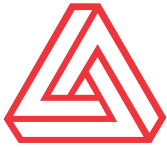
GLOBAL INVESTOR CIRCULAR



Inversion Reversion Subversion
The Inverted Yield Curve

June 2019 Edition

Kindly remember that these monthly circulars are for educational purposes only and should not be taken as advice. All views shared within them are Australian Standfirst views and do not represent any other organisation or individual (unless cited accordingly).

AFSL 510315

Within the architecture of markets, bonds and related fixed income products bedrock what is referred to as the capital stack and as important and influential as investors recognise this asset class as being, bonds more often than not confuse, puzzle and bewilder investors for often very rudimentary reasons.

This is not surprising, as financially and even culturally, when the value of something, anything, goes up, so too does its price and in the vernacular, this is referred to as a positive yield.

However, in bond markets, this precept is flipped on its head thanks to the very nature of fixed income products, which lock-in a future fixed principal return of capital and interest, meaning that as its current day value and price changes, the yield being received on that particular product is reversed: put simply, when bond prices go up, their yields go down and vice versa.

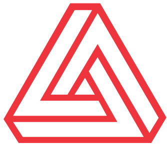
This precept alone is not what perplexes most but when you invert what is already an upside down or back to front basic concept – such that the recently reported inverted yield curve for US 10 Year Government Bonds exampled – global investors lose track of why such market machinations matter, what this tells vis-à-vis historical norms and what it may mean for those with risk mitigation front of mind.

The significance, and hence media attention to this phenomenon lies in the observation that an inverted yield curve is an interest rate paradigm in which longer term fixed income products possess a lower yield than shorter term equivalents of the same credit quality.

Why this is material is because inversions of this particular bellwether have preceded seven of the past ten US economic recessions since 1968 and is viewed as a peripeteia for economic business cycles.

And this is because lower levels of longer-term capital investments, represented by longer dated bonds, infer that future economic prosperity

continue over



June 2019 Edition

Simplifying Global Investing, Elevating Funds Management and Empowering Australians with clear Financial and Philanthropic Education.

AFSL 510315

EDUCATION

FUNDS MANAGEMENT

PHILANTHROPY

> “If interest rates are to shares what gravity is to matter, then duration risks are to bonds what the arrow of time is to entropy.”

will be lesser than that found in nearer alternatives, such as those represented by three-month or two-year fixed income equivalents.

Notwithstanding, inversion is not a sufficient condition for a recession and the inference that it does is subversion in and of itself.

Throughout three of the past ten instances when the US curve inverted, there was no recession over a subsequent two-year horizon; such as in 1965, 1998 and 2005.

Serendipitously, all three instances coincided with new and at that moment in time, untested unconventional monetary experiments by the US Federal Reserve's Federal Open Market Committee, or FOMC.

The 1965 inversion coincided with the FOMC's 1961 Operation Twist, dubbed after the twist dance craze of the era and the intention was to flatten the yield curve in order to promote capital inflows into the United States and strengthen the Greenback consecutively.

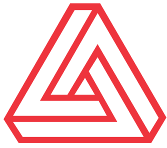
Continued up and until 1966, this markets operation 'twisted' the curve by selling US shorter-term three-year bonds and purchasing in the public market longer term government debt, which was instrumental in fiscally funding the burgeoning Cold War and Space Race.

The 1998 inversion coincided with the unprecedented FOMC intervention and backstopping due to the fallout from the Long-Term Capital Management, or LTCM, hedge fund collapse with the FOMC, "recapitalising" fourteen financial institutions – this was instantly viewed by the public as a bailout and led to the popularisation of the phrase, the 'Greenspan Put', inferring that Federal Reserve Chairman Alan Greenspan and the FOMC would not only backstop an imploding hedge fund, but the bedrock of the capital stack en-masse.

The 2005 inversion overlay the largest fixed income collapse in human history – The Great Recession of 2007 until 2009 – and stoked Troubled Asset Relief Program, or TARP and of course Quantitative Easing Round One, or QE1.

The assertion of these anecdotes is that the base effect of FOMC interference goes beyond flattening of the yield curve and what was previously accepted as a recessionary alarm bell, may today be questioned as another false alarm triggered by redundant precedents.

continue over



Australian Standfirst

June 2019 Edition

Simplifying Global Investing, Elevating Funds Management and Empowering Australians with clear Financial and Philanthropic Education.

AFSL 510315

EDUCATION

FUNDS MANAGEMENT

PHILANTHROPY

Buffett reminds us that If past history was all there was to the game, the richest people would be librarians.

For those with an eye to risk mitigation, it is becoming clearer that the risk in the system is not economic in nature, but financial and employing a Socratic approach, the answers may also be found in the historical data.

Since 1961, eighty percent of the times that the US Government yield curve inverted, European equities delivered positive returns in the next three and six months following the inversion, returning on an aggregated averaged eight percent after twelve months and four percent in the subsequent two years.

Equally, retrospectively looking back at a one-year return from the month preceding each US inversion since 1961, European equities yielded seven percent as a collective aggregate.

This may be explained by the fact that it takes some time for a recession to materialise after an inversion and that meanwhile, share markets still deliver positive returns and that it can be more costly to be underinvested in equities late cycle, as investors tend to miss returns, than to stay invested and hedge or exit accordingly.

February 2019's inverted US yield curve was preceded by The European Central Bank's latest financial stability report suggesting that European listed banks average return on equity in 2018 was between six and seven percent – if the historical ten previous episodes are to be considered, this observation may present as an omen to those looking past the optics and squarely focused on identifying the mispricing of risk assets.

If interest rates are to shares what gravity is to matter, then duration risks are to bonds what the arrow of time is to entropy.

Late cycle bull markets do not die of old age nor the singularity of an inverted differential in benchmark yields but they do suffocate when entropy fissures energy from a system when it can least afford to lose momentum.

The inverted yield curve may not be that fissure but it is a direct reflection of time and momentum and it does not get any more rudimentary than that.

Yours,

Stirling Larkin
CIO, Australian Standfirst
Asset Management