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Time to Panic?

There's almost zero chance that you missed the alarmist headlines on Friday about the inverted yield curve, which (you probably also read) inevitably signals an upcoming economic recession. So the smart move is to retreat to the sidelines until the economic bust is over, and get back into the market once the yield curve has developed a healthy steepness. Right?

Investors certainly thought so. The S&P 500, on Friday, dropped 1.9%, as people reacted as if a recession would happen on Monday. It would be nice if investing were that simple. But in the current case, it is much further from simple than normal.

Why?

The yield curve is a line plotting out the interest rate (yield) that is paid to investors across maturities, from three month to 30 year. An inversion happens whenever the shorter maturity bonds provide higher yields than longer-term ones—which is counterintuitive since the risks of holding bonds longer-term are greater than if you're parking your money for a few months. Longer-term, you could experience inflation, default or a rise in interest rates that may make you regret committing your money at a particular rate for 10 years or longer.

This current so-called "yield curve inversion" really looks more like a flat line stretching from short-term to intermediate-term bonds. What was widely reported was a (probably brief) moment when the 3-month Treasury note offered higher interest than the 10-year bond—by (get ready to be shocked) 0.022%. You could see roughly the same spread difference around the beginning of 2006, which was not a very clear signal. There was no recession until a year and a half later. Some months afterwards, the yield curve inverted with a vengeance, although it righted itself before worst carnage of 2008.

The lesson here is that, yes, we have experienced a yield curve inversion sometime before each of the last seven recessions. However, there have also been two false positives—an inversion in late 1966 that was followed by economic growth, and a largely flat curve, like the one we are experiencing now, in late 1998 that also didn't presage a recession.

Moreover, even if we accept the idea that a yield curve is a recession signal, the actual timing is almost impossible to predict. Data from Bianco Research has shown that over the last 50 years, a recession followed, on average, 311 days later—roughly a year. This is an average of some pretty broad fluctuations. Following that brief inversion in 2006, the economy didn't experience recession for another 487 days. An inversion in December of 1978 was followed by a recession—389 days later. In contrast, it took just 213 days for the U.S. economy to enter recession territory after a July, 2000 yield curve inversion. Based on this evidence, selling the day after an inversion seems like a poor strategy. Selling a month, or six months after doesn't make sense either.

Finally, some economists think that the yield curve is not nearly the accurate signal that it once was. The reasons are a bit technical, but they have to do with the increasing control that the central banks—including the U.S. Fed—have on the shorter end of the yield curve. The Fed and other central banks have been buying up government bonds for their balance sheet, which means the shorter-term yields can no longer be seen as market driven.

So what IS an accurate signal of upcoming recession? There are some tried-and-true signs, including an overheating rate of GDP growth (which we haven't seen at all in this long, slow recovery), rising unemployment (nope) and spiking interest rates (no sign yet). Another sign that directly impacts the yield curve is a sudden demand for longer-term bonds as a safe haven for nervous investors, causing the bond rates to drop below shorter-term paper. There has been no indication of a shift in demand for bonds over stocks.

So what does all that mean? The simple lesson is: don't fall for clickbait. We are still as much in the dark about what the economy and markets will do in the future as we were before 3-month Treasury bills returned a shocking 0.022% more than 10-year Treasury bonds. We might experience a recession this year, or next, or in 2022. All we know for sure is that we WILL experience one, possibly with a few unexpected market ups and downs in the meantime.

-Bob Veres

Sources:

