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The Yield Curve is Inverted. Don't Panic.

Wednesday was another "interesting" day in the markets. The S&P 500 Index was down almost 3% on the day – and follows on the heels of last Monday, where the market was *also* down nearly 3%. It's been an eventful week and a half. Rather than dissect what's caused these drops (and annoy one half of our readers or the other), I want to talk about the broader picture: What are the effects of these drops, what you should do about it, and we'll take a close look at what an inverted yield curve means.

Let's start by looking at some basic facts. As I mentioned, over the past 8 trading days, there have been two days where the S&P 500 Index dropped by nearly 3%. Over that period (from August 5th through August 14th 2019) the S&P was down 3.12% in total. To put it mildly, this is not fun, but it's worth keeping in mind that a 3% drop over the course of a week and a half is hardly unprecedented. In fact, it's usually something that we probably wouldn't really notice. The reason we are paying so much attention to it is because of *how* this drop happened. It was driven by two reasonably bad days that were themselves driven by some pretty big events.

The drop on August 5th was driven by the Trump administration declaring China a currency manipulator, and Wednesday's drop was driven by the inversion of the yield curve – which was in turn driven by uncertainty around the trade war with China. There's a narrative that we can apply to these movements, so we will tend to focus on it a lot more than is probably warranted by the pure numbers. It's not just a week and a half of uninspiring returns that just happened to end up with a 3% drop.

When will the bull market end?

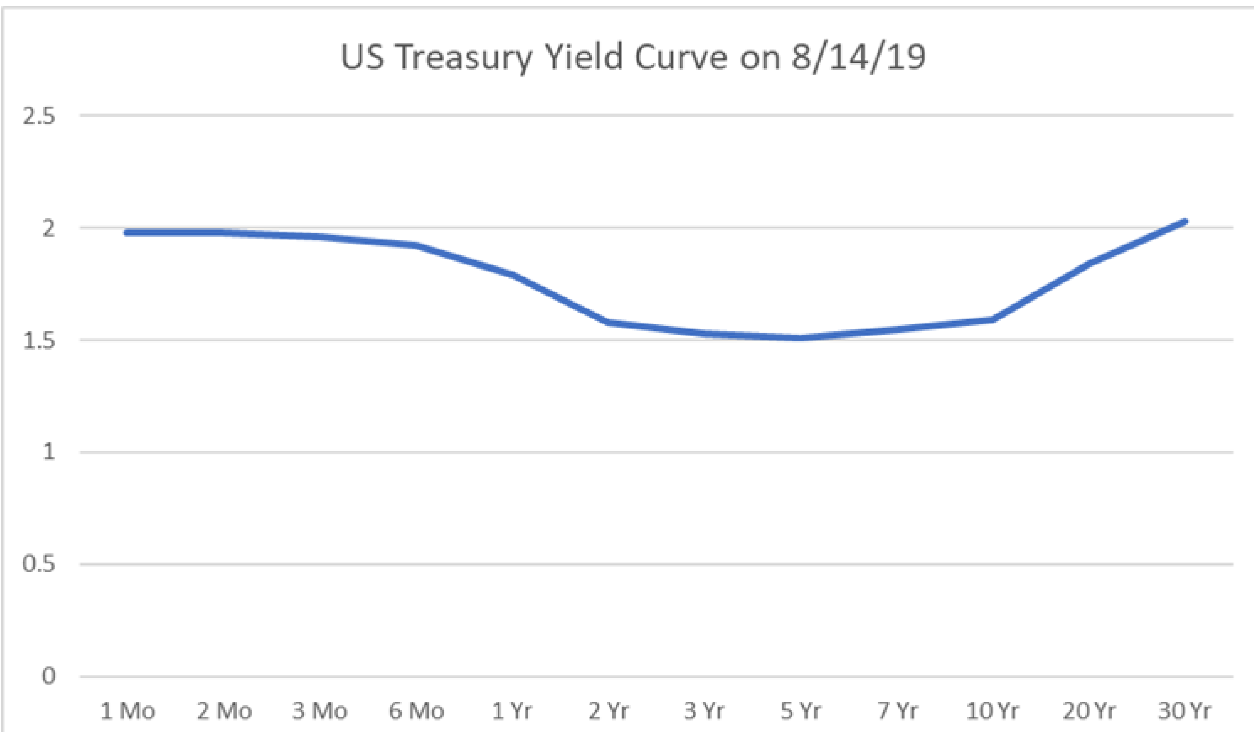
Another piece of the puzzle is that everyone is waiting for the other shoe to drop. Since the 2008 financial crisis, we've had one of the longest and most profitable bull markets in US history. One of the few definitive statements we can make about the stock market is that this too shall end. We know that the market will turn around since it can't keep going up forever (or going down forever). This means that everyone is going to be on alert for bad news that might foretell the end of the bull market – especially if that bad news can be tied into a broader narrative (which this past week and a half definitely can be).

