Interview: Man Group professor predicting a slowdown

For Professor Campbell Harvey, who has been advising Man Group since 2006, this summer’s rise to fame has been 33 years in the making. His theory that an inverted yield curve forecasts a growth slowdown, which made headlines when the yield on 2-year US Treasuries overtook the 10-year, was the subject of his doctoral dissertation in 1986.

The theory, which has held true for the past seven recessions, dominated headlines in global markets, while President Trump referenced the “CRAZY INVERTED YIELD CURVE” in a Twitter attack on Federal Reserve chief Jerome Powell.

“It is a little bit odd as I haven’t done research on the topic in 25 years,” says Harvey, speaking from the US where he has been based during a 33-year career in academia for Duke University.

“For a long time [the theory] lay fallow. People didn’t notice that it predicted the 1991 and 2001 recessions. And in July 2006, when the yield curve inverted, nobody thought that was a big deal either.”

Theory test
That changed after the global financial crisis (GFC), which showed the theory had worked for a seventh time out of seven, with no false signals (four of the recessions hit before he published the research, while three came subsequently).

His theory suggests that if investors are willing to accept a lower return for lending for a decade rather than two years their economic confidence must be low. It contends that investors, sensing economic headwinds and lower growth, will start buying the US 10-year, often seen as the safest asset in the world, driving prices up and yields down, causing an inversion.

“It is likely a recession starts in mid to late 2020,” predicts Harvey, but he does not think it will be on the scale of 2008. “The banks were really levered. We’d never had a banking situation like that,” he says. “Given the leverage of the banks and extraordinary measures that had to be undertaken, that made the GFC a lot deeper than other recessions. If you look today at the health of the banking system it looks a lot different to 2006 or 2007. The banks are in better shape today.”

Despite the attention his theory has received this summer, figures including former Fed chair Janet Yellen have cast doubt on its reliability. She criticised the theory as a “less good signal” in a world of quantitative easing.

“The four most dangerous words from policymakers are ‘this time is different’” says Harvey in response. “The Federal Reserve was much more powerful in the 1960s and 1970s than today. The size of the debt market is so massive, it is difficult for the Fed to deal with it. The Fed is not in my model but has been active over the entire span of my analysis, over 50 years. They probably do add some noise but it hasn’t diminished the ability of the simple signal to predict recessions.”

He adds that the Fed’s balance sheet peaked in 2017 and has since fallen by about $700bn. “Contracting tends to drive the rates up, achieving the opposite.”
Career at Man
Harvey was hired as an adviser in 2006 by Manny Roman, a former University of Chicago classmate who was running GLG Partners, four years before the firm became part of Man Group. He visits the UK several times a year and also spends time in the $114.1bn firm’s New York and Australia offices, bouncing ideas around, giving views on economics and speaking to investors.

“I do a wide range of things, including helping Man with their scientific research,” he says. “I will talk to important clients about the problems they’re having and hopefully give some insights.”

What is he saying to investors about the inverted yield curve? “This is the ideal time to re-evaluate the positioning of your portfolio. You’ve got a yield curve ‘code-red’ and know its track record. There could be a recession in the next year accompanied by a substantial equity market drawdown, so what should happen to portfolios?” he says.

“I tell asset owners that when markets are going up, during good times, it is a lot easier to be the investment manager. You earn your keep in a crisis situation. What you don’t want to do in a crisis is be forced to improvise. You need a plan in advance. Is your portfolio positioned to weather the storm?”

That serves as a neat argument for hedge funds, given their role to protect investors and flourish in all market conditions.

“You need to have a strategy, especially right now. It would have been easy not to have one for the past ten years.”

Quant's moment?
Harvey is clearly an evangelist for quantitative investing and enthusiastically discusses the sophisticated tech driving Man’s systematic strategies, but also the quant elements in its discretionary strategies.

CTAs, particularly trend-followers, have come in for heavy criticism after losses last year, but he notes how well managed futures performed in 2008. “What is the alternative to getting protection like that? One alternative would be rolling puts, which is enormously expensive.

“Managed futures are really good at providing defensive positioning. But it is not just defence – they don’t just mitigate the drawdown, they lead to a pay-off.”

Conversation returns to the unprecedented publicity surrounding Harvey’s theory, which throws up the interesting question of whether it could become a self-fulfilling prophecy, if knowledge of the theory causes decision-makers to behave differently.

 “[Imagine] you’re a CEO or CFO planning a major expansion and you need to borrow to do that," he says. "If you see the yield curve has inverted are you going to take that risk, knowing the [thesis] is seven-for-seven? Why not wait a bit and see how this plays out. If there is a recession you ride it out and potentially make the investment at a more favourable time?”

That, in turn, could aid risk management by reducing the “chance we go into a global financial crisis-like recession".

Harvey notes that his model forecasts economic growth, rather than recessions. “Even though economic growth is highly correlated with recessions. If the US drops from 3% growth to 1%, but dodges a recession, then my model has worked.”

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