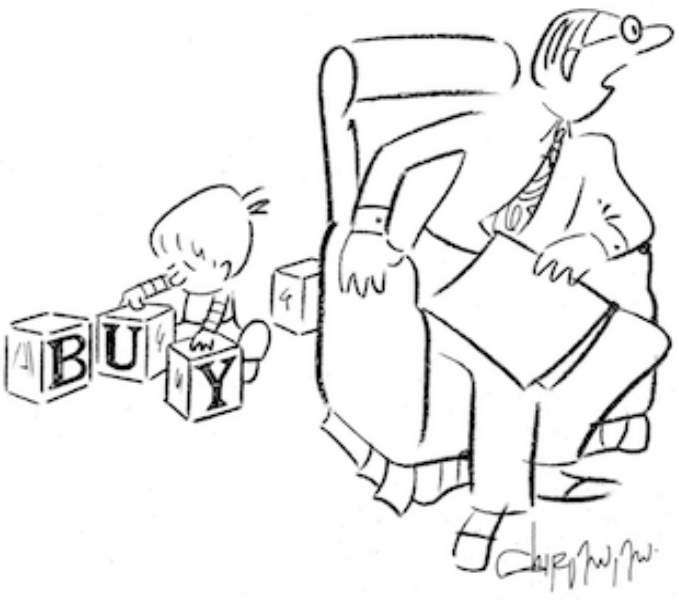
Don't Panic

"The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd." – Warren Buffet



"Margaret, call the broker!"

The yield curve has received a lot of attention lately, with many commentators worrying what an inversion could mean for financial markets and economic growth. Recent searches over the internet for "yield curve inversion" have spiked to an all-time high according to Google Trends, which tallies data going back to 2004. So, what is the yield curve, why should we care about an inversion, and most importantly, what does this mean for the stock market?

What is the yield curve?

The yield curve is a line that plots interest rates for bonds of similar credit quality but different maturity dates. Put another way, the yield curve is a visual representation of how much it costs to borrow money for different periods of time. Usually, the longer the term one would like to borrow money, the higher the interest rate will be, due to the risks associated with time.

The most popular yield curve in the U.S. is for debt issued by the U.S. Treasury. The U.S Treasury regularly issues debt that matures in as short as one week and as long as thirty years. The U.S Treasury yield curve is considered the benchmark for all other debt in the market, and is used to determine interest rates on mortgages, auto loans, and corporate bonds to name a few.

Normal Yield Curve – A normal yield curve is where short-term debt instruments have a lower interest rate than long-term debt instruments.

Flat Yield Curve – A flat yield curve is where there is little difference between interest rates on short-term debt instruments and long-term debt instruments.

Inverted Yield Curve – An inverted yield curve is where short-term debt instruments have a higher interest rate than long-term debt instruments.

Why should we care about an inversion?

Normally investors demand more of a return for locking up money for longer periods of time. This is due to our increased uncertainty the further we go out into the future. Therefore, yield curves are usually upward sloping. The yield curve also reflects the market's view on both economic growth and inflation. Investors who believe that both economic growth and inflation will be higher in the future will demand to be compensated today to offset this effect.

Historically, steep yield curves signify that the collective market has a positive view on future growth and that future short-term interest rates will need to be increased to slow things down. Conversely, inverted yield curves signify that the collective market is negative on future growth and that future short-term interest rates will need to be decreased to speed things up. An economic letter written in August of this year by researchers at the Federal Reserve Bank of San Francisco, "Information in the Yield Curve about Future Recessions" has garnered a lot of attention in today's environment, as the yield curve has predictably flattened through the Feds current tightening (short-term interest rate hiking) cycle. The paper cites the relationship between the 3-month Treasury bill rate and the 10-year Treasury note rate and concludes that an inverted yield curve between these two points has been a reliable indicator of economic declines.

What does this mean for the stock market?

This past week the U.S. Treasury yield curve inverted between the 2-year note and the 5-year note. This means that investors are willing to accept a lower interest rate for lending money to the U.S. government for the longer maturity (5-years) compared to the higher interest rate of the shorter maturity (2-years). Although the yield curve is still positively sloped beyond the 5-year point, a couple of market analysts recently crunched data taking a look at historical stock market returns after an inversion. Please note that the current yield curve between both 3-month Treasury bills and 10-year notes as well as 2-year notes and 10-year notes are still positively sloped by approximately 46 basis points and 13 basis points respectively.

