INVESTING IN AN INVERTED WORLD

Bradley Krom – U.S. Head of Research
12/14/2023

The potential for stubborn inflation, a higher-for-longer policy from the Federal Reserve and structural $1 trillion deficits have all contributed to an abnormal shape in the U.S. Treasury curve. In this piece we look to other periods of curve inversion and conclude that inverted yield curves are generally not an impediment to equity returns. For fixed income, the impact is more nuanced and depend on when the Fed stops hiking rates.

In a "normal" bond market, the yield curve slopes upward. The structural driver of this yield premium is that investing becomes riskier the further you get into the future. In today's markets, short-term rates need to remain high to tamp down inflation, but in the future, the Fed is likely to cut rates once the storm has passed.

Today, investors can lock in a higher rate of return in exchange for the risk that rates may fall in the future. Over the last 35 years, the U.S. experienced an inverted yield curve in five distinct periods, which we have reviewed from the initial inversion of the two year versus the 10-Year Treasury until that part of the curve ultimately shifted back into positive territory on a sustained basis.

Total Returns vs. Bond Yields

	1990	1998 (cumulative)	2000 (cumulative)	2007	2023
S&P 500	21.46%	4.49%	-4.30%	16.49%	12.60%
2Y	8.94%	0.99%	7.51%	3.73%	2.74%
Starting Yield	9.31	5.58	6.59	4.52	2.82
Ending Yield	8.62	5.46	5.10	4.95	4.97
5Y	10.58%	1.16%	12.74%	2.65%	-0.73%
Starting Yield	9.29	5.58	6.66	4.45	2.82
Ending Yield	8.64	5.48	4.98	4.93	4.61
10Y	11.72%	1.89%	15.03%	1.54%	-7.76%
Starting Yield	9.25	5.57	6.57	4.52	2.81
Ending Yield	8.63	5.47	5.11	4.96	4.65
30Y	12.36%	3.29%	17.39%	-1.33%	-19.89%
Starting Yield	9.09	5.84	6.28	4.68	3.04
Ending Yield	8.63	5.71	5.46	5.08	4.83

Sources: WisdomTree, Refinitiv, as of 11/30/23. Past performance is not indicative of future results. All time periods indicate when the first period of inversion occurred. The analysis periods for 1998 and 2000 represent returns of less than one year, thus cumulative returns are displayed.

Big Picture

In every episode of yield curve inversion except 2007 and the current episode (2023), bonds delivered positive total returns as a result of falling rates. The challenge today is that not only have bond yields risen dramatically across the curve, but they were at

much lower levels when the inversion occurred.

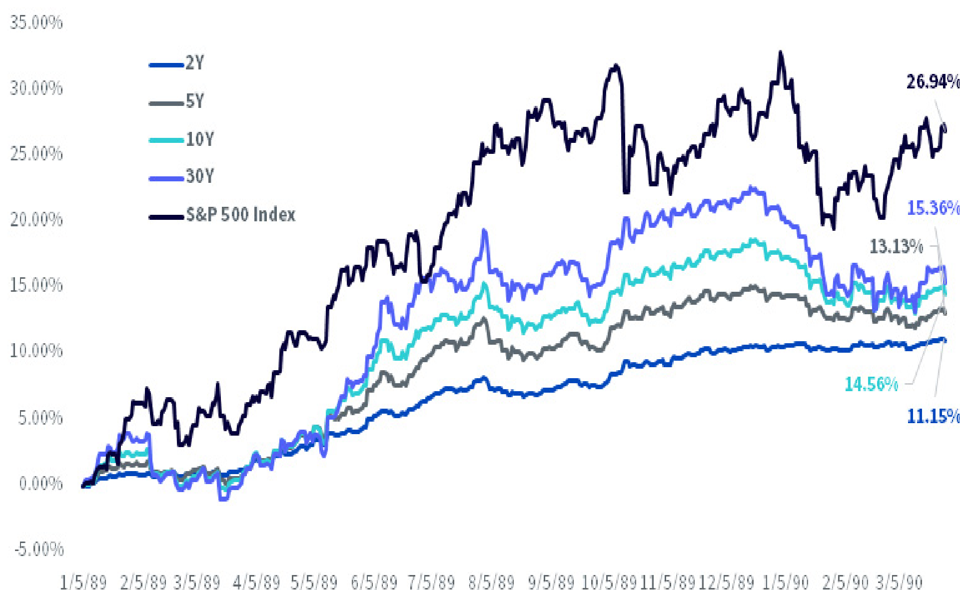
With the exception of 2000, equities significantly outperformed fixed income in this environment despite the implication that inverted yield curves signal a looming recession.

