

INVESTING

Fear Not An Inverted Yield Curve

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An inverted yield curve doesn't necessarily mean a recession. GETTY

While E always equals MC^2 , an inverted yield curve doesn't always equal a recession.

An endless feedback loop.

There is much talk these days about the yield curve, and what its shape can tell us about the future of markets. I will not review the analytics of the curve because it is exhaustively covered in the media. Even the proverbial “shoeshine kid” is talking about the predictive power of an inverted yield curve. How can this simple graph have such undisputed utility in predicted recessions? I don't believe that it does. Disciples will tell you that almost all recessions follow an inverted curve. They won't tell you that not all inverted curves lead to recessions.

In the many years that I have managed money, current times have the most intense coverage and focus on daily economic data and graphs than ever. This is understandable, because we are emerging from a world pandemic and don't have a road map of how things will unfold. This anxiety of not knowing the future path causes us to seek

predictive patterns about 2023. Enter the yield curve and its current inversion, among other tools out there.

The yield curve is not a divine message from the heavens. It is not a natural law of physics or chemistry that has been confirmed experimentally. But many investors are treating it that way. Who determines the shape of the yield curve anyway?

We must remember that mortals—U.S. Treasury traders & investors—are responsible for the resulting shape of the curve. That’s very important when weighing the significance of this singular graph. Think of it this way: If many treasury traders are pessimistic about the economy, their own trading actions will invert the curve. (Don’t forget we are fallible when it comes to predicting the future.) The problem arises when they interpret the inverted curve as an objective signal, rather than a product of their own actions. When that happens, an endless feedback loop occurs:

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“Look—the yield curve is inverted. I better sell short-term bonds and buy long-term bonds... Good thing I did because the curve has inverted more. I need to sell more short-term bonds and buy more long-term bonds...”

And so it goes. At best the curve is a summary of investor sentiment that can feed on itself. The people that wanted an inverted yield curve made it invert. It is not a solution to a physics-type problem. What is an investor to do?



It doesn't matter to fundamental analysts.

When the world is almost unanimous about the possibility of a recession, the best investors maintain a fiercely independent outlook. They screen for companies that have

been overlooked in the mania despite great prospects ahead. Consider **Booz Allen Hamilton** BAH +0.5% (BAH, recent \$105/share). This mid-cap consulting company derives most of its revenues from the US government in the brainy field of cybersecurity. The stock has performed very well this year. Returns are in the mid-twenties. Even if the yield curve correctly predicts a recession, BAH won't care much. The reason? BAH's government backlog consulting revenues are over four times their current annual revenue. The contracts are virtually non-cancellable and involve top priority technologies. This visibility is remarkable, but overlooked by many. My outlook for BAH is optimistic no matter what the yield curve says.

Need more than one stock? There are many. Take **United Rentals** URI -0.1% (recent \$360/share). This construction equipment rental company has an impressive history of acquiring competitors, leveraging its balance sheet, growing the top line and then deleveraging in the process. It is said that deleveraging companies are a bondholder's dream. I would extend that to stockholders too. As the trend of contractors' renting rather than buying their heavy construction equipment continues, URI is well positioned and has an excellent history of balance sheet discipline. The point is, even in the face of great uncertainty into 2023, there are opportunities in this inverted world.

Einstein's famously said "God does not play dice with the universe." Sadly, he was silent on yield curves.

Disclosure: Andersen Capital owns the referenced stocks. Investment Advisory Services offered through Integrated Advisors Network LLC (IAN) a Registered Investment Advisor. Andersen Capital Management and IAN are not affiliated.

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