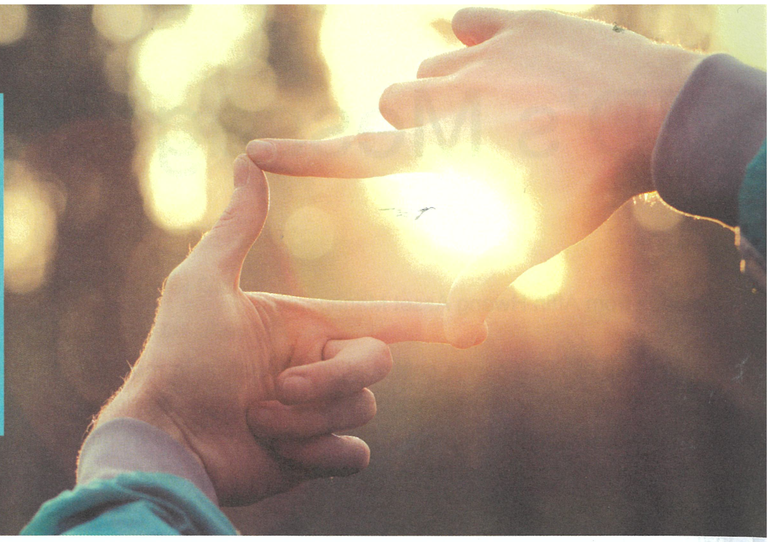


Looking Beyond the Yield Curve

Prepared by: Affin Hwang Asset Management

If you're a keen market observer, you would have read about the yield curve inverting which sent chills down the spine of investors globally. Financial and business news outlets were in a frenzy to point out that a key financial indicator was flashing warning signals that a recession is looming ahead.

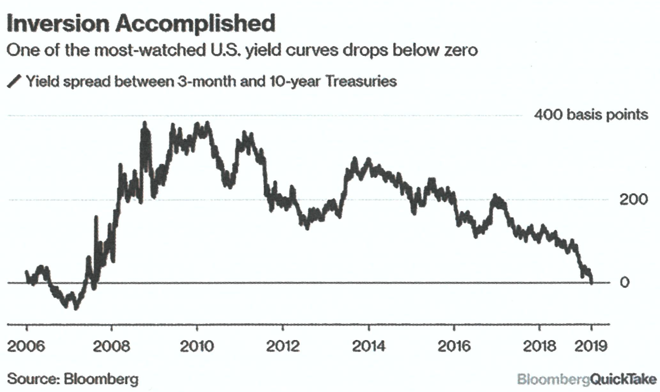
Benchmark gauges surrendered gains back in March due to recessionary fears when the spread between the 3-month and 10-year Treasury note went negative for the first time this year since a decade ago. A pallid economic picture painted by the US Federal Reserve which downgraded its economic outlook and tilted its policy stance towards a more dovish approach also added to concerns.

But how accurate is the yield curve as a dark omen for markets that an imminent economic slump is coming for us all? Here is what you need to know about the yield curve and what bond markets are trying to tell investors.

Yield Curve Inversion, Explained...

Logically, people would demand higher interest rates for longer-term loans because the risk is higher over longer time horizons. Think about your fixed deposits (FD), where the longer your FD placement is with a bank, the higher your rate of return. So, a normal yield curve would have an upward slope indicating higher yields for longer-dated maturities.

A yield curve inverts when yields for longer-dated maturities fall below shorter-dated maturities. As mentioned earlier, the yield for the 10-year Treasury note dipped below the 3-month yield back in March'19 which is a rare occurrence in markets. This means that an investor is now getting paid more to hold shorter-dated maturities.



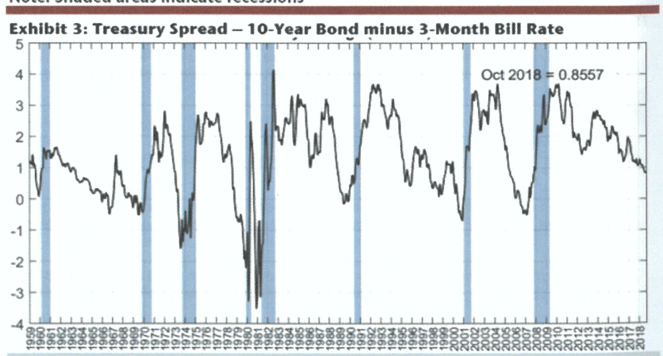
For the yield curve to invert implies that bond markets are pricing-in lower expectations about future growth and that inflation is going to stay low. Technically, it also signals expectations of lower interest rates and that central banks would stay dovish to help spur economic activity.

Bond markets are trying to surmise why interest rates need to come down (for whatever reason) to justify long-term yields being low, in spite of the risk that comes with a longer-dated bond. Essentially, this means that the long-term picture is unclear and it's unlikely to be calm waters. Most investors read this as a sign of a recession.

Time to Panic and Sell?