The clear implication for 2023 is that longer duration has underperformed short duration while the curve has been inverted due primarily to rising rates as opposed to lower levels of carry. However, unless investors expect this atypical period to persist, they need to consider when to start positioning for the ultimate pivot from the Fed.

In our view, the key factor that's driving inversion is that short-term interest rates are too high. Any signals from the Fed that it may be inclined to start cutting rates have resulted in massive rallies for the long end, which has boosted total returns. While this may not result in an upward-sloping curve immediately, investors will have locked in rates not seen since the early 2000s.

We also contrast this with above-average equity performance during an inverted yield curve environment as an opportunity to de-risk. However, this view also depends on timing, which we discuss during specific periods of curve inversion below.

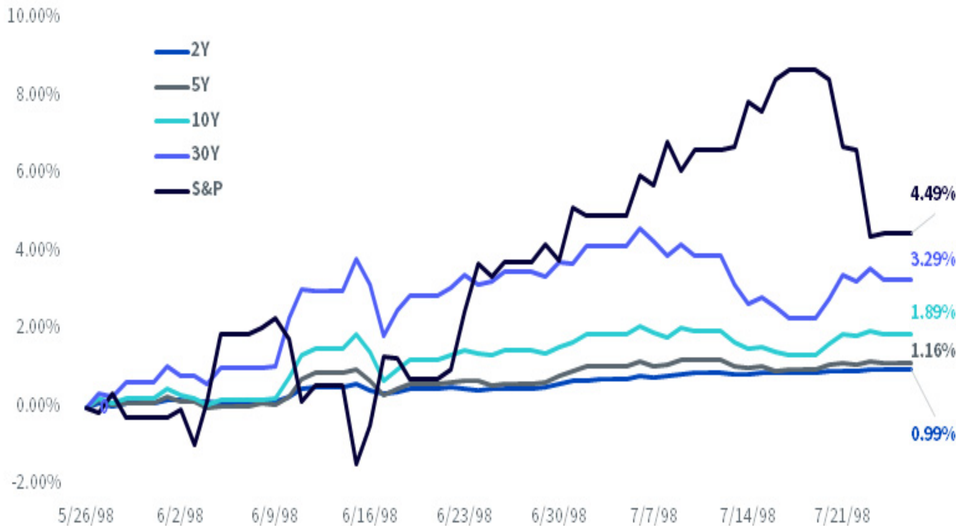
Cumulative Returns: 1/5/89–3/29/90



Sources: WisdomTree, Refinitiv as of 11/30/23.

During this period with a flat/inverted curve, fixed income experienced less significant drawdowns on account of higher starting yields. As the Fed started cutting rates in July 1989, duration started to outperform in a big way. The equity market also rallied strongly as the Fed moved away from restrictive policy. However, the U.S. tipped into recession in July 1990, which further favored allocations to fixed income as opposed to equities.

