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Trouble with the Curve

The Myopic Focus on the Yield Curve

By David P. Harris, CFA

In the mid-1960's Italian film director Sergio Leone gained fame for a series of movies that became known as "Spaghetti Westerns". He scouted locations in various geographies and found the desert climate in Andalusia, Spain ideal for simulating the American West. He then cast a U.S. television actor as the lead, launching Clint Eastwood's stardom. Unbeknownst to most viewers, films like *A Fistful of Dollars* and *The Good, the Bad, and the Ugly* were some of the first truly global movie productions.

Nearly fifty years later, Eastwood portrayed an aging baseball scout with failing vision in *Trouble with the Curve.* His character was reluctant to embrace modern statistical analysis to evaluate players - the type popularized in another baseball-themed film, *Moneyball*. A different kind of curve has been studied by economists, market strategists, and portfolio managers -- the yield curve which is simply interest rates graphed over a range of maturities, typically three months to thirty years. Given the unique circumstances of nearly two years of pandemic-induced fiscal and monetary distortions to the global economy, are investors today correctly interpreting the yield curve?

There is no denying the significance economists have traditionally placed on the yield curve as an indicator of future economic activity. An inverted yield curve – when short-term rates exceed long-term rates - has long been considered a harbinger of future recessions. In fact, the yield curve is what drives the widely watched New York Fed's forecast of recession probability, which is updated monthly. The profound impact that recessions have on jobs and financial markets explains why so much intellectual firepower is devoted to studying the yield curve. Virtually every member bank of the U.S. Federal Reserve has published extensive research on the yield curve.

Investors have long focused on the yield curve since it often has an outsized impact on market sentiment, leading to sharp sector rotations as some industries, especially financials, are viewed as especially geared to changes in the curve. The last sustained decline in equity markets prior to the pandemic occurred in the fourth quarter of 2018 when equities, as measured by the S&P 500 Index, plunged 13.5% on fears of the yield curve potentially inverting. The spread between two-year U.S. Treasuries and ten-year US Treasuries began the fourth quarter of 2018 at 24 basis points (bps), already much lower than long-term norms, and ended 2018 at 20 bps.

One key lesson we learned from 2018 was how poor the yield curve is as a timing tool – a tiny compression in the yield curve of 4 basis points led to an outsized market decline of 13.5%. By the time the yield curve finally inverted in August 2019, the equity market had rebounded strongly as the US Fed had already begun to cut rates, emboldening investors that a recession would be averted.

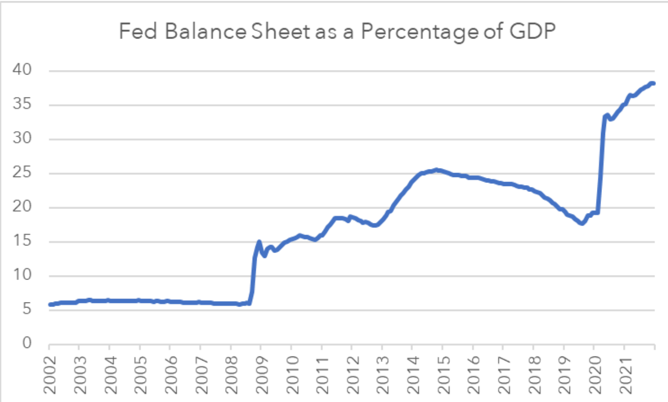
The trouble with the yield curve in 2021 is that many of its moves were driven by changes in sentiment around the pandemic which may prove myopic and fiscal stimulus which may prove fleeting. Consider the very pro-cyclical widening of the curve in the first quarter of 2021 that was spurred by declining COVID case counts as vaccines were just starting to be widely administered. The prevailing wisdom at the time was that we were at the cusp of exiting the pandemic. During the remainder of the year, the yield curve flattened as fears about Delta, Omicron, and President Biden's Build Back Better plan's failure to pass all raised economic growth concerns typically associated with a flattening yield curve.

Date	2-10 Spread	Change in Spread	Value - Growth
12/31/2020	79	23.7	3.3%
3/31/2021	157.6	78.6	8.2%
6/30/2021	121.7	-35.9	-7.2%
9/30/2021	120.8	-0.9	-3.1%
12/31/2021	77.4	-43.4	-5.5%

Source: Bloomberg

As we look ahead to 2022 and beyond, some of the recent yield curve changes may prove incorrect as investor focus shifts from the pandemic to the need for the U.S. Fed and other central banks to finally reckon with inflation. So far, we have seen Norway and the U.K. raise rates, but this hiking cycle is just getting started.