What was the outcome for future stock market returns? Fairly positive to say the least. Granted the number of data points was limited; however, the realized positive returns from the stock market as measured by the S&P 500 index after a yield curve inversion was intuitively the opposite of what I had expected. According to Dan Suzuki at Richard Bernstein Advisors, an inversion of the 3-year versus 5-year curve resulted in average positive returns of 6% over the subsequent 6-months, 13% over the subsequent 12-months, and 19% over the subsequent 24-months (Figure 1). While Michael McDonough of Bloomberg crunched the numbers for an inversion of the 2-year versus 10-year curve and similarly came up with positive historical returns (Figure 2), while a recession was delayed by close to two years.

I am not sure what to make of this, but I'll speculate and give it a shot. Maybe, investors look at the yield curve inversion as a signal that future monetary policy will be easier (short-term interest rates will be lower) and therefore view equities as an appealing asset class to leverage up. Historically, as Dan Suzuki concluded, "not only have returns tended to be very strong, but the bear market has generally been years away."

S&P 500● subsequent returns after 3-year Treasury yields exceeded 5-year yields

3yr > 5 yr yield	6m	12m	24m	Months until next bear market
March 24, 1964	8%	14%	20%	23
February 21, 1973	-11%	-15%	-22%	Already begun
June 14, 1976	5%	2%	7%	53
June 23, 1978	3%	13%	33%	29
December 7, 1988	20%	29%	26%	19
January 5, 1998	18%	29%	47%	27
December 19, 2005	-1%	15%	20%	22
Average	**6%**	**13%**	**19%**	**29**
Median	**5%**	**14%**	**20%**	**25**
Positive %	**71%**	**86%**	**86%**	

Source: Richard Bernstein Advisors LLC, Bloomberg

Figure 1

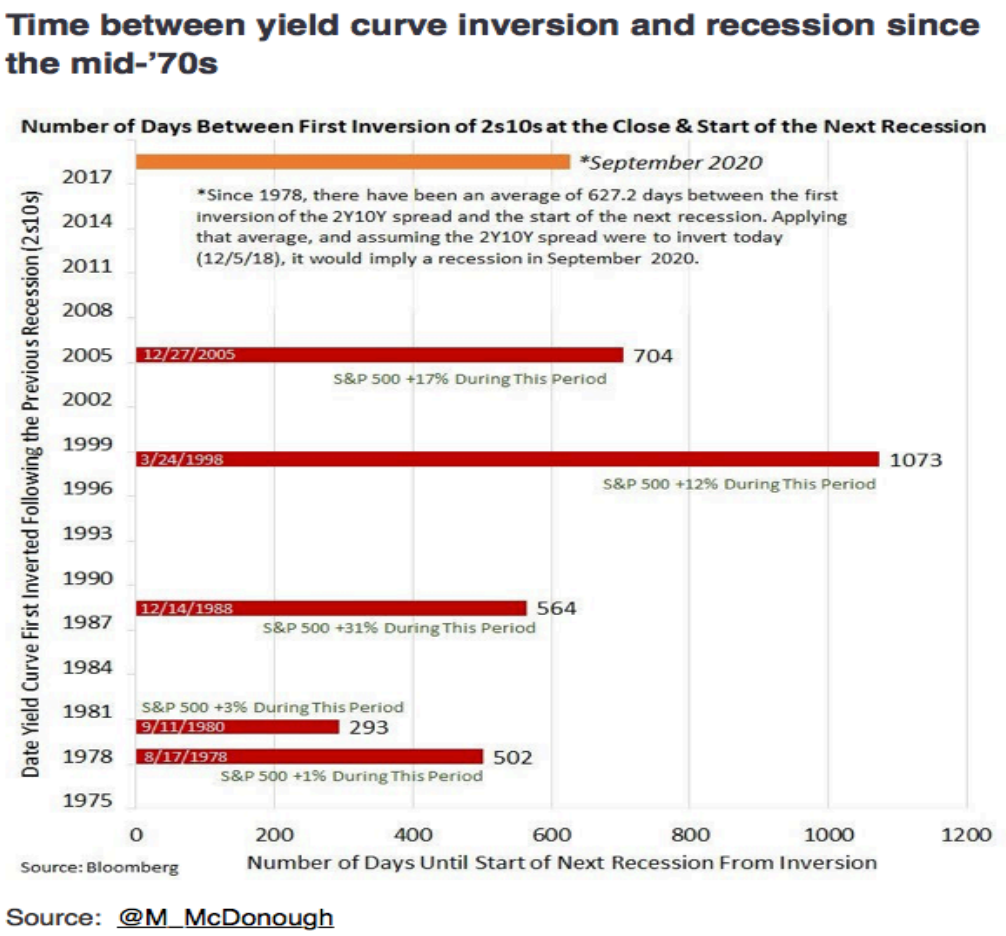


Figure 2

Sincerely,

Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