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The market at a glance

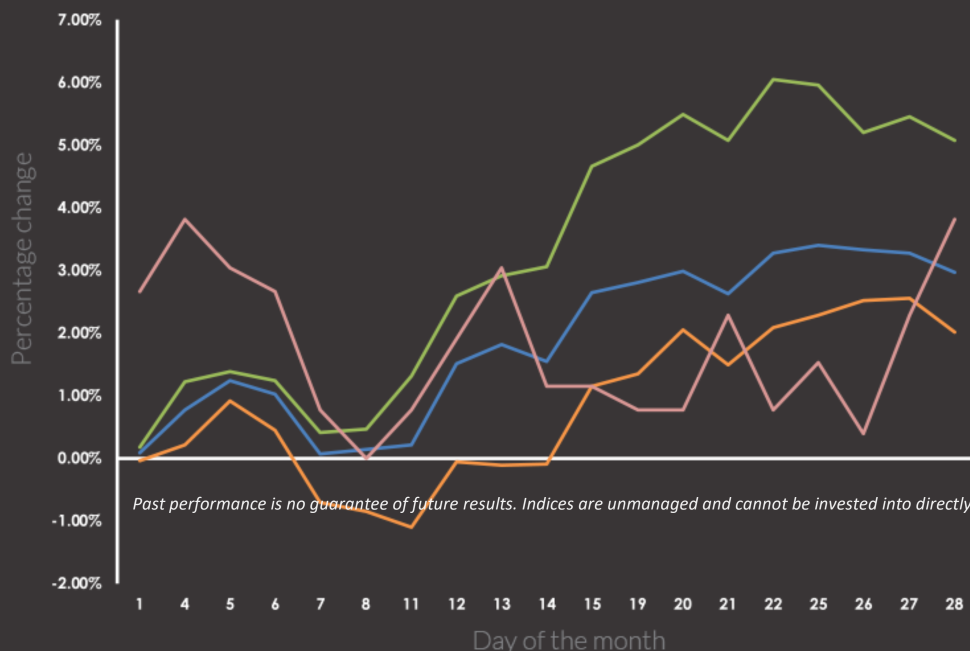
February

U.S. Large Cap
(S&P 500)
2,784.49 (2.97%) ▲

U.S. Mid/Small
(Russell 2000)
1,575.55 (5.08%) ▲

International Large
(NYSE International 100)
5,381.68 (2.01%) ▲

U.S. Treasuries
(U.S. 10-year Treasury yield rate)
2.73 (3.80%) ▲



The market in action

- Discount shoe retailer Payless filed for bankruptcy and announced it will be closing all of its nearly 2,500 stores in North America. The liquidation could be the largest ever in the retail industry in terms of store count and will impact its more than 13,000 employees.

- General Electric Co. (GE) shares soared following the announcement of a $21.4 billion sale of its biopharmaceutical unit. The news comes just months after a two-year stock collapse erased more than $200 billion of shareholder value at the end of 2018.

- E-commerce giant Amazon announced it will no longer build a second headquarters in New York City following local opposition. Originally announced in November 2018, the projected dubbed ‘HQ2’ drew large interest from state and local governments across the country for its plan to bring 25,000 jobs to the area.

- A federal appeals court cleared the telecommunications takeover of Time Warner by AT&T, allowing the $85 billion deal to stand. AT&T, who now serves nearly 30 percent of the 90 million U.S. pay TV households, said the deal will help it compete against streaming services such as Netflix and Hulu.

Crazy Facts, Great Lessons

If you're a dedicated market geek with plenty of time on your hands, you can uncover some really interesting things about stock market history and—perhaps—learn some interesting lessons from them. Thus Michael Batnick, of Ritholtz Wealth Management in New York, took a deep dive into the numbers, and these are some of the things that he found.

Since 1916, the Dow Jones Industrial Average (which predates the S&P 500 index, and has performed very similarly through history) reached new all-time highs on fewer than 5% of all market days. Think about that: during a time period when the index has delivered 25,568% positive returns, investors have been under-water 95% of the time. Since 1970, the Dow has grown at less than .03% a day—but through the powerful magic of compounding, that has resulted in a 3,000% total gain.

If you're the sort of person who might be inclined to bail out during a market decline, then Batnick points out that 20.6% of the time—while these incredible long-term returns were being generated—the Dow was down 40% or more from its highs. His comment: "no pain, no gain."

One time period when you might have been inclined to bail out was during the 1970s. Over that entire decade, from January 1, 1970 to December 31, 1979, the Dow gained just 38 points, from 809 to 838. (It's over 25,800 today.)

You also might have been inclined to bail more recently. At the low in 2009, U.S. stock indices were back to the point where they had been in 1996. It could have been worse. At their low in 2009, Japanese stocks were back to where they had been in 1980s.

If you're convinced that gold is the ultimate hedge against inflation and a darned good investment for the long term, Batnick offered some statistics that don't exactly back up the argument. He noted that since 1980, gold has risen 153% in value, while inflation, over the same time period, has risen 230%. A better inflation hedge? Gold and the Dow were both around 800 in 1980. Today, gold trades at $1,300 an ounce while the Dow is, as mentioned before, over 25,800.

Nevertheless, Batnick notes that most of the gains in the equities markets are generated by a small handful of the wide universe of stocks—and of course, it is impossible to know which ones will be home run investments in advance. His statistic: 96% of U.S. stocks generated a lifetime return that match one-month T-bills—the safest and lowest-returning investment you could put your money into.

You can find the whole list of amazing facts here: https://theirrelevantinvestor.com/2019/03/13/the-twenty-craziest-investing-facts-ever/. The facts are, indeed, crazy—and also entertainingly informative.

-Bob Veres

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