IFB258: Discussion Around the Yield Curve and Potential Recessions

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[00:00:00] **Dave:** All right, folks. Welcome to Investing for Beginners Podcast. Today we have episode 258 today, Andrew and I thought we would take a moment and talk about the potential most anticipated recession. Right, and talk about a yield curve and maybe explain some of these terms in a general 30,000 foot view so people can understand them.

So when they're watching C N B C, they're not going, what are they talking about? So maybe this episode can help better explain those terms to you so you can kind of understand what's going on in the news and everything. So without any further ado, then I'll turn it over to my friend Andrew, and we can start chatting about fun stuff like yield, curves, and recessions.

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[00:00:39] **Andrew:** Sure, let's start with recessions cuz um, if eco recession indicator is how crazy people around me are driving, um, we're definitely progressing towards a recession.

I guess what's interesting about the recession to me, um, being somebody who is in earnings calls a lot. I know you're in earnings calls a lot, listening to a lot of those, and it's very interest, it's a very interesting time because you hear CEOs. . A lot of 'em seem to say, I don't see a recession. Like we're seeing demand.

Things are gray. Profits are up. Revenues are up. Mm-hmm. like they're not seeing a recession. But then whenever you, like you said, turn on the TV or get on Twitter or wherever it is, or people are talking about the stock market, it's recessions coming. Recessions coming, recessions coming. Mm-hmm. . And so what the real answer is, Could be actually both like it.

It could be yes, you're not seeing the recession yet, but yes, the recession is coming and I think the yield curve and particularly the inverted yield curve can help even the beginner to understand why a recession probably will happen. And hopefully if you understand the basics of it, you can understand what to expect, but also what, what you should do.

Or not do with your portfolio as a result.

[00:02:09] **Dave:** Yeah, that, that, those are all great points. And when people hear the R word, it can be scary and people don't know how to react, don't know what to do. And maybe today we can help explain a little briefly how some of these kinds of ideas work. So I think maybe we should start with maybe the, the yield curve and talk about that and talk about how that kind of.

Impact a potential recession or not. So maybe you had a good analogy for the yield curve. What can we, can wetu touch on that a little bit?

[00:02:43] **Andrew:** Yeah, I'd love to. Uh, you know, in the past, if you go on one of the archives I mentioned, I think interest rates are kind of like a pendulum and that's actually not a great picture for 'em.

I think they're more like the waves in the ocean, where as. interest rates. Try to think of 'em in a line where you have the short-term rates all the way up to the long-term rates, and if that's confusing, just think of the difference between a mortgage you have. You could get a 15 year mortgage or you can get a 30 year mortgage.

And then all the way to the short-term would be like a cd, which I might be aging myself by even saying that because I don't even know if, like my brother, for example, would know what a CD is. A CD is something where you can lock your money away for like three months and get some interest for it, and it'd be a higher interest than a savings account.

So on the shore end, you could have something like a CD or a savings account all the way to a mortgage, 30 year mortgage. And if you think about the difference between a 15 year mortgage and a 30 year mortgage, the interest rate on the 30 year mortgage is going to be higher than the interest rate on the 15 year mortgage because you're basically getting rewarded for having your money locked.

Longer. So you being rewarded in the sense of like the bank is the one lending you the money. And so they're being rewarded for giving away that money at a longer time by the higher interest rate. And so that's where the kinda line between the short term and the long term goes. And if you think of the waves of the ocean, The Fed is the one who basically sets the short term rates, the Federal Reserve.

And so as they push those up, the long term rates will eventually follow. Um, sometimes they do follow in lockstep, not quite like the ocean, but sometimes it takes a while. And so we're in that weird stage. And the inverted yield curve is kind of like, okay, the short term has come up and the long term's still down.

and that's not normal and that's why you get all this discussion about it.

[00:05:00] **Dave:** So let's, I guess talk a little bit about, when we're talking about inverted, really what you're, what you really mean is as one rate goes up, the other one goes down and they kind of cross. Correct? Yeah. And that's, and that's where, that's where you have.

A potential problem is because you see the Fed pushing out higher rates, but then the long term rates aren't reacting and going up in lockstep with that, which causes potential catastrophe, not, maybe not catastrophe is the right word, but potential problem. So why, what is the, what is the, I guess the, the nexus of the problem then why is that a problem when one is going up and then the other one is going.

[00:05:45] **Andrew:** I guess just because it's not normal, like it's, it's really hard to say, well, this is the problem because the economy has so many moving pieces. Parts, right? So if you think of like the short term rates, we can talk about the Fed. and their impact, but there's, there's a lot of banks that are involved with that.

