Investment Insights

Is the Inverted Yield Curve Signaling Recession?

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The Model Wealth Program
Principle-Based Investing

"Principal-based investing means we focus on investment principals that have stood the test of time rather than basing our decisions on short-term market predictions. Our goal is to identify a small number of experienced managers who offer the potential to outperform their peers over a long period of time. Our approach is to combine a well-defined quantitative and qualitative due diligence process with proprietary construction tools to build, manage, and monitor our client's portfolios."

The Model Wealth Program is a managed fee-based investment program, available through Cornerstone Wealth Management, LLC. The MWP investment team has developed sophisticated long-term strategies in an effort to manage and control risk, to help investors pursue their financial goals. For more information about the program, contact your Cornerstone Wealth Management representative.

Key Points

- A yield curve goes flat when the premium, or spread, for longer-term bonds drops to zero. If the spread turns negative, the curve is considered "inverted."
- An inverted yield curve has been a reliable indicator of impending economic slumps. The spread between 3-month bills and 10-year Treasuries has inverted before each of the past seven recessions.
- Making investment decisions in reaction to changes in the yield curve is a dicey proposition. The payoff for accurately predicting recessions is poor, and the penalty for poor market timing can be huge.
- The focus of the Model Wealth Program is to help investors earn a competitive return while carefully managing risk. We believe owning quality investments, properly diversified portfolios, and rebalancing at appropriate times is a better approach than jumping in and out of the market in response to changes in the yield curve.

Understanding the Yield Curve

Lately, investors have seen headlines screaming about the inverted yield curve like this one from Fox Business on August 8th, 2019:

Is a U.S. recession coming? Yield curve flashes dire warning.

If you're wondering what a yield curve is and why there's so much fretting about it, you're not alone. Let's take a few minutes to understand what the yield curve is and why it's important.

What is a yield curve?

The yield curve is a plot of interest rates for government bonds of all maturities. Usually, investors demand a higher interest rate for loaning money for a longer period, because inflation has a larger impact on bondholders over the long-term. So, for example, a bond with a 10-year maturity would have a higher interest rate than a short-term obligation of 2 years.

What are flat and inverted curves?

A yield curve goes flat when the premium, or spread, for longer-term bonds drops to zero -- when, for example, the rate on 10-year bonds is no different than the rate on 2-year notes. If the spread turns negative, the curve is considered "inverted."

What causes a flat or inverted curve?

The Federal Reserve greatly influences the short end of the yield curve through its changes in monetary policy. The Fed will often hike short-term interest rates to make borrowing more expensive and slow the economy before it gets overheated and causes higher inflation. If the Fed raises rates too fast, or too much, long-term rates (which reflect long-term inflation expectations) fall, causing the yield curve to become flat or inverted.

Why does it matter?

Because inflation usually comes from strong economic growth, a sharply upward-sloping yield curve generally means that investors have rosy expectations about economic growth. An inverted yield curve, by contrast, has been a reliable indicator of impending economic slumps, like the one that started in 2007. In particular, the spread between 3-month bills and 10-year Treasuries has inverted before each of the past seven U.S. recessions.

What's been happening?

Since late 2018, markets have been concerned about the possibility of a global economic slowdown, fed in part by the trade war between the U.S. and China. Those signs of weakness led the U.S. Federal Reserve first to pause the series of interest rate hikes it had been pursuing and then to cut rates in July. At the same time, however, the Fed signaled that the cut wasn't necessarily the start of a cycle of rate reductions. That statement led investors to believe the Fed was keeping short-term rates too high for too long, which could hurt the economy. Inflation expectations fell, driving long-term rates lower than short-term rates. 30-year Treasury yields fell to a record low.

What should we do?

Making investment decisions in reaction to changes in the yield curve is a dicey proposition. As the chart below shows, inverted yield curves lead recessions and peaks in the stock market, but the lead time can vary significantly. As an example, the yield curve inverted nearly two years before the last recession and the peak in the stock market.

Inverted Yield Curve (10-Yr minus 1-Yr), Recession, and S&P 500 Peak (1956-Present)

Earliest Yield Curve Inversion	Recession Start	Recession End	Month of S&P 500 Peak	Inversion to Recession Lag (Months)	Inversion to S&P Peak Lag (Months)
Dec-56	Aug-57	Apr-58	Jul-56	8	-5
Sep-59	Apr-60	Dec-61	Jul-59	7	-2
Dec-67	Dec-69	Nov-70	Nov-68	24	11
Mar-73	Nov-73	Mar-75	Jan-73	8	-2
Sep-78	Jan-80	Jul-80	Feb-80	16	17
Sep-80	Jul-81	Nov-82	Nov-80	10	2
Feb-89	Jul-90	Mar-91	Jul-90	17	17
Apr-00	Mar-01	Nov-01	Mar-00	11	-1
Jan-06	Dec-07	Jun-09	Oct-07	23	21
Average Lead Time				**14**	**6**

Source: Ned Davis Research

The inversion of the yield curve in March 1973 and April 2000 correctly anticipated stock market declines that followed. But in other periods, the stock market was significantly higher 12 and 24 months after inversion.

