YIELD CURVE INVERSION AND MOMENTUM RETURNS

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The 2 year / 10 year Treasury yield curve dipped below zero on August 27th. A yield curve measures the difference between yields on two different bond maturities. Normally, investors receive a higher yield for a longer-dated maturity because it is more difficult to forecast the farther you look out into the future. Every once in awhile the reverse happens and the yields on longer-dated maturities are actually lower than those with shorter maturities. This is referred to as an “inversion,” and is considered a predictor of a coming recession.

Using the yield curve as a timing tool is difficult. The yield curve has inverted before every recession since the 1970s, but the lead time has varied tremendously. The chart to the right shows the inversions circled in red. The gray shaded areas on the chart are recessions.

From an investor standpoint, predicting what will happen to stocks is actually more important than predicting when the recession will come. The current yield curve inversion may mean a recession is coming, but should not be a signal for equity investors to panic. In fact, on average, stocks have done very well for 12 and 24 months after the initial inversion. Each inversion is different so it is also informative to look at each one individually.

When the yield curve first dips below zero we mark that date and look at the performance of several indexes over the next 6, 12, 18, and 24 months. We use the S&P 500 Total Return Index for large-cap stocks, the Russell 2000 Total Return Index for small-cap stocks, Barclays Aggregate Bond for fixed income, and two indexes representing high and low momentum stocks. The momentum indexes come from the Ken French Data Library. We used the, “6 Portfolios Formed on Size and Momentum” series. This series allows us to focus on large and mid-cap stocks so results aren’t skewed by low liquidity stocks. This series is also a conservative measure of momentum because it separates the universe into three momentum buckets instead of the usual 5 or 10.

The table below shows the average forward returns of all of the observations. Twelve months from the first inversion observation the returns are good across the board. Two years after the inversion, the returns are still good, but the rate slows down.

<table>
<thead>
<tr>
<th>Average</th>
<th>6 Months</th>
<th>12 Months</th>
<th>18 Months</th>
<th>24 Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 TR</td>
<td>4.43%</td>
<td>14.33%</td>
<td>20.73%</td>
<td>22.71%</td>
</tr>
<tr>
<td>Russell 2000 TR</td>
<td>2.07%</td>
<td>11.62%</td>
<td>20.93%</td>
<td>16.47%</td>
</tr>
<tr>
<td>Barclays Aggregate</td>
<td>3.52%</td>
<td>9.75%</td>
<td>13.00%</td>
<td>19.98%</td>
</tr>
<tr>
<td>High Momentum</td>
<td>4.66%</td>
<td>16.61%</td>
<td>34.74%</td>
<td>38.70%</td>
</tr>
<tr>
<td>Low Momentum</td>
<td>0.33%</td>
<td>11.87%</td>
<td>9.87%</td>
<td>8.27%</td>
</tr>
</tbody>
</table>

Momentum returns remain strong along with the broad market 12 months forward. The spread between high and low momentum is decent after a year, but unlike the broad indexes, the spread really accelerates during the second year.

Each yield curve inversion has been different. Below we examine each one individually. On average, the forward returns are very strong, but in some cases, they haven’t been.
**Yield Curve Inversion: August 1978**
This instance began with a quick sell-off, and high momentum was hit the hardest. Once that sell-off was complete, all of the indexes except for bonds performed very well. This looks like more of a sharp correction and rebound rather than a recession-induced bear market. *(Note: we don’t have Russell 2000 TR returns going back this far)*

**Yield Curve Inversion: September 1980**
This instance began with a quick rally, which lost steam quickly between 6 and 12 months. About a year in, bonds rallied sharply leading them into the generational top in September 1981. Equities moved sideways in a trading range for two years after the curve inverted. It didn’t hurt to own stocks, but you didn’t make much headway either. The exception was the momentum laggards. Poor momentum stocks had a brief run between 6 and 12 months after the inversion but were to be avoided the rest of the time.

**Yield Curve Inversion: January 1982**
After a shallow correction over the first 6 months, stocks spent the next 18 months tacking on tremendous gains. Bonds also performed very well during this time. Everything was strong across the board. High momentum stocks did very well but pulled back along with small caps during the final 6 months. The laggards closed a huge performance gap at the end of the period but were generally to be avoided.
Yield Curve Inversion: December 1988
The first yield curve inversion after the market crash in 1987 wasn’t much of a problem for investors. Returns were very strong across the board for 12 months. Momentum laggards and small caps performed during the second year after the inversion. The spread between high and low momentum stocks remained robust for the entire sample.

Yield Curve Inversion: June 1998
Markets sold off because of the currency crisis in 1998. Like a lot of the yield curve inversion instances, it is really tough to determine how much the inversion played a part in the correction. But like the observation in 1978, the market rebounded quickly and we did not suffer a long bear market. There was a big laggard rally once the correction ended, which is similar to what we saw at the end of 2018. Once the market bottomed, the forward returns were very strong.

Yield Curve Inversion: February 2000
This is the instance that spent the entire 24-month window in a bear market and was to be avoided. This was also the second instance after a “double-dip” of the yield curve below zero. The momentum laggards were very volatile during this period. They started out with decent returns but quickly fell apart. That performance profile is really a function of how a momentum index is calculated. The first 12 months of the window the momentum indexes were adjusting to the new leadership. Technology moved from leading to lagging, and the former laggards worked their way into the leadership group. By the second 12 month window, those changes were reflected in the indexes and the laggards (now full of technology) performed poorly in 2001 into 2002. Bonds had a nice run during this period and provided a nice offset to declining equity prices.
Yield Curve Inversion: December 2005
The inversion in late 2005 didn’t affect stocks for quite a while. There was a momentum correction during 2006 where the laggards performed much better than the leaders for a brief period. Large and small-cap stocks did fine up until the very end. Investors had plenty of time to book gains before the markets finally cracked in late 2007. Momentum investors did very well once the laggard rally was over in 2006. Momentum performed very well into the middle of 2008 so it was a good couple of years for the strategy. The laggards started to falter in late 2007, but high momentum did just fine. The spread 24 months out was very strong for momentum, and that would continue for another six months into the middle of 2008 (not shown).

Summary
An inverted yield curve doesn’t mean investors should immediately avoid equities. If anything, investors would have been better off on average just holding stocks for 2 years after the yield curve inverted! Most of the observations contain some sort of sell-off within 24 months after the yield curve inverted. The reality is that the market corrects all the time. There have been many corrections following a yield curve inversion, and plenty that were nowhere near an inverted curve! It is important to realize an inverted yield curve is not normal. When things are abnormal you should be on heightened alert. But looking at past instances of inverted yield curves it doesn’t seem prudent to proactively avoid equities. Use other indicators for signs of market weakness. An inverted yield curve has historically proceeded recessions but hasn’t always been a bad sign for equities in the near-term.

1https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

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