Equities and inverted yields: "So what?"

News from the financial markets

On 19 December 2018, 3-month USD Libor exceeded the yield on 10-year US Treasuries for the first time since the financial crisis. For many investors, this has set the alarm bells ringing. Why? Because, in the past, this development has usually heralded a recession in the foreseeable future. Having discussed the current state of the economy in the leading regions ("Is a recession imminent?"), we now analyse how the equity market will be affected. While our general attitude towards the American stock market is one of caution, our main concern right now is not the inverted yield curve. However, the current business cycle seems to have reached its zenith.

Events shaped by the central banks

An inverted yield curve is when short-term yields are higher than long-term yields. Normally, the yield curve is sloped upwards, at least in theory, as longer-dated interests reflecting expectations of future growth and inflation as well as the relevant country risk. Thus the yield curve, like fundamental stock valuations, is a reflection of market expectations. However, because of the unusual ways and dimensions in which central banks around the world – and notably in the USA – have intervened, the reality has become more complicated. In the heavily engineered ultra-low interest rate environment that has prevailed for the past ten years, many investors keen to achieve their desired levels of return have increasingly resorted to capital investments that entail higher risk. Because the Federal Reserve has begun the process of normalising its monetary policy, US interest rates are higher than in most other industrialised nations. Anticipation that this will trigger an economic slowdown in the future has driven up demand for long-dated US Treasuries. In this way, investors secured the relatively high rates available on 10-year maturities. In response the yield has fallen so far that it is now lower than the 3-month money market rate, thereby inverting the yield curve.

S&P 500 yield during US yield curve inversions

Inverted Yield Curves in USA	6 months after	During inversion	Duration
November 1988	20.7%	20.6%	549 Tage
October 1995	9.3%	3.7%	68 Tage
April 1998	23.2%	56.2%	544 Tage
April 2000	0.0%	−22.2%	266 Tage
January 2006	1.8%	4.3%	562 Tage
December 2018 *		11.7% *	69 Tage

*Current inverted yield curve phase (3m USD Libor versus 10-year US Treasuries) is still under 6 months; calculation up to & including 25.3.2019

Sources: VP Bank, Bloomberg

All of this in spite of the fact that the US economy is currently performing well. Which might help to explain why, when the US yield curve becomes inverted, the S&P 500 generates positive returns for the subsequent six months, and often a lot longer.

The table also makes it abundantly clear that yield curve inversions can last a very long time. In only one of the cases cited – the economic slump at the turn of the millennium – was a significant loss recorded. But that does not mean that the stock markets have not been through phases of weakness at other times. It is worth taking investment decisions calmly and carefully and staying invested even in this difficult period.

Stock market unimpressed

If we go one step further down the macroeconomic path and focus on phases of recession, we see that the S&P 500 generated a relatively positive yield both before and during these periods of recession. This is particularly interesting given that important leading indicators, such as the purchasing managers' index for the manufacturing sector, begin to tail off as early as twelve months before an economic downturn.

S&P 500 yield during US recessions

Recessions	During recession	12 months before	12 months after
Dec 1969 – Nov 1970	-2.9%	-10.6%	11.3%
Nov 1973 – Mar 1975	-20.1%	0.0%	28.3%
Feb 1980 – July 1980	6.6%	20.6%	13.0%
Aug 1981 – Nov 1982	14.2%	13.0%	23.0%
Aug 1990 – Mar 1991	7.9%	6.8%	11.0%
Apr 2001 – Nov 2001	-1%	-21.7%	-16.3%
Jan 2008 – June 2009	-35.01%	5.6%	13.4%

Sources: VP Bank, Bloomberg, NBER

Stronger variations are discernible within the American stock market at industry group level. In particular, sectors with high levels of cyclical dependence suffer higher price fluctuations and very often produce a lower rate of return than the market as a whole. Sectors with a strong focus on basic supplies and services are much better at weathering crises and periods of economic weakness. It can also be seen that industry groups that played a large part in the preceding economic upturn likewise suffer more heavily. During such phases, high expectations are corrected and relative valuations are thereby normalised.

Industry group yield movements

	During inversion *	During recessions **
Banks	↓	↓
Insurance	→	↓
Food & Beverage	→	↑
Automotive	↓	↓
Materials	↓	↓
Household goods	→	↑
Energy	↑	↓
Technology	→	→
Industrials	→	↓
Telecom	↑	↓
Health services	↑	↑

* 5 inverted yield curve phases between 1995 and 2019;
** two recessions, beginning in April 2001 and January 2008

Sources: VP Bank, Bloomberg

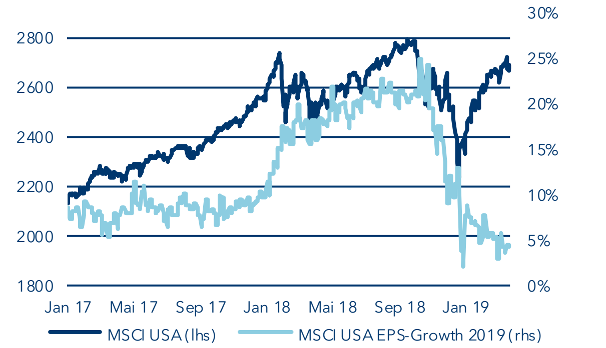
Thus it cannot be said that, at the overall market level, an inverted yield curve leads directly to a bout of weakness on the stock markets – a fact amply borne out by current developments. Yet it is fair to say that an inverted yield curve is very often accompanied by higher volatility and a recession, although with the latter there may be quite a delay – up to 20 months – before it occurs.

