The Next Recession Won’t Be So Bad, According to the Professor Who Uncovered the Yield-Curve Indicator

By Sunny Oh, MarketWatch  Oct. 9, 2019 5:05 am ET

A tide of disappointing data is raising fears the U.S. may be knocking on the door of a recession.

But the professor who first established the relationship between the yield curve and recessions says investors shouldn’t worry too much, if only because it will likely be a relatively shallow downturn—in part because people are expecting it.

With investors, companies and the public highly attuned to any sign of a recession this time around, the hit to the economy would be more limited, according to Campbell Harvey, senior adviser at Research Affiliates and finance professor at Duke University, in an interview with MarketWatch.

“That increases the probability of a soft landing,” he said.

Harvey’s three-decade old dissertation on the yield curve’s predictive powers has continued to draw attention in financial markets, especially after short-term yields popped above long-term yields earlier this year. The bond-market phenomenon raised fears that the U.S.’s record expansion would finally come to an end.

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But its Harvey’s more recent research in behavioral finance that he feels is also worthy of attention. He found that when the sudden economic slowdown came as a shock to investors and companies, the ensuing damage was heightened as businesses slashed investment and jobs.
Yet with investors and analysts, scarred by the financial crisis, looking for a sign of recession in every nook and cranny, companies were less likely to take drastic measures when growth took a turn for the worse, if only because they were more prepared.

It helps, he said, that there has been a multitude of surveys and market-based indicators pointing to the increased alertness of corporate executives to the prospect of a recession.

The Duke CFO survey conducted in September said 53% of chief financial officers for U.S companies expect a recession by the end of 2020.

In addition, the inversion of the yield curve has put investors on guard. The spread between the 3-month bill and the 10-year note yield turned negative for the first time since 2007 in May. An inversion by that measure has preceded all nine recessions since World War II.

More forward-looking survey data this week also pointed to growing trade-related uncertainty from businesses. The ISM manufacturing indicator stayed below 50% in September, indicating a contraction in factory activity, and its services counterpart fell sharply to 52.6%, well below the 55.3% estimate from MarketWatch-pooled economists.

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Given the gloom, “it’s naive to think you won’t have a drawdown” in stocks, said Harvey.

The growth worries hasn’t seem to have dented the resilience of equity markets, however. The S&P 500 (SPX) and the Dow Jones Industrial Average (DJIA) are still both on course for double-digit percentage gains this year.

But when they do fall, investors should stay prepared by holding a slug of value stocks in their portfolios, he said. Equities that fall in the value column are those that are considered underpriced relative to a fundamental analysis of the companies worth based on measures like price-to-book ratio. Such stocks tend to thrive when the economy turns for the worse or risk assets struggle.

After the financial crisis, value has underperformed other factors like growth and momentum, raising questions among stock pickers if value will ever make a comeback.
Still, Harvey says investors should remain hopeful. Value doesn’t have to revert to the mean, or the 50th percentile of historical returns, to see significant gains, and only has to follow the historical return profile of the value factor by a “trivial” amount to make a big difference for investors.

“Value only has to go from 96th percentile for returns to the 94th percentile of historical returns to make a difference,” he said.

*This article was originally published on MarketWatch.*

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