A Tale of Two Quarters

April 2019

It was the best of times, it was the worst of times… With all due respect to Charles Dickens, I'm obviously talking about the first quarter of 2019 and the fourth quarter of 2018. October-thru-December ended up as the worst quarter for domestic equities in seven years. The past three months were the best quarter for domestic equities in ten years.

Index	Q4 2018	Q1 2019
S&P 500 (US Large Cap)	-13.52	13.65
Russell 2000 (US Small Cap)	-20.20	14.58
MSCI ACWI ex-US (International)	-11.46	10.31
MSCI Emerging Markets (Emerging Markets)	-7.46	9.91
Barclay's US Aggregate Bond (US Fixed Income)	1.64	2.94
S&P United States REIT (US Real Estate)	-6.09	15.77

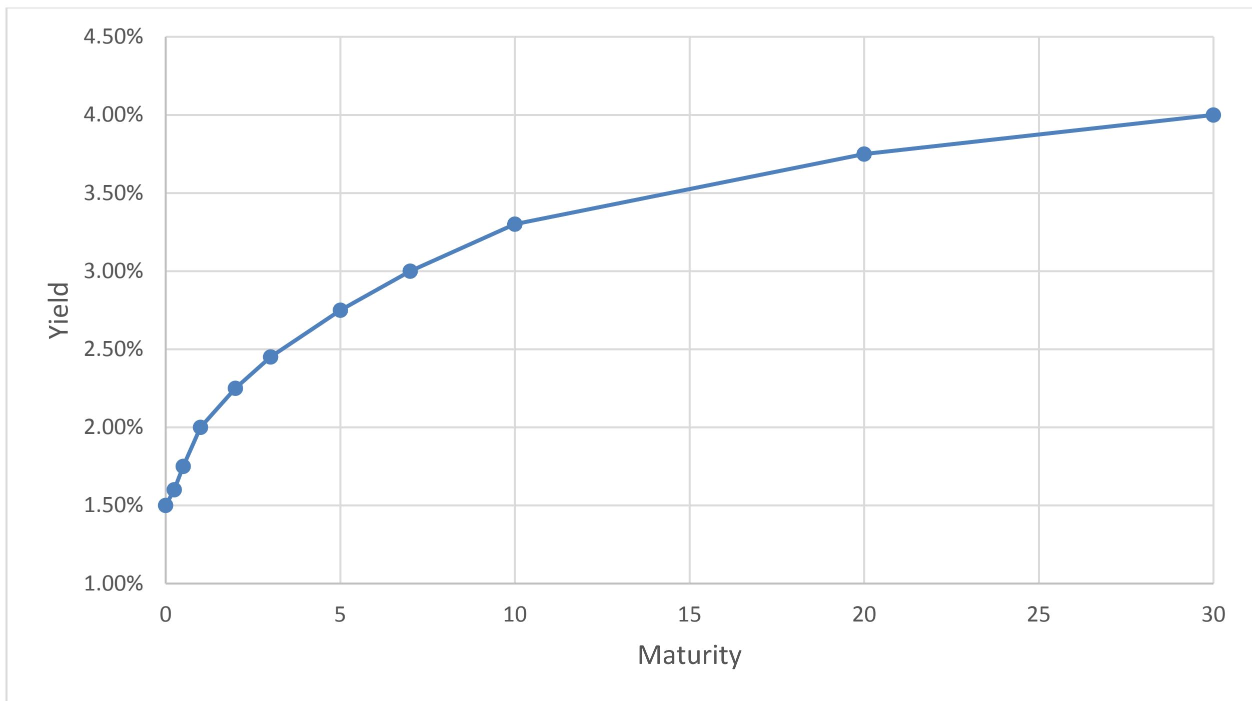
Data Source: Morningstar as of March 31, 2019. All indexes represent Total Return.

In last quarter's investment commentary, we discussed the aftermath of other severe market pullbacks from this decade. What we illustrated then was that when markets experienced sharp losses, there has been a swift recovery after a bottom was reached. That is basically how things have played out this time, as well. Investors that had discipline have recovered the majority of the 4th quarter losses. Investors that jumped ship locked in those losses and watched from the sidelines as markets posted their best quarter in a decade.