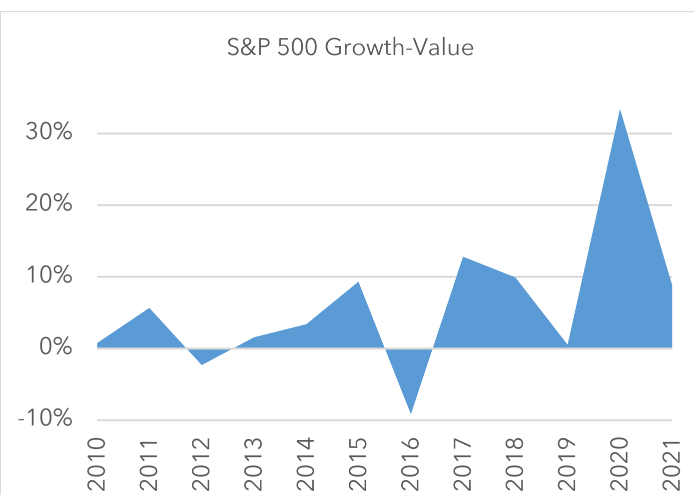
As one measure of pandemic-related distortion, the chart on the following page shows the size of the Fed's balance sheet relative to US annual economic output (GDP). The balance sheet equates to 38.2% of GDP - a staggering figure considering we entered the pandemic at about 18% of GDP. From 2014 to 2019, the Fed had been shrinking its balance sheet which grew sharply in the wake of the global financial crisis, but still much less than it did during the pandemic.



Source: Bloomberg

It is sobering to consider that the Fed has grown its balance sheet more in the last two years than it had in its 106 years of existence prior to the pandemic. While the Fed is still growing its balance sheet, it has at least signaled that rate increases are ahead in 2022 and has already begun to taper the size of its bond purchases. If there is one curve that should really trouble investors, it's the one in the chart above.

This massive surge in liquidity has impacted overall market valuations and has especially rewarded growth stocks with ever-higher multiples reflecting their low equity duration (a subject discussed in the last edition of *Global Foresight*). The chart below illustrates the stunning magnitude of how much growth has outperformed (again using the S&P 500 Growth and Value Indices as proxies for growth and value). Growth stocks had already been doing better than value stocks for the nine years heading into the pandemic, yet they outperformed more in the last two years than they had in the previous nine.



Source: Bloomberg

As the Fed begins to shrink its balance sheet, some of the beneficiaries of the massive excess liquidity created in 2020 and 2021 may face headwinds. These include many richly valued growth stocks such as software companies, meme stocks, cryptocurrencies, and non-fungible tokens (NFTs). In 2022 we may once again see an environment where fundamentals and valuations are at the forefront for investors, as has been the case in most periods in investment history. I expect the distortions caused by the record large infusions of liquidity and fiscal stimulus over the last two years will be looked back on by investors as an anomalous period akin to other extremes over the last twenty-five years like the global financial crisis, the dot-com bubble, and the Asia currency crisis.

In each case, investors tended to get caught up in the moment and overreacted by extrapolating that the current conditions they faced would exist well into the future. In reality, economic cycles and other dislocations are usually a short-term phenomenon. The lingering pandemic holds the keys to changing investor psychology, as well as decisions from policy makers. If there is one curve that has been giving investors a lot of trouble it is interpreting COVID case counts. Early in the pandemic, many feared there would be a "second wave", yet now we may be on wave five or six depending on geography.

For most of the pandemic the drumbeat of the news stories on spiraling case counts added to investor concerns. It seems like fear, in terms of stock market impact, may have peaked when the Omicron variant news broke in late November. While case counts are growing exponentially, I view Omicron as an accelerated off-ramp from the pandemic. I expect the world for most of 2022 will look a lot like it did in 2019. It seems like some central bankers, politicians, and investors are now rethinking the implications of the return to normalcy.

Conclusion

Record infusions of liquidity by central banks and record levels of fiscal stimulus by governments will likely wind down in 2022 as we shift from the pandemic phase of COVID. Some of the initial steepening then subsequent flattening of the yield curve in 2021 was likely driven by a resurgent pandemic whose duration extended well past most expectations once vaccines became widely available.

Excess liquidity ushered in a new generation of investors noted by the surge in account openings at many discount brokerages. NFTs, crypto, and stocks of software companies soared as rates plummeted and the yield curve flattened. Value stocks continued their underperformance in 2021 after a poor showing in 2020.

Within the value stock category, financials have very low valuations and could be beneficiaries of a "return to normal" with respect to monetary policy. Some things in investing do not require advanced data analytics but typically stand the test of time, such as shares of companies that generate growing cash flows with thoughtful management teams in businesses with decent growth prospects.

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