and demand.

There are very short-term securities (under a 1 year); short-term securities (2-5-years); medium-term securities (7-15-years) and long-term securities (20+ years).

These are all different market segments with different supply / demand characteristics at any given time.

For instance, pension funds mostly favor long dated securities. Why?

Think about it. What is a pension?

A series of monthly payments that goes on for decades.

What is a 30-year bond?

A series of payments for 3 decades. The 30-year bond matches up beautifully for pension funds whereas; a 1-year bond does not.

The mortgage industry favors 7 and 10-year bonds.

Why is this if they loan out *30-year* mortgages?

Ah, how many folks do you know that kept a 30-year mortgage for 30 years? People refinance or sell their house and pay off the mortgage in less than 30 years.

Mortgage holders are constantly calculating the average holding period for a mortgage. When rates are declining, refinancing increases. This reduces the average holding period. On the other hand, when rates are rising, the average holding period stretches out.

When a company wants to borrow a sum of money, they're going to match up their needs with what's available in the market. A quarter percent rise in rates will make it more expensive - perhaps too expensive - for a company to issue a bond.

Let's say Big Dog Widget Company wants to build a new factory. They need \$10 million dollars. They have to estimate all kinds of numbers... how long will it be before that factory is up and running, how much money can they pay out on a monthly basis, how much more profit can they make with the factory.

After looking at their numbers and business goals, they'll come up with an acceptable bond maturity and a maximum interest rate they'll pay. If market rates are below their maximum, they'll issue the bond - creating supply.

If market rates are above their maximum, they won't issue a bond. No increase in supply.

Thus, at a certain level of interest rates, corporations are friendly to the idea of selling bonds to fund growth. This in turn fuels economic growth.

My What A Shapely Curve You Have

The yield curve has been the object of numerous studies (as well as a lot of opinion). When it comes to predictive value, there are three characteristics of interest: level, slope and curvature.

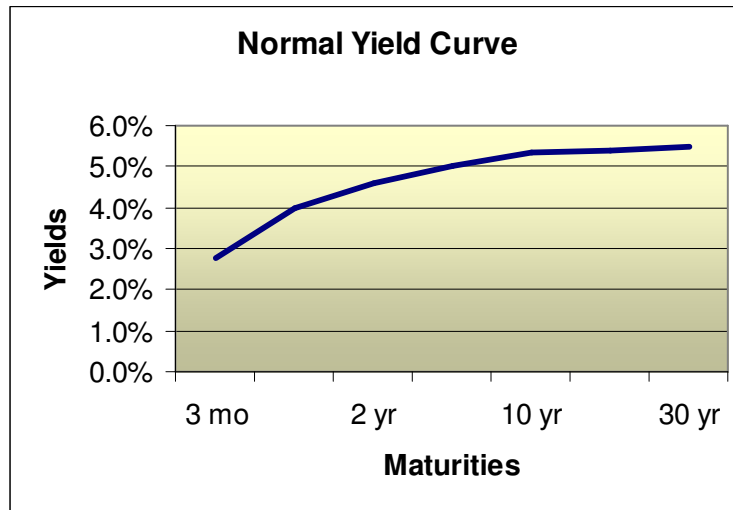
We have our yield curve from the first trading day of 2007 above. Not much life in it, huh? Much like a palm reader will look at your hand and proceed to tell you *all* about yourself, there's an ample supply of yield curve aficionados that will look at a yield curve and tell you about the economy... better yet, the future of the economy.

In fact there is one particular yield curve shape that can really kink an economist's bow tie. But let's not get ahead of ourselves.

Let's take a look at four yield curve models and see what the fuss is all about, shall we?

First we'll look at a "**Normal**" yield curve

How to Read Yield Curve Tea Leaves

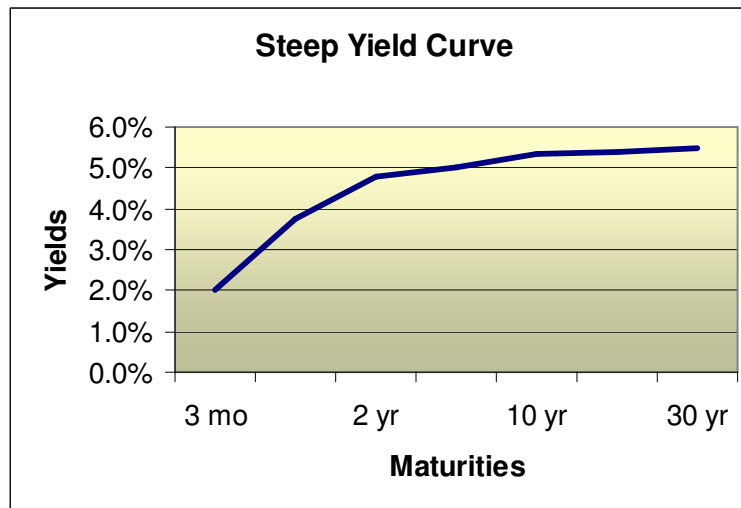


This chart is based on data obtained from the U.S. Treasury website: www.ustreas.gov

As you can see, it slopes up and then levels out a good bit. With a 3-month security, you're not tying your money up very long. In that shorter period – statistically – there's less risk of the unknown. Moving to the other end of curve, there's a larger premium for a 30-year bond over a 10-year bond.