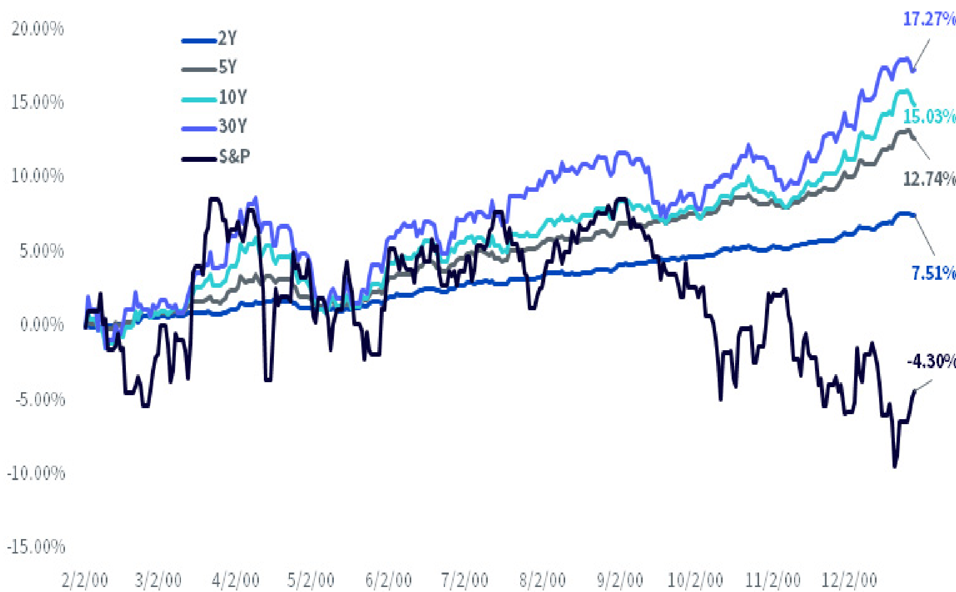
Cumulative Returns: 5/26/98–7/26/98



Sources: WisdomTree, Refinitiv, as of 11/30/23.

It's hard to draw too many conclusions from this period of inversion on account of the short period (two months), but fixed income delivered positive total returns over the entire period, albeit at much smaller levels since changes in yields were the primary driver as opposed to income. While equities delivered the highest total returns, this came at the cost of a much more volatile ride.

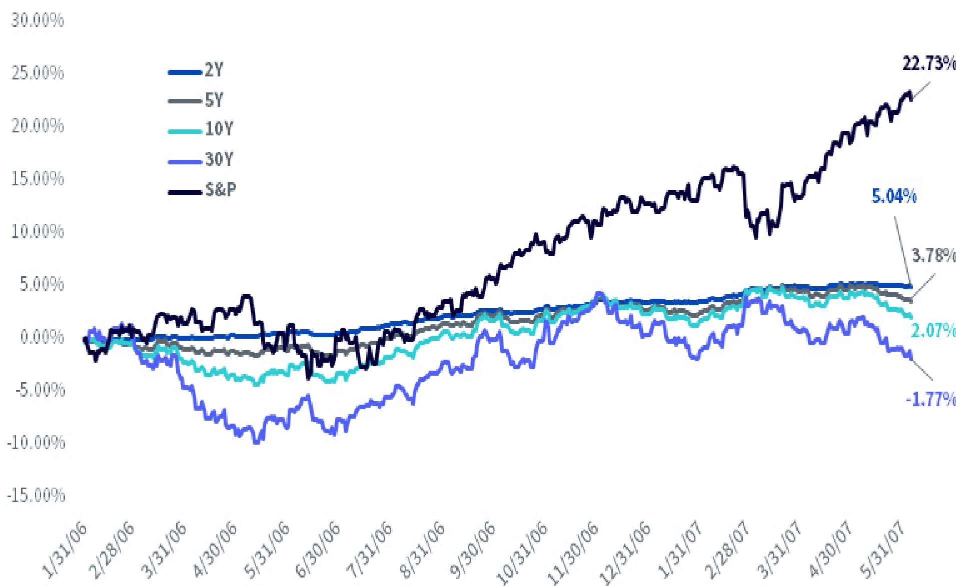
Cumulative Returns: 2/2/2000–12/28/2000



Sources: WisdomTree, Refinitiv, as of 11/30/23.

This period coincided with the peak of the dot com bubble in March 2000, and is perhaps the most anomalous for the current environment. Frothy equity markets ultimately resulted in a pullback for stocks whereas longer-term Treasuries rallied. After a final rate hike in July 2000, Treasuries then proceeded to rally as the Fed switched to neutral policy. It may be possible that we see a similar reaction in December 2023.

Cumulative Returns: 1/31/06–6/5/07



Sources: WisdomTree, Refinitiv, as of 11/30/23.

This period is marked by the largest outperformance for equities combined with general underperformance in the bond market, particularly in the long end. The Fed had been gradually tightening policy since 2004 in a measured, predictable fashion. In response, bonds generally languished whereas equities continued to run.

