Portfolio Manager Insights

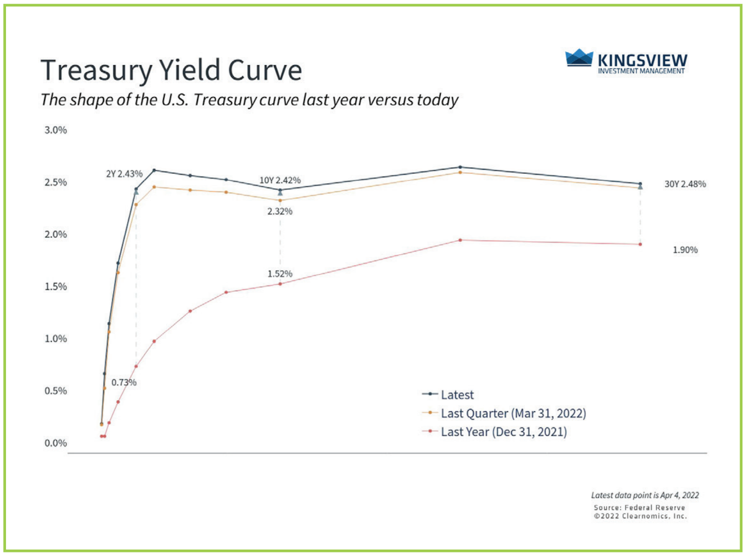
Weekly Investor Commentary | April 6, 2022
Investment Committee

Of the hundreds of market and economic indicators that investors watch closely, perhaps none is as important as the shape of the yield curve. Not only does it summarize the state of the economy, but the level of interest rates across the yield curve directly affects investors, businesses and individuals. It's for this reason that markets had a mixed reaction to last week's yield curve inversion, the first time it's occurred since 2019 prior to the pandemic. This adds to investor concerns over inflation, the Fed, the war in Ukraine, and more. **What does this mean for long-term investors and could it be different this time?**

Although the yield curve is a technical concept, the basic idea is easy to understand. A yield curve is just a graph that shows the level of interest rates across different time horizons, or maturities. In plain English, it tells you what interest rate you would earn if you invested in a new note or bond issue for that duration, be it 3 months or 30 years. Typically, when investors talk about the yield curve, they are referring to one based on government-issued Treasury securities.

These rates are important for those investing for portfolio income, taking out a mortgage, applying for a personal loan and more. However, the yield curve is arguably much more important as an economic indicator. This is because the shape of the yield curve tells us about the health of the economy and where we might be in the business cycle.

THE YIELD CURVE HAS INVERTED



Key Takeaways:

1. **The yield curve inverted last week based on the 10-year and 2-year Treasury yields.**
2. **Other measures which use shorter-dated maturities still show significant steepness. These rates will likely rise as the Fed accelerates its rate hike process.**

Traditionally, economists and market professionals look at the difference between 10-year and 2-year Treasury yields. Since we often plot these yields on a graph, when the difference is large, we say that the yield curve is "steep" (it slopes upward to the right). When the difference is small, we say that the yield curve is "flat."

The shape of the yield curve changes throughout the business cycle. Early on, all rates are low as the economy comes out of recession. Long-term rates then begin to rise as growth picks up, followed by short-term rates that are influenced by the Fed as it tightens policy. Thus, it's natural for the curve to flatten over time, giving us a hint as to how far along the cycle may be.

Eventually, the curve flattens so much that it "inverts" - i.e., when it slopes downward instead. As of last week, the 10-year Treasury yield reached 2.38%, the 2-year 2.44% and the 3-month Treasury note 0.5%. The fact that the 2-year yield was higher than the 10-year is what signals this inversion to many. However, deciding how to measure and interpret this can be tricky.

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There are three important facts to highlights:

First, while yield curve inversions may predict eventual economic downturns, they don't tell us about their timing. For example, the yield curve flattened significantly in the mid-1990s, remained flat for a few years, inverted for a period in 1998, then re-steepened. The bull market then continued for another couple of years before the recession in 2001.