What is an inverted yield curve?

The proximate cause of Wednesday's drop was an inverted yield curve, caused by uncertainty about the economic situation largely as a result of the trade war between the US and China. Inverted yield curves make people nervous because they are just weird –

they go against our basic intuition of how the bond market (and financial markets in general) are supposed to work.

To make sure that we are all on the same page, an inverted yield curve means that the yield on (some) shorter-term bonds is higher than the yield on (some) longer-term bonds. Typically people will focus on the US Treasury bond market so that we can minimize the effects of credit risk, and when we look at the yield curve, you can see it pretty clearly.



Data from the US Treasury Department

That dip is what we are focused on here. If I were to go out and buy a 5 year US Treasury bond I would get a lower yield than I would if I were to buy a 1 year US Treasury bond. And like I said, that’s kind of weird.

To put this in terms of the risk premiums we normally think of financial returns in, an inverted yield curve means that we have a negative term premium. We normally expect to get a higher yield when we loan our money out for longer, but that's not what's going on in the market right now.

Now, astute readers may have noticed something – the yield curve has had this dip for a while now. This isn't something that just happened overnight. So what has changed that we're all talking about it now? The hook that the news media is using is that during intraday trading on Wednesday, the yields of the 2 Year and 10 Year Treasury bonds crossed – which has "predicted" all of the recessions since the 1970s.

A couple of things on this. The first is that the 2 year and 10 year yields crossing was pretty fleeting – when the markets closed on Wednesday afternoon, the yield of the 10 year bond was (slightly) higher than the yield on the 2 year bond.

More importantly, we need to ask what is so uniquely important about the relationship between the 2 year and 10 year US Treasury bonds? Well, nothing particularly. You can come up with stories around liquidity and things like that, but pretty much all US Treasuries are incredibly liquid. It's just the relationship that happened to fit the data in a way that tells a good story, and this should make us pretty skeptical of the relationship going forward. It's always important to remember the old cliché about economists predicting 8 of the last 5 recessions.

Whenever we're looking at a big dataset (like the financial markets) there will always be *some* relationship that stands out – so we need to be careful about how much we read into the data. There simply no reason to think that the relationship between the 2 year and 10 year bonds is any more (or less) important than any other set of bonds that have been inverted recently.

What it really comes down to is that we had a bad day in the market – and this is the explanation that the financial media seized upon.

To figure out what an inverted yield curve means, we can actually think of longer-term bonds as a series of short-term bonds stacked on top of each other. So, let's say that we're looking at a 5 year bond. We can envision that as a series of five 1 year bonds that each start one after the other (or any other set of bonds that adds up to five years.) This matters because it allows us to use the yield curve to estimate what the market is estimating rates will look like between any two points.

Looking at the yield curve as of Wednesday night, the market seems to be saying that it expects yields to be relatively low in the medium(ish) term. Or, put another way, they expect a lot of people to be buying bonds in the future – and a pretty reasonable interpretation of that is that investors don't expect the stock markets to be all that great in the next few years.

Should You Change Your Allocation Based on the Yield Curve?

To say the least, that's not a great sign. But what should you do about it? Well, the financial media is full of all sorts of suggestions for how to weather whatever the markets throw our way, but is that a good idea? Should you listen to the financial media?

Well, no.

To pretty much all of the questions – presuming that you have built a well-diversified portfolio that is designed around your risk tolerance and retirement income needs, you probably don't want to make any changes to your portfolio based on what the yield curve happens to do.

While it is worrying that an inverted relationship between 2 year and 10 year Treasury bonds has "predicted" the past few recessions, everyone knows that. To the extent that the market actually thinks this relationship holds any water, that information is already in the prices – that's what the market was doing on Wednesday when it dropped by 3%. This may, or may not, foretell a big downturn in the markets, but it is certainly new information that will impact the market's expectations for the future. And unless you have a crystal ball, it will be hard to confidently out guess everyone else in the market.