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Perspectives

If the Yield Curve Inverts, What Should You Do?

One of the most oft-cited recession predictors is an inversion of the Treasury yield curve. According to research from the San Francisco Federal Reserve released in March 2018, between January 1955 and February 2018, the Treasury yield curve inverted before each of the nine officially designated recessions and only one false positive occurred in the mid-1960s. This is a strong track record, but the report also noted that the curve historically inverted between six months and two years in advance of those recessions. This is one of many “indicators” that get a lot of press and cause a lot of anxiety for investors. If the yield curve inverts (it has come close this year), what should investors do? Before answering that question, a closer examination of the data is necessary.

A Closer Look

Before the global financial crisis of 2008, the yield curve first inverted at the end of December 2005 when the two-year Treasury rate topped the 10-year rate by one basis points. The curve remained largely inverted for all of 2006, though it had bouts of reversion back to a normal upward sloping curve. At its peak, the two-year Treasury rate outstripped the 10-year rate by 35 basis points (early December 2006). The curve changed shape and reverted in June 2007 and has yet to invert again. If an investor swapped her equity exposure for bonds when the curve first inverted, would she have been better off?

Between January 2006 and June 2007, when the yield curve first inverted to when it reversed course, the S&P 500 Index gained 24% on a cumulative basis. Between January 2006 and October 2007 (Lehman Brothers collapsed in mid-September 2007 and is widely seen as the start of the 2008 bear market), the S&P 500 Index gained 28%, cumulatively. During those same two periods, the Bloomberg Barclays US Aggregate Bond index gained 5% and 9%, respectively. Our investor would have missed out on some strong gains over that 18-month period. Of course, the stock market tanked shortly thereafter, and our investor would have been immensely better off fully invested in bonds from the time the curve inverted to the S&P’s bottom. The table below details the return periods discussed above.

With the benefit of hindsight, making a whole sale portfolio shift looked to be the right choice. Market timing in real time, however, is nearly impossible. Our investor, having moved her portfolio to bonds in January 2006, would likely catch a serious case of FOMO (Fear of Missing Out) as she watched the S&P 500 march higher for the next 18 months. She would also likely have re-entered the market, buying in at higher prices than she sold. Perhaps she would be reassured by the “reversion” of the curve in June 2007 and the continued equity market rise. She is also highly unlikely to pinpoint the exact bottom as the market moves in fits and starts—up a little, then back down before heading up again. Because of this, she’d probably miss much of the stock market’s initial recovery—the S&P 500 gained 42% from the bottom in March 2009 to the end of 2009, much more than it gained in any calendar year since.

Index Returns: Inversion and Reversion

Index	Total Return Jan. 2006 to June 2007 (Inversion to Reversion)	Total Return Jan. 2006 to Oct. 2007 (Inversion to Lehman Collapse)	Total Return Jan. 2006 to Mar. 2009 (Inversion to end of bear market)	Current Market Cycle Oct. 2007 – Sept. 2018
Bloomberg Barclays US Aggregate Bond	5.35	9.32	17.59	50.11
S&P 500	23.85	28.38	-31.51	141.58
60/40 S&P/Agg	16.45	20.76	-11.87	104.99

Source: Morningstar

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If we instead focus on a more balanced portfolio (60/40 S&P/Agg), returns are much less dramatic during both the up and the down markets. Yes, that portfolio gained less than an all-equity portfolio over the current market cycle (from Oct. 2007 to Sept. 2018), but a lower volatility profile helps investors stay the course, an important factor in reaching long-term investment goals.

At the end of the day, "beating the market" is nice, but not necessary. Investors have goals that are not always tied explicitly to beating benchmarks. Portfolios that are calibrated properly will help investors stick to their plan and reach those goals. Now is a great time for investors to revisit their investment goals to be sure their portfolios reflect them appropriately. Perhaps a modest rebalance is necessary, given the strength of the equity market and the weakness of the bond market this year, but wholesale portfolio shifts are generally not recommended or required, unless investment goals have changed. Investing for the long term takes patience and often nerves of steel.

The table below shows returns for major indexes through the third quarter. Emerging markets continued to struggle on the back of a strengthening U.S. dollar as well as idiosyncratic issues in several countries including Argentina and Turkey. Domestic large cap stocks benefited from another strong earnings season and robust GDP growth. High-yield bonds again outpaced the investment-grade Aggregate Bond index. High-yield bonds tend to have a relatively high correlation to equities and broadly benefited from the rosy economic picture in the United States. After two quarters of negative returns, the Aggregate Bond index was flat last quarter.

Index Returns: Third Quarter 2018

Index	Total Return Q3 (%)	Total Return 1-Yr (%)	Total Return 3-Yr (Annualized) (%)	Total Return 5-Yr (Annualized) (%)	Total Return 10-Yr (Annualized) (%)
Equities					
S&P 500 (Large Caps)	7.71	17.91	17.31	13.95	10.17
Russell 2000 (Small Caps)	3.58	15.24	17.12	11.07	10.60
MSCI EAFE (Intl Equity)	1.35	2.74	9.23	4.42	2.84
MSCI Emerging Markets	-1.09	-0.81	12.36	3.61	2.26
Fixed Income					
Bloomberg Barclays US Aggregate Bond	0.02	-1.22	1.31	2.16	3.72
Bloomberg Barclays US Corporate High Yield	2.40	3.05	8.15	5.54	9.46

Data as of 9/30/2018. Source: Morningstar

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