What is said about "normal" is: longer dated bonds (10+ years) command a significant premium over shorter dated bonds. One primary reason being - risk of the unknown which can impact the value of the bond. But that premium levels out.

Moving on...
The "Steep" yield curve.



This chart is based on data obtained from the U.S. Treasury website: www.ustreas.gov

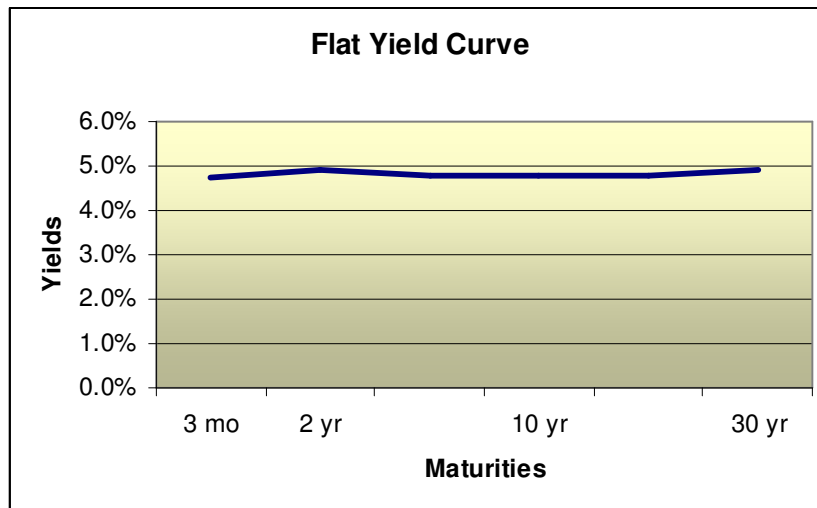
How to Read Yield Curve Tea Leaves

At first glance, this graph may not look different... but it is. It has a steeper *slope* at the short-term end. The long-term end is about the same as "Normal" above.

The story this picture tells is one of economic expansion. You're likely to see a steep curve at the end of a recession.

Demand for capital starts growing quickly. Long-term investors anticipating growth ahead, rebel against being locked into lower rates and demand higher yields. This pulls up the long end of the curve. As growth matures, the short end will come up and the curve will again be "normal".

From "steep" to "Flat" yield curve.



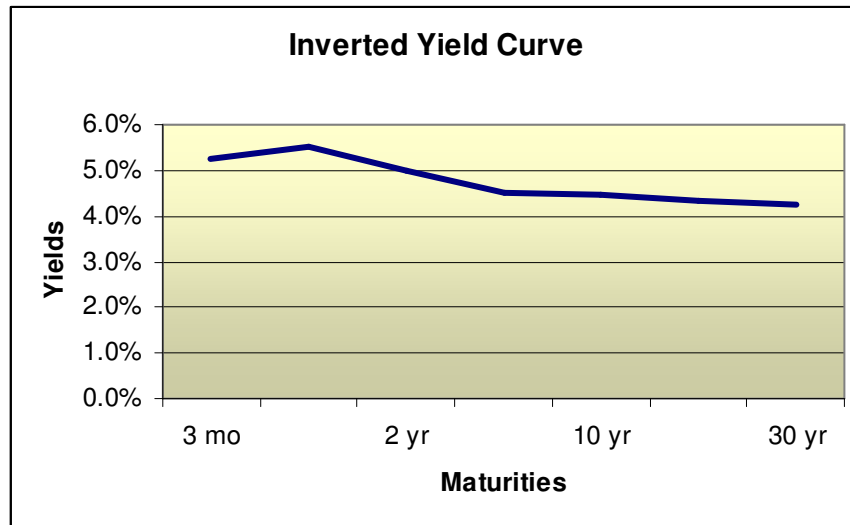
This chart is based on data obtained from the U.S. Treasury website: www.ustreas.gov

Does this look familiar? It looks much like our first yield curve above from January 2, 2007. With a Flat yield curve, there's little variance in rates from the short-term end to the long-term end. It implies a level of uncertainty in the economy. Investors aren't sure if rates will be going up... or down.

This situation is tough times for banks. Their cost of money is not much less than what they can lend it out for... leaving little profit potential That can slow down lending... which can slow down the economy.

A flat curve can signal – *but not guarantee* - the economy is in transition and headed for the dreaded...