Of the six recessions since the early 1980s, some form of yield curve inversion occurred anywhere from 9 to 23 months before, during which markets often performed well. Thus, yield curve inversions are a blunt tool that should not be interpreted as a market timing indicator. Instead, history suggests that being positioned properly throughout these events, with an appropriate combination of stocks and bonds, preferably with the advice of a trusted advisor, is much more important.

YIELD CURVES ARE A BLUNT TOOL FOR PREDICTING RECESSIONS

Key Takeaways:

1. **While yield curve inversions do precede recessions, they do not predict their exact timing. Over the past 50 years, recessions have occurred anywhere from 9 to 23 months after the 10-year Treasury yield falls below the 2-year - a large variation in timeframes.**

2. **Additionally, there are other factors that could affect the yield curve this time around.**

Second, the reality is that not much has changed for long-term investors over the past week. The flattening of the yield curve has been driven by well-known factors such as inflation, the economic rebound, ongoing pandemic outbreaks in certain parts of the world, supply chain problems, and geopolitical risk. Even the Fed's rate hike was fully anticipated by the market, which is one reason that stocks have rebounded.

In fact, other measures of yield curve steepness have not inverted in the same way. While using 10's and 2's is common, comparing the 10-year yield to the 3-month shows that the short-end of the curve is as steep as it's been going back to early 2017. Similar measures, such as the "near-term forward spread" which is also accepted as a recession indicator, is the steepest it's been since the early 2000s. Other leading economic indicators have softened but have not turned negative. So, not only is the timing unclear, but which measure to focus on is often determined in hindsight.

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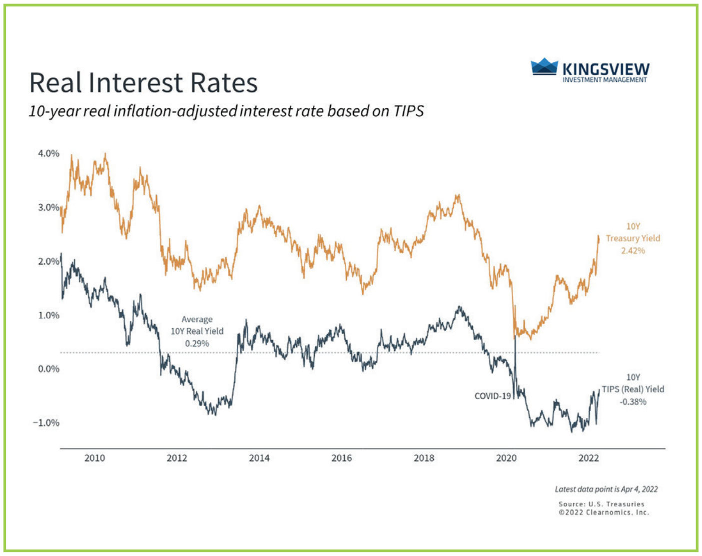
KINGSVIEW
INVESTMENT MANAGEMENT

REAL, INFLATION-ADJUSTED INTEREST RATES ARE STILL SUPPORTIVE



Third, even with the curve flattening, real inflation-adjusted interest rates are still stimulative for the economy. In fact, all interest rates along the yield curve are still in negative territory once taking inflation into account. This may resolve itself as inflation cools and policy rates rise. However, negative real rates are usually viewed as accommodative for the economy, just as they were a decade ago.

Thus, the goal of any long-term investor is still to stay balanced throughout all phases of the market cycle, and not to focus on day-to-day changes in market and economic indicators. A recession is always possible and, in the longer-term, is inevitable. But trying to predict its exact timing isn't just difficult - investors run the risk of missing out on opportunities in the meantime. Interest rates are sending mixed signals based on the level and the shape of the yield curve. Investors ought to stay balanced and avoid overreacting.

Key Takeaway:

1. **Economists often focus on “real” interest rates - i.e., interest rates after adjusting for inflation. At the moment, these real rates are still extremely accommodative. They continue to be negative which is often supportive of economic growth.**