The Yield Curve & Negative Investment Signals

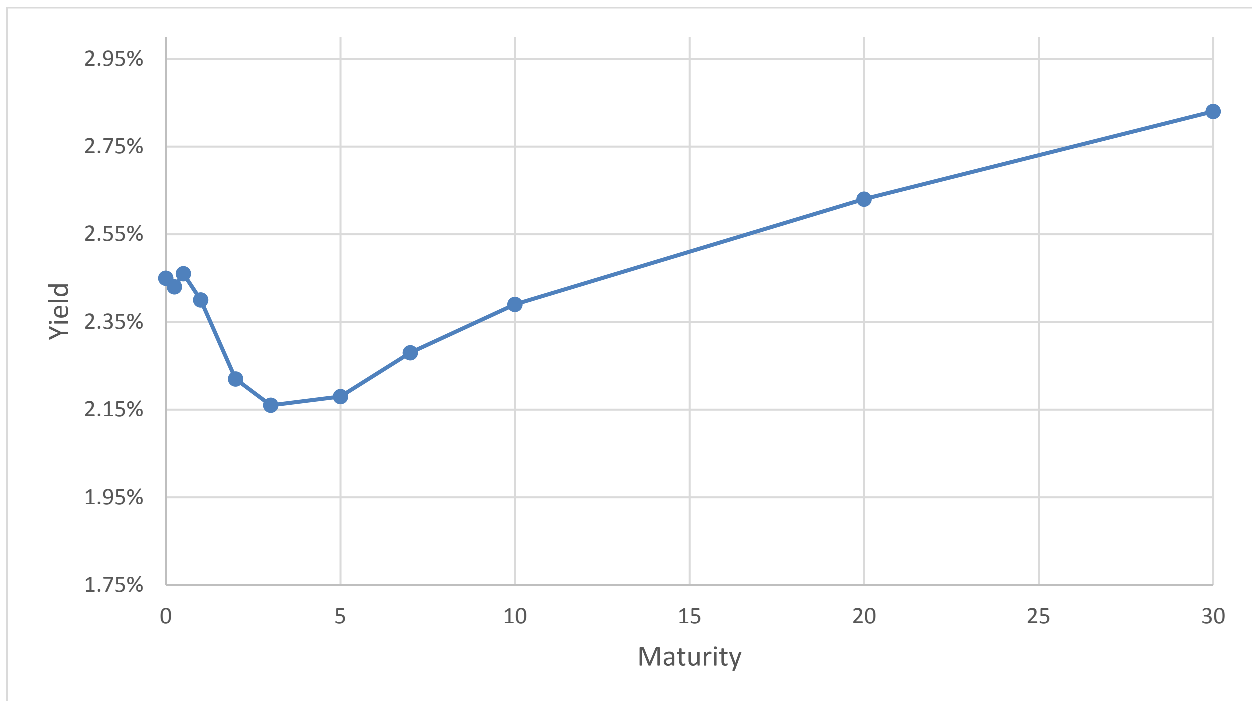
Moving on to forward-looking discussion, the yield curve inverted a few weeks ago, kind of. On March 27th, the yield on a three-month T-bill was 2.44% compared with a yield of 2.39% on the 10-year Treasury note. A couple days later it reverted back and 10-year has maintained a few points of advantage on yield since. So, why is this important?

The yield curve is a visual representation of the yield earned on U.S. treasuries at various maturities. A "normal sloping" curve illustrates that investors are compensated more for holding bonds with longer maturities and less for holding bonds with shorter maturities. This is pretty intuitive. All else equal, a bond that matures in 10 years carries more risk than a bond that matures in three months. Here's what a normal sloping yield curve looks like:



Not Actual Data

This is what the yield curve looked like on March 27th:



Data Source: US Department of the Treasury as of March 27, 2019

It looks like the United States Treasury is sponsored by Nike. For a couple days, investors could expect to earn a greater yield on short term instruments than some longer term securities (the 20- and 30-year maturities still offered a greater yield). It's a fascinating occurrence, just from a logical standpoint.

I'm sure all of this is terribly uninteresting to most readers, so, I'll get to the point. The real reason I'm talking about a quirk that is only of interest to pension managers and finance nerds is what has happened the last eight times the yield curve has inverted: A recession has followed about a year or two later.

Let me start by pointing out that a sample size of eight is a worthless number of trials for any meaningful data observation. Despite, a seemingly strong correlation at face value, if we look globally, "returns of indices were higher 86% of the time 12 months later and [higher] 71% of the time 36 months later[1]" according to research compiled by Dimensional.

There is always something to point to as a signal for doom in the markets. Always. Today, it's the yield curve. A few days ago it was Brexit. A few weeks ago it was rising interest rates. A few months ago it was tariffs. A year ago, it was Chinese growth. Most of those "signals" will end up as red herrings for investors. Most of the time, markets go up – regardless of the sign of the times. Occasionally, markets go down. Point me to someone who can reliably figure it out and I'll show you the world's first trillionaire.

There are *billions* of market participants, each with their own reasons for making the decisions they make that influence the market. In Michigan, a retiree is selling stocks to free up cash for her property tax bill. In Ohio, a plumber is buying stocks in his 401(k) after his paycheck was processed. In Maryland, a financial advisor is rebalancing client portfolios. In New York, a banker is buying index futures to hedge an exposure. In London, an ex-pat is liquidating her mutual funds because her broker told her they won't hold U.S. funds for an international client. In Utah, a college student is investing an inheritance from his late grandfather. In California, an early employee in Lyft is selling her shares of company stock and reinvesting in a diversified portfolio.

None of these people (well, maybe the banker), bothered to notice that the yield curve inverted a few weeks ago. It doesn't matter to their plans. They're going to place their trades that move prices regardless of what's on the CNBC chyron.

We construct allocations and build financial plans under the assumption that economic recessions and market declines will happen. It's built in. It's accounted for. Taking an outsize position in cash isn't factored in to most investment plans. Cash generally offers investors a negative real return. At the end of the day, it is probably riskier to abandon a well-thought out investment plan to time a recession based on a dubious predictor than it is to simply remain committed to that plan.

Try not to worry, get plenty of sleep, and enjoy the springtime.

John, Derek, Jon, & Stacie

[1] "What Does a Yield Curve Inversion Mean for Investors", Wes Crill, Research Matters, Dimensional Fund Advisors, August 30, 2018.

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