"Inverted" yield curve



This chart is based on data obtained from the U.S. Treasury website: www.ustreas.gov

As you can see, yields are higher on **3-month** securities than **30-year** securities. This is the opposite of "normal".

The thousand words this picture tells is long-term investors are willing to take lower yields now... because they believe yields are headed lower still. Lock 'em in and batten down the hatch. This curve also implies expectations for inflation are low.

The reason alarm bells go off when we have an inverted yield curve is because there's a good track record of this scenario preceding a recession.

From Inversion to Recession

The theory is investors anticipating bad times ahead sell off stocks and pile into long-term bonds. This creates a significant increase in demand without an increase in supply. Sellers have the hammer, long-term rates are pulled down.

With an inverted yield curve, the focus is on the difference between the 3-month and 10-year Treasury rates. A recession has very often followed an inverted yield curve when the 3-month rate was 0.12% or greater than the 10-year rate (remembering that under normal conditions, the 3-month rate is lower than the 10-year rate).

Thus, for example, if the 3-month rate was 5.12% and the 10-year rate was 5% or lower, historically, there has been a greater chance for recession.

The yield curve has to remain inverted for a month or more, for there to be a greater risk of recession. It's not predictive if it inverts for a day or two and then corrects. The lead time is 3-6 quarters (9-18 months). Meaning 9-18 months after the yield curve inverts, the economy has a higher likelihood of being in a recession.

How clear is this crystal ball?

Negative Yield Curve

Sept. 1966 – Feb. 1967
Dec. 1968 – Feb. 1970
June 1973 – Nov. 1974
Nov. 1978 – May 1980
Oct. 1980 – Sept. 1981
May 1989 – Aug. 1989
July 2000 – Jan. 2001

Effect

1967: Economic Slowdown
Dec. 1969: Recession
Nov. 1973: Recession
Jan. 1980: Recession
July 1981: Recession
July 1990: Recession
Mar. 2001: Recession

This chart is based on data obtained from the U.S. Treasury website: www.ustreas.gov, and www.fdic.gov.

Pretty clear.

Correlation Is Not Causation or, What Came First – The Chicken or The Egg?

The last week of 2005, the yield curve briefly went negative. During 2006 it was mostly flat, occasionally dipping negative.

There are Wall Streeters who no longer consider an inverted yield curve an absolute harbinger of recession. And the Federal Reserve has been publicly downplaying the predictive nature of an inverted yield curve.

The rationale goes back to supply and demand.

In recessions, credit is tight. Tight credit slows down borrowing, slows down business expansion and growth.

For all of 2006, credit was not tight. It's been loose and cheap even though the Fed raised rates 17 consecutive times between 2004 and mid 2006. Remember – the market sets interest rates not the Fed.

The current business cycle launched after the recession of March, 2001. Since that time, foreign investors have financed 77.9% of the (growing) Federal budget deficit.

Foreigners now hold 45% of the outstanding Treasuries. And they favor the 10-year maturity. Foreign investment was not as significant a factor before 2000.

(Foreigners used to favor 30-year bonds. The Fed discontinued 30-year bonds in October, 2001. Folks then had to switch to another maturity when their 30-year bonds matured. The Fed brought back 30-year bonds in January, 2006. That may lead to more shifting going forward.)

So what you have is a growing demand from outside the U.S. for 10-year (and longer) Treasuries. That demand could be a factor that keeps the 10-year rates from inverting.

Will that stop a recession from occurring? Or will it make the yield curve a murkier crystal ball? That's fodder for the prognosticators to debate.

Is it different now?

How to Read Yield Curve Tea Leaves



Remember the *new paradigm*? All the way up to the day *before* the Tech crash in 2000 people were saying "this time it's different". "The old rules no longer apply". "It's a new paradigm".

Historically, an inverted yield curve has been a good prognosticator of a recession not only in the U.S. but in Canada, Germany and the U.K. also. Perhaps the expanded global market weakens the accuracy of the relationship. Maybe it's a tail wagging the dog scenario now.

But you know what they say about those who choose to ignore history.

Monitoring the yield curve is a tool you can use with your financial advisor to guide your investment choices.

(June 2007)

An investment in ETFs involves risk, including loss of principal. Diversification does not eliminate the risk of experiencing investment losses. By investing in high yield bonds you may be subjected to greater price volatility based on fluctuation in issuer and credit quality. When investing in bonds, you are subject, but not limited to, the same interest rate, inflation and credit risks associated with the underlying bonds owned by the ETF.

ETFs are subject to trading risks similar to those of stocks including those regarding short-selling and margin account maintenance.

Funds distributed by ALPS Distributors, Inc.

An investor should consider the investment objectives, risks, charges and expenses of the ETF carefully before investing.

To obtain a prospectus containing this and other information, please call 800-394-5064. Please read the prospectus carefully before investing.