Difficult markets have their causes

Returning to current market developments, there are obvious reasons for the phase of increased share price volatility, including some extreme events, which began last year. The main reason is the abnormally long-lasting period of expansionary monetary policy operated by the central banks. By expanding their balance sheets the central banks channelled enormous amounts of liquidity into the capital markets, while at the same time secure long-term investments were rendered unattractive by low interest rates. The thinking behind this was clear: low borrowing costs are supposed to create incentives to invest. As a result, even ten years after the great financial market crisis companies can still borrow at historically low capital costs. It was therefore perfectly logical for the US Federal Reserve to start raising interest rates in 2015 and shrinking its balance sheet last year, but these moves have ushered in a phase of higher price volatility on the stock markets. Another compelling reason for this heightened volatility is the international trade dispute triggered by the USA. Companies with cross-border operations, and consequently their suppliers as well, have developed production processes that span the globe. Besides finished goods, semi-finished products play a major role in international transport. The imposition of punitive tariffs set off a fatal chain reaction, starting with costlier commodities, continuing in the form of additional costs in decentralised production chains and ending with a negative impact on sales wherever these higher costs are passed on to the end-customers.

The consequences can now be seen in the steep fall in corporate earnings.

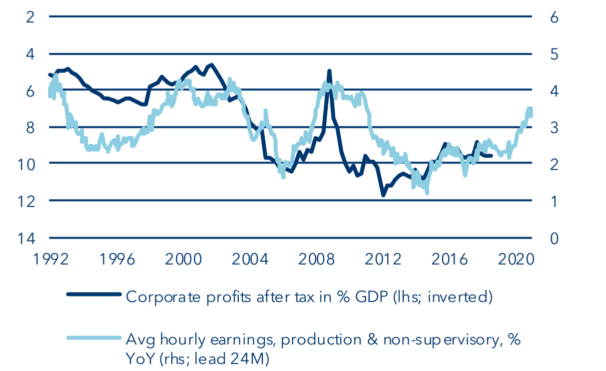
US equities v. profit growth in 2019



Sources: VP Bank, Thomson Reuter's Datastream

Initially, market attention centred on the hardest-hit countries and regions (e.g. Mexico, Europe and China), but now the wave is rebounding on the nation that caused it. The affected globally active companies are realigning themselves and reconfiguring their production lines accordingly. The end result is re-designing or shifting of production lines. One fascinating aspect of this process is that the USA might lose export-oriented production capacity, with lasting consequences. In addition, progressively rising operational costs will bite into profit margins going forward. The salient factor here is the sharp increase in wages. Given that profit margins in the USA are already very high, we expect to see profitability fall over the next two to three quarters. This means that overestimations of net earnings for the third and final quarters are very likely. In countries outside the USA the picture is not the same, since margins there are nowhere near their all-time highs.

US corporate earnings in relation to wage costs



Sources: VP Bank, Thomson Reuter's Datastream

Conclusion

We were already expecting to see clear signs of cooling in US corporate earnings in 2019. Our annual profit growth forecast of 4.5% now looks rather generous, given current estimates of 3.9%. A resolution of the trade dispute could conceivably prompt a recovery, although on the flip side rising costs and increasingly difficult economic challenges are whipping up headwind. Share prices in the USA are now only slightly below the peaks they reached last year. As far as the fundamentals are concerned, the situation is not comparable with 2016 to 2018. At best we expect the US stock market to consolidate and we believe that medium- to long-term investors will find more attractive investment opportunities in Europe and the Asian emerging economies.

Contact

VP Bank Ltd	Aeulestrasse 6 9490 Vaduz · Liechtenstein T +423 235 66 55 · F +423 235 65 00 · info@vpbank.com
VP Bank (Switzerland) Ltd	Talstrasse 59 8001 Zurich · Switzerland T +41 44 226 24 24 · F +41 44 226 25 24 · info.ch@vpbank.com
VP Bank (Luxembourg) SA	2, rue Edward Steichen · L-2540 Luxembourg T +352 404 770-1 · F +352 481 117 · info.lu@vpbank.com
VP Bank (BVI) Ltd	VP Bank House · 156 Main Street · PO Box 2341 Road Town · Tortola VG1110 · British Virgin Islands T +1 284 494 11 00 · F +1 284 494 11 44 · info.bvi@vpbank.com
VP Bank Ltd Singapore branch	8 Marina View · #27-03 Asia Square Tower 1 Singapore 018960 · Singapore T +65 6305 0050 · F +65 6305 0051 · info.sg@vpbank.com

Responsibility for content

Bernd Hartmann, Head CIO Office
Author: Harald Brandl, Senior Equity Strategist