There's people on their checking accounts and money markets and we can just go on and on and on. And then on the long term, you have anything from a mortgage, which is regular, everyday people like you and I all the way up to like somebody like Apple or Amazon issuing debt and, and the and then the US government issuing debt and the Fed can also affect the long term.

So there's so many factors. Go into why the yield curve's inverted and why it affects the economy. But what we can know is, all right, maybe I don't know how the molecules work in a, an ocean wave, but I know that we can predict what it's gonna do eventually, and you can do pretty much the same thing with the yield curve and the economy.

[00:06:55] **Dave:** That makes a lot of sense. And I think I remember reading a while back that every recession that we've ever had has been predicted by a yield curve inverting. Is that correct?

[00:07:06] **Andrew:** Yeah. I don't know for a hundred percent, but that seems like if you

[00:07:10] **Dave:** Google it a really good, in a really high,

[00:07:12] **Andrew:** almost every, everybody, yeah, almost everybody is saying that.

[00:07:15] **Dave:** Yeah. And so that's why, that's why that terminology gets brought up on cnbc, for example, so much is because they look at that as a early indicator of a potential recession. Yes. Okay.

[00:07:31] **Andrew:** So what I find interesting about. and I don't know if, if, if this is like a valuable nugget you can kind of take home to the bank, but there's um, an agent that's not how you say it.

Adjunct Finance professor, adjunct. There's an adjunct. Thank you. There's an adjunct finance professor at UCLA and uc, Berkeley. His name's Richard Lehman and he wrote the gray article on Seeking Alpha recently about the inverted yield curve. And according to his article, he says, He, he says, he, he shows a chart where you do see the, the previous recessions and how the yield curve predated those.

And he also said that the inversion tends to happen, and then you don't see the recession until six to 18 months later. And so the, I mean the, the curve inver. I think it was in November. Mm-hmm. Yeah, that sounds right. Don't, don't quote me on it. I'm not interest rate expert, but based on that timeline, then it makes a lot of sense that the CEOs are saying one thing while the finance people are saying another thing because.

The, it basically just takes a while to work, work its way through the economy

[00:08:52] **Dave:** system, right? Yeah, you, yeah, you're, you're right. And even it's interesting being involved in the earnings calls and listening to 'em and reading through them. Different sectors and different industries are seeing different impacts.

And you know, if you talk to Visa for example, everything's sunny, everything's great, you know, MasterCard, same. It's like the most amazing thing ever. But then when you talk to Walmart, They are starting to see a change in how people are buying or seeing a, a change in the demographic of people that are buying, or they're also seeing a, maybe a, a change in the, the basket cart, like the cart average, like the, the check average of items that are being purchased is shrinking, and so that indicates to them that people are starting to cut back.

Their purchases, and they're not buying as many big ticket items as they were six months ago, a year ago. And that is leading to them to indicate that they think that, you know, something is coming. And I think that the interesting thing about economics just in general is I'm by no means an economic expert in any way, shape, or form, but it does seem to be a little bit of a mad science.

Like there's no, there's. Actual predictors of, of anything. It's all indicators of potential and it's never anything like, Hey, this is happening. This is gonna happen. It it, like you said, there's so many levers to all these different things that what happens at Walmart doesn't necessarily impact visa and vice versa.

It may eventually, but it may not. It may never. Impact them. And so it's just, it's just really hard to know. And then you also don't know how much of the news, talking about death doom and despair is going to impact how people psychologically think when they go to Walmart to buy groceries as they're not gonna, you know, are they gonna buy chicken and hamburger as opposed to going to steak?

You know, it's, you just don't know. And so those to me are, it could be a little bit an alchemy, you know, you just don't know what all the different brews are. To lead to. So I think let's talk, can we talk a little bit about like that lag between what the in inverted curve is and the stock market? Because you know, we've seen, we've seen some craziness in the stock market over the last year, year two plus, right?

So I guess let's, I guess let's talk about that in conjunction with the yield curve.

[00:11:15] **Andrew:** That's a really great point too, because, yeah, up to now we've said inverted yield curve and recession and that. Has a strong historical pattern with the stock market. It's the, uh, I haven't done the historical research on it, but to your point, because it is such an alchemy, you really have to, I feel like you need to take it back to the basics of, okay, if I were to look@the.com.

Bust in that recession, or if I were to look at the 2008 bust in that recession, well, there were different things that made those recessions happen. In one case, technology had way too much over investment. In another case, the banks over levered themselves, and then if you continue going back in history and back in time, the companies are different.

