August 2019

AEGON Asset Management

IMPLICATIONS OF AN INVERTED YIELD CURVE—UPDATE

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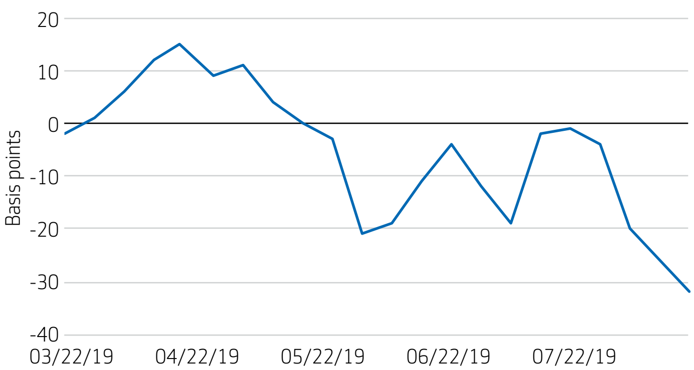
A year ago we explored the behavior of major US asset classes for the two years preceding and following yield curve inversions (Implications of an Inverted Yield Curve, August 2018). Specifically (and using an admittedly limited sample size consisting of the three preceding cycles), we found that although the near-term aftermath of a negative yield curve did not imply material declines in the price of risk assets, risk-adjusted performance favored assets on the safer end of the risk spectrum.

In late March, the spread between the 3-month and 10-year US Treasury yields crossed the zero threshold (Exhibit 1). The timing of the inversion is a bit fortuitous for this analysis as it largely eliminates the V-shaped trajectory of the equity market following the selloff during the fourth quarter of last year and the subsequent first quarter recovery. In this piece, we look at the performance of the major US asset classes since the yield curve inverted.

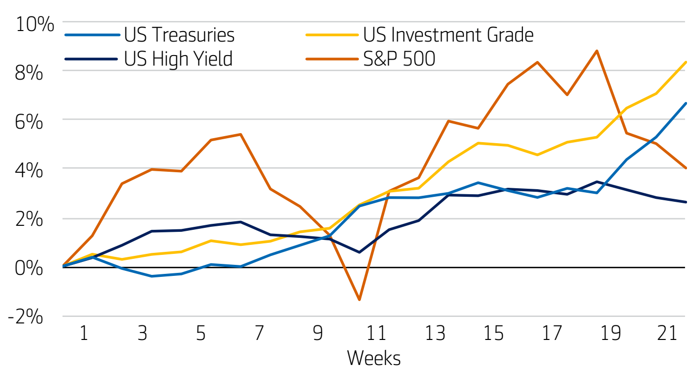
Exhibit 1: US Treasury 3-month / 10-year spread, since inversion



Source: Aegon Asset Management, Bloomberg. Dates shown: March 22 through August 16, 2019.

Looking across asset classes since the week of March 22 when inversion occurred (Exhibit 2), cumulative performance shows asset classes have all advanced. US equities and high yield bonds are up 3 to 4% since the week the inversion occurred while Treasuries and US investment grade are 6 to 8% higher.

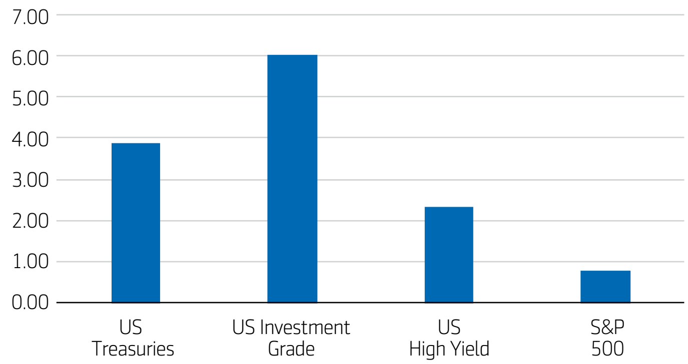
Exhibit 2: Asset class performance, since inversion



Source: Aegon Asset Management, Bloomberg. Dates shown: March 22 through August 16, 2019. Indices for asset classes provided in the disclosures on page 2.

However, when volatility is factored in, the performance difference is more pronounced. To date, the Sharpe ratio has followed the pattern exhibited in the preceding three cycles. As seen in Exhibits 3 and 4, post inversion, US Treasuries and investment grade bonds have posted materially higher annualized risk-adjusted returns relative to equities and US high yield bonds.

Exhibit 3: Annualized Sharpe ratio, since inversion



Source: Aegon Asset Management, Bloomberg. Dates shown: March 22 through August 16, 2019.

Exhibit 4: Annualized return and volatility, since inversion

	US Treasuries	US Investment Grade	US High Yield	S&P 500
Annualized return	14.57%	19.06%	4.20%	7.71%
Standard deviation	3.74%	3.17%	3.03%	12.81%

Source: Aegon Asset Management, Bloomberg. Annualized excess returns over cash. Dates shown: March 22 through August 16, 2019.

An inverted curve has real economic consequences—it removes the incentive for lending to longer-term projects that are likely to boost growth prospects. It tends to encourage the allocation of capital to cash or cash-like asset classes as yields become relatively attractive in conjunction with potentially lower volatility. As such, while the timeframe here differs from our original two-year window, and past performance is not indicative of future results, we see little economic grounding in uttering the words, "This time is different."

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Asset classes throughout this document are represented by the following indices: 10-year US Treasury, Bloomberg Barclays US Treasury Total Return Index; US Investment Grade, Bloomberg Barclays US Corporate Total Return Index Value Unhedged; US High Yield, Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged; and the S&P 500, S&P 500 Index.

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