It's true, recessions, and the bear markets that often accompany them can be painful in the short-term. But recessions are less painful for investors who have the courage to hold their investments over the long-term. The example alongside shows a comparison between two hypothetical investors. The first invested $10,000 on the first day of the last 11 recessions. The second invested on the last day of the last 11 recessions. After 10 years, their results are virtually the same.

For the assets we manage in the Model Wealth Program, here's our approach to volatile periods in the market:

- We recognize that corrections are a normal part of the investing process. This prevents us from making knee-jerk reactions in response to short-term events.
- We know our managers completely: Through our due diligence process, we make every effort to know how our managers are positioned and what risk management processes they employ. This gives us the confidence to hold through difficult markets.
- Diversification: Our models are broadly diversified by security, asset class, and manager. *The fixed income portion of our portfolios has provided a strong cushion during stock market sell-offs.*
- During market declines, our managers put their "shopping lists" to work, by buying good securities at lower prices.

Inverted Yield Curve (10-Yr minus 6 Month) (1959-Present)

Earliest Yield Curve Inversion	3 Months Later	6 Months Later	12 Months Later	18 Months Later	24 Months Later
Sep-59	5.29	-2.71	-5.91	14.38	17.32
Dec-65	-3.46	-8.32	-13.09	-1.94	4.37
Mar-67	-6.50	3.22	7.66	1.29	-4.57
Mar-73	-6.51	-2.77	-15.73	-43.02	-25.25
Oct-80	1.63	4.19	-4.38	-8.65	4.90
Feb-82	-1.09	5.66	30.90	45.35	38.86
Mar-89	7.84	18.41	15.28	3.79	27.25
Apr-00	-1.49	-1.59	-13.97	-27.03	-25.85
Jan-06	2.39	-0.27	12.36	13.69	7.69
Average	-0.21	1.76	1.46	-0.24	4.97

Source: Ned Davis Research, August 1, 2019

$10,000 Invested in S&P 500	1 Year Later	3 Years Later	5 Years Later	10 Years Later
1st Day of Recession	$10,582	$14,051	$16,815	$34,467
Last Day of Recession	$11,635	$14,533	$18,900	$35,929

Source: Ned Davis Research as of July 30, 2019. Hypothetical $10,000 invested includes reinvested dividends using average annual total return since 1945. The S&P 500 is an unmanaged index and cannot be invested in. Taxes and commissions not included. Source of Recession dates: NBER. 1945 – present. Dates for 11 recessions since 1945 were not known until after the fact. Past performance is not an indication of future results.

- We avoid performance-chasing. Every manager has a style, and every style has a cycle. By understanding the reasons for outperformance or underperformance, we avoid the classic trap of buying a manager whose style is temporarily in favor and selling managers whose style is temporarily out-of-favor. Instead, we carefully diversify our models by manager style. We avoid simply buying managers with a strong 1-year, 3-year, or 5-year track record.
- Quality: The managers we include in the program are experienced and credentialed with supporting teams and resources that are broad and deep. They have a long track record of outperforming peers in good times and bad.

Here is our bottom line for investors who are concerned about the inverted yield curve and recent market volatility:

- Don't put a lot of faith in economists' ability to predict recessions. Recessions are *inevitable*, typically short, and completely unpredictable.
- The payoff for accurately predicting recessions is poor.
- The penalty for poor market timing can be huge.
- Stay focused on the things you can control and manage risk.
- Don't own investments today you wouldn't want to own in a recession tomorrow.

Important Disclosures

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

The examples provided are hypothetical and are not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing. Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

Past performance is no guarantee of future results. All indices are unmanaged and may not be invested in directly.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Model Wealth Program: The Strategic Portfolio

Our Strategic portfolios seek to maximize returns while minimizing risks by investing with managers who offer the potential to outperform their respective benchmarks over a long period of time. The portfolios are implemented with a three-to-five year time horizon, but changes may take place sooner if market conditions change or if a change in managers is deemed necessary. These portfolios may be preferable for investors who pursue an approach that blends both active and passive investing strategies. These portfolios are properly diversified among managers in the three major asset classes: U.S. equity, international equity, and fixed income. Within the Model Wealth Program, we rebalance the portfolios we manage when market conditions push the portfolio out-of-balance in an effort to maintain a steady level of risk consistent with your long-term goals and objectives.

We offer five different choices for investors with varying risk tolerance and need for current income: Aggressive Growth, Growth, Growth & Income, Income with Moderate Growth, and Income with Capital Preservation. We believe a professionally-managed advisory account can help take the emotions out of the investment decision-making process, and offers an attractive solution for investors with long-term goals, like saving for, or investing in, retirement.

Investments and strategies mentioned may not be suitable for all investors. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Asset allocation does not ensure a profit or protect against a loss. Tactical allocation may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

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