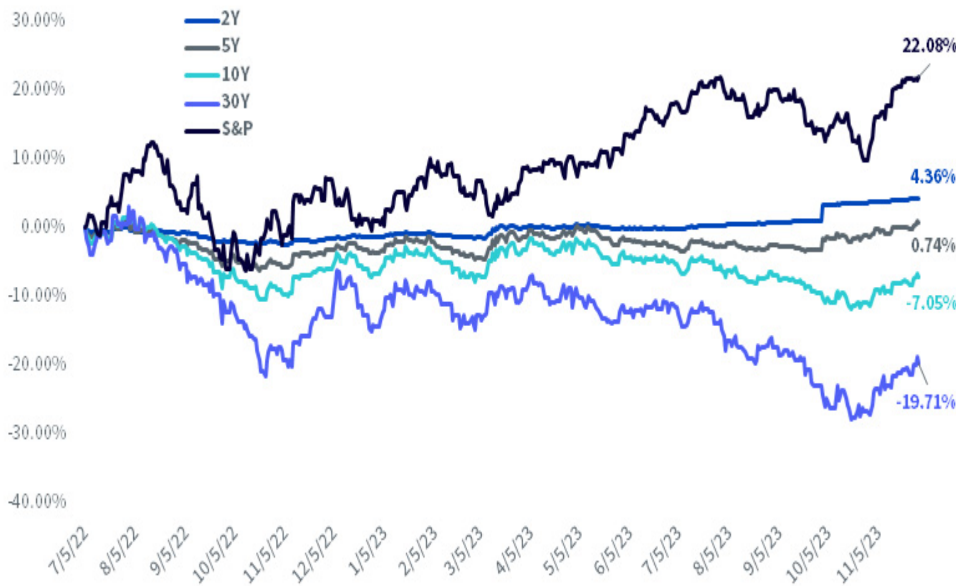
2022–2023

As most investors have been painfully aware, the long end of the Treasury curve has massively underperformed. The big difference during this period is that despite a modest steepening in the yield curve, the spread between 2-Year and 10-Year rates has remained inverted at 35 basis points, which contrasts with the other historical analyses.

For relative value investors, the key question comes down to how much more divergence can occur between long-term bonds and equities. While the timing of that mean reversion is open for debate, given the nearly unprecedented dislocation, it may make sense to make this trade before the Fed fully signals that rates will be falling.

Locking in a total return of nearly 4.5% for 10 years with the added upside potential of falling rates is becoming a more attractive trade, particularly if inflation falls sooner rather than later.

Cumulative Returns: 7/5/22–11/30/23



Sources: WisdomTree, Refinitiv, as of 11/30/23.

Conclusion

When the yield curve inverts, assumptions about the bond market get turned on their heads. While equities can generally tolerate inversion better than bonds, we know that markets are dynamic and nothing lasts forever. In light of recent underperformance, it may make sense to start shifting the duration of investor portfolios to take advantage of an eventual shift from the Fed.

In our view, any investor with exposure to a 60/40 allocation should consider the Wisdom Tree U.S. Efficient Core Strategy (NTSX) as an alternative. With fixed income providing much higher yields, we are more postive about the ability for the strategy to generate returns that differ from a 100% equity allocation given the uncertain otulook for equities heading into 2024.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. While the Fund is actively managed, the Fund's investment process is expected to be heavily dependent on quantitative models and the models may not perform as intended. Equity securities, such as common stocks, are subject to market, economic and business risks that may cause their prices to fluctuate. The Fund invests in derivatives to gain exposure to U.S. Treasuries. The return on a derivative instrument may not correlate with the return of its underlying reference asset. The Fund's use of derivatives will give rise to leverage and derivatives can be volatile and may be less liquid than other securities. As a result, the value of an investment in the Fund may change quickly and without warning and you may lose money. Interest rate risk is the risk that fixed income securities, and financial instruments related to fixed income securities, will decline in value because of an increase in interest rates and changes to other factors, such as perception of an issuer's creditworthiness. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Inverted Yield Curve : An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Yield premium : the additional amount of income investors require for holding a security.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Basis point : 1/100th of 1 percent.

60/40 Portfolio : A portfolio of 60% equities and 40% fixed income.