Whilst any predictions of when a recession would hit is typically a fool's errand, the 3-month/ 10-year yield curve has been historically accurate in predicting a US recession. Indeed, a yield curve inversion has preceded each of the last 7 recessions over the years. Thus, it warrants bond investors to pay close attention to the 3-month/10-year Treasury spread.

Note: Shaded areas indicate recessions



Source: New York Fed, Jefferies

Outthink. Outperform.

But this is where it gets tricky. A yield curve inversion may be a good predictor of a recession, but it sure is a very poor 'timer' of when it would actually happen. The time lag between a yield inversion and an actual recession could span anywhere between 6 months to over 3 years.

3 years is just too long a time an investor can afford to stay away from markets and not have any investment exposure at all.

Figure 8: Market Returns Following Yield Curve Inversions – 3 Month-10 Year Spread

Date of Inversion	Jan-14-66	Dec-20-68	Jun-01-73	Dec-01-78	May-26-89	Sep-11-98	Apr-07-00	Jan-20-06	Average
Months to Recession	*n.a.*	*12*	*6*	*14*	*14*	*31*	*12*	*23*	*16*
Date of Recession	n.a.	Jan-70	Dec-73	Feb-80	Aug-90	Apr-01	Apr-01	Jan-08	
Cumulative Market Perf (%)									
6 Months	-5.9	-8.3	-7.9	4.6	6.3	31.0	-4.1	-4.0	1.5
12 Months	-11.8	-15.6	-17.9	9.3	10.4	39.4	-22.6	11.1	0.3
18 Months	-1.6	-31.0	-36.2	15.5	-1.3	44.7	-30.5	20.6	-2.5
24 Months	3.0	-16.1	-16.1	45.2	15.9	56.2	-23.4	8.8	9.2
30 Months	8.3	-6.1	-17.1	37.1	19.1	26.7	-44.8	-3.7	2.5
36 Months	11.6	-9.2	-6.2	27.1	27.7	16.4	-42.4	-30.9	-0.7
Sequential Market Perf (%)									
6 Months	-5.9	-8.3	-7.9	4.6	6.3	31.0	-4.1	-4.0	1.5
6 to 12 Months	-6.2	-7.9	-10.9	4.4	3.8	6.4	-19.2	15.7	-1.7
12 to 18 Months	11.6	-18.3	-22.2	5.7	-10.6	3.8	-10.3	8.5	-4.0
18 to 24 Months	4.6	21.6	31.5	25.8	17.4	7.9	10.2	-9.8	13.7
24 to 30 Months	5.2	12.0	-1.2	-5.6	2.7	-18.8	-27.9	-11.5	-5.6
30 to 36 Months	3.1	-3.3	13.1	-7.3	7.2	-8.2	4.4	-28.2	-2.4

Key: Positive Negative

Note: Observations based on weekly (Friday) data, Market returns are S&P 500; Date of Inversion assumes no previous inversion over the prior 52 weeks; Returns based on 26-week increments beginning from week prior to inversion; Date of recession over next 3 years
Source: Standard & Poor's, Federal Reserve, NBER, The BLOOMBERG PROFESSIONAL™ service, Haver Analytics®, Credit Suisse

Data has shown that the reason why most investors perform poorly is because they try to time the market and they get out too early at the first signs of trouble. Similarly, they wait too long to re-enter the market when conditions appear to be recovering which is also too late.

Historically, the sweetest returns are made towards the late-cycle of a market. If we look back at the last 7 recessions, there were 4 periods when markets were up more than 20% after the yield curve inverted. During the late 90s, markets even climbed by over 56% before the recession hit.

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Profiting in the Next Recession

So how can you as an investor plan ahead before the last hurrah in markets and the bull party comes to an end? The panic sell-all approach is clearly not the smartest way to go about managing your portfolio as there is money still to be made in a recession as shown above.

Instead, employ late-cycle strategies and consider adding more exposure to dividend stocks and balanced funds to diversify. Fixed income also help investors cushion their portfolios by providing a measure of stability and capital preservation, as drawdown in bond prices are less severe compared to equities in a market downturn. Investors would also have a stable stream of income by reaping the coupons in bonds.

In terms of sector allocation, consider more defensive holdings in consumer staples, utilities, and healthcare. These sectors are less sensitive to global growth and display more resilience in a late-cycle. Cyclicals like tech, bank, energy and industrials still has the potential to outperform, but only if a recession is deemed to occur further in the horizon and the economic cycle can be prolonged. Central banks like the Fed which have turned more dovish could provide the ammunition for monetary stimulus to help extend the cycle and provide more room for markets to run.

Having said that, whether a recession is really around the corner or not should not dictate your entire portfolio decision.

The economy moves in boom and bust cycles and a recession is an inevitable phenomenon of markets resetting themselves. It's a normal albeit insidious part of the economic cycle that can be disruptive to growth and businesses globally. But that has not deterred investors globally from going back to the markets and profiting again.

The sooner you realise and accept this as a market truism, the sooner you are able to move on and make constructive decisions about your wealth.