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Markets Are Reading the Yield Curve Inversion All Wrong. What It Really Means.

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Dreamstime

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The recent trend by the market to frame new developments in a negative light received an assist early this month when the yield of the 2-year U.S. Treasury note briefly rose above that of the 10-year. This was the first inversion between these two maturities since a blip during the height of the 2019 U.S.-China trade war. On cue, bears emerged from hibernation, calling for imminent recession. The driver of inversion was the Federal Reserve's hawkish about-face as it grapples with 6.4% year-over-year core inflation. With the U.S. central bank having more-than doubled its own expectations for the number of 25 basis point rate hikes in 2022—from three last December to seven at its March meeting—investors grew concerned that the Fed would live up to its reputation as the killer of expansions.

We interpret the inverted yield curve differently. Much of the market's consternation is premised on the notion that the Fed has lost credibility due to its glaringly bad call on transitory inflation and taking its eye off its dual mandate by also prioritizing asset prices. But if the market thought the Fed had truly lost its way, we'd now be witnessing a steepening—not a flattening—yield curve. The fact that yield increases on Treasuries with maturities of 5 years and longer have not kept pace with the 2-year, in our view, means that the market sees the Fed's approach to controlling inflation as credible. Even when taking into consideration the Fed's newfound inflation-fighting chops, forward markets imply that real rates—nominal yields minus inflation—will remain very accommodative—likely well below 1.0%. Implicit in these market signals is the idea that not only should the Fed make inroads in combating inflation, but it can do so without condemning the U.S. economy to certain recession as it begins carefully tapping the brakes on the economy.

When "Bad" News is Actually "Good"

While the yield curve may have a notorious reputation among market bulls,this predictor of gloom—along with other leading indicators—often misses the mark. Still, the logic for an inversion signaling a cooling economy is clear: Facing inflationary pressure, a central bank raises policy rates which, in turn, pushes yields on short-dated Treasuries higher as these securities are more tethered to the official rate. The higher cost of capital for households and corporations resulting from higher rates should constrain future economic activity. Lower economic growth is then reflected in falling yields on longer-dated Treasuries. If short term borrowing costs are expected to rise too aggressively, the yield curve may invert as investors brace for recession.

Presently, we believe the flat yield curve is reflecting something quite different from recession. Rather, it suggests that the market appears to be taking the Fed at its word. The roughly 2.5% on the 2-year note is, if anything, perhaps slightly less than what we'd expect to see if the Fed follows through on its recent forecast of raising rates between nine and 10 more times between now and the end of 2023. Also, the considerable gap that emerged between Fed forecasts and rate hike expectations by futures markets as inflation accelerated has narrowed in recent weeks. Shorter-term inflation expectations have fallen over 100 bps from their peaks and longer-term expectations covering the period from 2027 to 2032 have remained anchored near 2.5%. All of this leads us to believe that the market thinks the Fed has a fighting chance in reining in prices and hence containing the rise in longer term interest rates leading to a flatter near inverted

yield curve. And this is what you want to see—the Fed's plan to raise short term rates is keeping long term inflation expectations in check. This "inversion" is "good".

Regime Change

To be sure, the primary driver behind the yield curve's inversion is the speed at which shorter-dated Treasuries have priced in the Fed's hawkish pivot. Other asset classes have not been immune. In addition to intermediate Treasuries declining 5% year-to-date through April 6 (an 18% annualized pace), rate-sensitive growth stocks, as measured by the Russell 1000 Growth Index, have slid over 11%, far outpacing the losses registered in broader U.S. equities.

The market has long known that the Fed would eventually have to change policy. What it did not expect was how soon regime change would occur and how pronounced the shift from extreme quantitative easing to very real quantitative tightening would be. Getting caught off-guard at such moments is what leads to tail-risk events as defined by four-to-five standard deviation moves in asset prices as investors scramble to adjust models for a materially higher cost of capital.

This shift marks the end of the era of extremely cheap money. But here, too, perspective is needed. Real rates—the main determinant in influencing corporate and household borrowing decisions—remain negative across most of the developed world, ranging from -0.17% in the hawkish U.S. (as measured by 10-year Treasuries) to -2.3% and -2.7% in Germany and the UK, respectively. Shorter-dated real yields are more deeply entrenched in negative territory as they reflect acute near-term inflationary pressure. These levels hardly qualify as tight money.

Inflation may continue to surprise. There is certainly plenty of kindling. Pandemic-era supply chain disruptions have yet to fully ease. Corporations and governments are inching toward the likely inflationary trend of deglobalization. Labor markets remain tight. And the war in Ukraine has upended commodities markets. Any of these could impact the pace of Fed tightening and, thus, the trajectory of real rates.

Removing an Equities Tailwind

A decade-plus of easy money has benefited equities in a myriad of ways. It lowered the cost of capital, enabling companies to finance operations, share buybacks and acquisitions on the cheap. It incentivized investors to reach for yield, thus bidding up equity prices. And a low discount rate raised the present value of cash flows companies expected to generate in future years. Unavoidable is that the raw math of stock valuation will push the present value of future cash flows lower as interest rates rise. With the value of—and demand for—these future cash flows set to decline, the premium that stocks fetch—especially those of the growthier variety—will likely fall.

In the years from 2003 through 2007, roughly the period between the tech implosion and Global Financial Crisis (GFC), the real yield on 10-year Treasuries averaged 2.04% and the median forward price-earnings (P/E) ratio of the S&P 500 Index stood at 16.3. From 2008 until the end of 2021, the index's P/E ratio averaged 16.8 while the 10-year's real yield muddled along at 0.39%. For growth stocks, P/E expansion was more notable, averaging 17.4 prior to the GFC and 20.5 afterward. For stocks in aggregate, multiple

expansion became turbocharged as real rates plunged deeply into negative territory after the onset of the COVID-19 pandemic.

The party has largely ended. In lockstep with rising expectations for policy tightening, the S&P 500's full-year 2022 P/E ratio has compressed by roughly 9% year to date, to 19.8. The multiple for the pure-growth component of the S&P 500 has contracted a more severe 19%. How much lower can multiples go? That depends upon the path ultimately taken by the Fed. What is certain is many equities segments will continue to see multiple compression as real rates march toward positive territory.

Just One Piece of the Puzzle

Stocks losing the support of buoyant valuation multiples does not mean it's all doom for equities. There are other factors influencing stock performance. Implicit in lower long-term bond yields is a slowing economy. Companies that can grow earnings at a pace higher than the economy can expand would still command a premium, thus supporting their multiples. There are plenty of candidates to deliver such growth. While much of the technology sector has been among the most richly valued in the broader market, the transformative secular themes behind many of these companies remain intact. Once valuations digest the painful adjustment to a tightening regime, many of these companies with dominant positions in growing markets will deserve another look.

Other growth segments include the global push toward decarbonization and the reconfiguration of supply chains as major regions of the world seek to localize key industrial inputs. These examples should serve as reminders that stock valuations can become more attractive not only through multiple compression but also by companies proving they can grow into elevated multiples by increasing earnings more rapidly than the market expects.