So the companies that were big in 2000. Not necessarily the same companies that were big in 2000 and they weren't necessarily driving the economy. And so even looking at, let's say, the s and p 500, and you could say, okay, well I'm gonna look at what the s and p 500 did after yield curve. Well, how helpful is that?

Because the, the, the, the companies in the s and p change, so the s and p today is different too. Uh, 26%, I mean, at. . I haven't looked to the most recent number, but it was for a while above 26% of the companies in the s and p 500 were in technology. Mm-hmm. . So you can try to look at history to say, okay, well I'm gonna figure out how to solve the market during this crazy time, but it's probably not gonna be a very fruitful endeavor because of all of these factors.

[00:13:17] **Dave:** Sorry, you broke up there for a second.

[00:13:19] **Andrew:** Okay, I'll, I'll, I'll, um, I'll repeat the last line. Okay. Um, it's so you can, you can go back into history and you can figure out what the, exactly what the s and p 500 is done during recession or during an inverted deal curve. To apply that to say, I'm gonna trade the market this way, or I'm gonna invest in the market this way to take advantage of all the uncertainty.

It's probably not gonna be a very fruitful endeavor, and you're probably better served just doing the same thing that you would do, whether there was all this R word talk or.

[00:14:02] **Dave:** Right, exactly. And I think it, you know, I, when I think about all this, I, I, I, I like to come back to the basics and I like to think about the businesses that I'm trying to invest in, regardless of all the chaos that's going around it, because it, it certainly can impact your, your psychology and your thought process if you.

if you let it, and I think if you focus on this is a great company and this is a great company and this is a great company, and what are their, what are their potential earning? Power over the next five to 10 years because the recession is not gonna last for 10 years. And if it does, then we got bigger problems,

But um, generally they tend to be shorter. And then we, then we have a recovery and it's just kind of the natural ebb and flow of the markets. And I think investing in, for me anyway, thinking about invest. because of a potential recession, I think takes me away from what I'm trying to do. And if I think about a great company like Visa, we mentioned earlier, I'm not gonna invest in them based on whether I think a recession is coming or not.

I'm gonna invest in them based on what I think, how they think this company is gonna do over the next 10 years. And is it gonna generate. Revenue, is it gonna generate growing free cash flow? Are their margins gonna improve? You know, how are there, how is their competition? All those things go into it. And I don't think about the economic impact of what could potentially happen because my time horizon is longer.

If I was thinking about, you know, if I was thinking about buying Visa and in selling it at six months, I would absolutely consider. All the things that we're talking about, but because that's not the way that I invest, then it doesn't really enter into the equation much. I think about it, but it's not, it's not the the end all be all.

Like, I have to buy all defensive stocks. All things that can withstand a recession right now because, and, and again, now you're trying to market time because now you're trying to anticipate when the market's gonna react from a recession. And we were just talking about how generally there's a lag in the market.

When a recession happens, and generally there's a lag in interest rates and so how do you time, how do you, how do you time all that it, I'm not smart enough to do that, and so it's just easier for me to just try to focus on making sure that I'm buying a great company and that it's gonna do well and let

[00:16:28] **Andrew:** it do all the hard work.

Yeah, I don't, I don't think most, I think a vast majority won't be able to time it and. I, I even questioned if it's even possible to time it consistently. I mean, I haven't seen it.

[00:16:45] **Dave:** No, I haven't. I haven't either.

[00:16:49] **Andrew:** So I mean, if it's, if it's kind of discouraging, you know, or you think about, man, I just don't wanna deal with that volatility, or I don't wanna deal with continued hardship.

Also remember that there's a lot of research that does show. That there are recoveries pretty much every time. And again, the, the timing of it's different, but inverted yield curve and recessions the market tends to recover from in the long term. So I will just double down on what Dave is saying. You know, you, you don't wanna completely put your head in the sand about the fact, okay, maybe there is a recession, so maybe the company's earning power right now.

Is gonna be less if it's a company that's more exposed to cyclical nature. So you do wanna think about that in your valuation, but as far as am I gonna try to fret about how, how am I gonna, you know, best optimize and, and maximize this environment? Wholeheartedly agree that that's a very difficult, if not impossible thing to do.

So focus on the things you can control. Like what is this company's competitive advantage? How likely are they to sustain growth over the long term? And am I paying a reasonable price? Even with the chance that we do have a recession, is there still enough cash flow after that? And if you've done all those things, I think you can feel a lot better about the investments.

[00:18:33] **Dave:** Preach on, preach on. Okay. All right. Well, with that we will go ahead and wrap up our conversation for today. Thank you guys for listening, and if you have any questions about anything we were talking about like learning more about yield curves, interest rates, learning more about how to pick stocks or how to value stocks.

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