OUTSIDE THE FLAGS

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# Upside Down World

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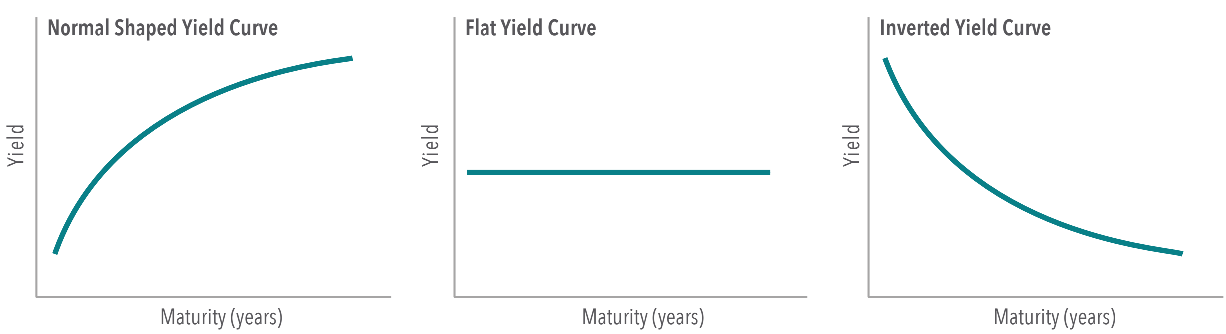
The financial media is currently full of gloomy-sounding references to 'inverted yield curves' as a harbinger of a global recession. In lay terms, what does all this mean and how should a long-term investor respond?

A yield curve is a line that plots the yields of bonds of the same credit quality across different maturities. Normally, this curve is upward sloping, but recently yield curves in certain markets have flattened or inverted so that bonds of longer maturities are trading at equivalent or lower yields than those with shorter maturities. In some cases, long-term interest rates have turned negative.

**Exhibit 1:** Yield Curves



Let's look at it another way. Imagine two friends ask you to fund their ventures, searching in far-off lands for rare minerals. The details of both are the same, except one friend will be gone for a year and the other for 10 years. Most likely, you'll demand a higher return from the person who will be gone for a decade because your money is locked up for longer and you could miss out on other opportunities in the meantime.

It works a bit like that in the bond market. Most of the time, investors demand a higher yield, or expected return, for lending their money out for longer periods than they do for shorter ones. If you've ever had a term deposit, you'll know that offers on five-year terms tend to be more generous than those on one-year terms.

The customary higher expected return for longer-term bonds over short-term ones is known as a *term premium*. This premium is the compensation investors demand for uncertainty about the future economic environment. For instance, inflation could be higher than expected and eat into their returns. Interest rates may rise and make their bonds less attractive, depressing their prices.

Now, the point about yield curves is they are always changing. That's because news and information is always changing. An update on company fundamentals, data about the overall economy, geopolitical developments, a general change in investors' appetite for risk, and a host of other factors all can affect the curve.

Not only are yield curves inverting, but rates on government bonds in many countries are now below zero. In other words, investors are paying governments to look after their money. According to analysis by Deutsche Bank, about $US15 trillion of government bonds worldwide, or 25% of the market, now trade at negative yields.[1]

This development has sparked a deluge of media commentary about yield curve inversion as a signal of a coming recession and major stock market downturn. Naturally, this is worrying a lot of people who are asking their advisors how to respond.

Here are a few points to consider:

1. First, drawing firm conclusions about what an inverted yield curve might say about the stock market outlook is made difficult by the fact that they occur only rarely. In the US market, for instance, there have been only four inversions in more than 40 years.

   To get a broader picture, Dimensional's research team looked at stock market performance in five developed economies – the US, the UK, German, Japan and Australia – following 14 cases of yield curve inversions since 1985.[2]

   They found that in 10 of those cases, local investors would have had positive returns investing in their home stock markets after three years of the curve inverting. That is not much less than the historical experience of those markets over the same time frame. Ultimately, 14 observations across the globe in the space of three decades are too few to give you enough information to base an investment decision on.

2. Markets are moved by multiple factors at any one time and it's extremely difficult to draw simple cause-and-effect conclusions about why the curve is shaped in a particular way at a particular time. Alongside demand and general risk inversion, curves can be influenced by variability in the supply of bonds, demographic trends (people getting older and living longer), and many other reasons.

3. Recessions often only become apparent in retrospect. Economists themselves, including many central bankers, have a poor record of correctly predicting downturns. As Nobel Prize-winning economist Paul Samuelson once quipped, declines in stock prices have correctly predicted nine of the last five recessions!

1. 'Negative-Yielding Debt in the World Balloons to $15 Trillion', CNBC, 7 Aug 2019
2. 'The Flat-Out Truth', Dimensional Fund Advisors, Nov 2018

Of course, this isn't to deny the yield curve inversion as a recession indicator may turn out to be correct in this instance. It just means that markets are highly complex beasts and it can be foolhardy to try to time your exit and entry points based on information that is already reflected in today's prices.

4. Just because bond yields are at historic lows (prices at historic highs) does not mean they won't go any lower (and prices higher). In the year or two after the GFC, for instance, some investors assumed that so-called "quantitative easing" by central banks would lead to higher interest rates and spikes in inflation, resulting in poor returns on bonds. Based on that thesis, these investors decided to get out. As a result, they missed out on several years of very solid returns.

5. Even with bond yields at historically low levels, they still pay a regular income. And because bonds tend to behave differently to equities over time, they still play a diversification benefit in your portfolio.

In summary, when confronted by headlines about inverted yield curves, it's useful to reflect on how markets work. New information is built into prices instantaneously and there is little to be gained by trying to second guess those prices.

Even the experts are torn on whether this episode of yield curve inversion is a harbinger of recession. And in terms of what it might mean for the stock market, our own research over the last three and a half decades does not suggest these inversions are a sign you should get out of the stock market.

That leaves you as an individual to focus on the elements within your own control – in other words, developing and sticking to a long-term plan designed by your advisor for your circumstances, your goals and your risk tolerances. Doing that gives you a better chance of looking past the daily noise in the markets and focusing on investing in a systematic way that helps you meet your long-term goals.

Even when the world looks upside down, this might make it a less dizzying experience.


*"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.*

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