Opportunities abound in value stocks following yield curve inversion

By Campbell Harvey
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An inverted yield curve is the unusual situation in which short-term interest rates are higher than long-term rates. This is almost always a harbinger of bad news.

Ten-year bond interest rates have fallen below short-term rates in the US, Canada, and the UK – and are essentially flat in Australia.

Buying stocks with low price-to-earnings ratios following a yield curve inversion can outperform growth investing. BLOOMBERG

Concern is growing among investors, companies and central bankers that recession may be looming on the horizon.

Recessions are bad for stock returns.
First, they are associated with slower economic growth, which is a negative for companies’ revenue.

Second, recessions bring times of uncertainty and heightened risk that are almost always associated with lower stock prices.

While much discussion has focused on the US economy, recessions in North America are also bad news for almost every country that does business there.

However, within this scenario, there is still some opportunity for equity investors.

Our analysis shows that value investing – buying stocks with low price-to-earnings ratios – as far out as three years following a yield curve inversion, can outperform growth investing. That is, buying stocks with high price-to-earnings ratios over the same time frame.

Indeed, over the past 10 years, a small number of tech growth stocks – the FAANGs (Facebook, Amazon, Apple, Netflix, and Google) – have accounted for most of the gains in the US stock market.

“Will this time be different? No, I don’t believe it will”

Campbell Harvey, Professor of Finance at Duke University

Historically, that reverses after yield curve inversions.

Will this time be different? No, I don’t believe it will.

First, my model has worked consistently over all business cycles in the US since 1968. Its predictive ability has not faltered.

Second, some have suggested that the US central bank’s buying of bonds – quantitative easing – and subsequent selling of these bonds over the past couple of years has altered the landscape.

Economic foundations

Selling should lead to lower prices and higher yields. We’ve seen the opposite.

I believe the drop in longer rates is a flight to quality, a direct result of fears about the future economic outlook.

The heightened rhetoric and movement towards anti-trade and anti-growth policies in the US and in Europe – the latter primarily a result of Brexit – contributes to the economic anxiety.

The economic foundations of the yield curve’s ability to predict recessions is tightly linked to a flight to quality.
The safest assets in the world are US Treasuries and when risk increases, investors pour into the 10-year Treasury bonds. This drives up the price of the bond and its yield down, flattening or inverting the yield curve. Investors may also be liquidating shorter-maturity bonds and re-investing in the 10-year, which adds further pressure on the inversion.

Value stocks have outperformed growth stocks after the last seven US yield curve inversions. The data suggests there is no reason why this time will be any different.

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