THE YIELD CURVE'S CRYSTAL BALL IS SHAKY

But It's Saying Avoid High Beta Stocks

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It's going to be a yield curve summer.

Inversions—when 10-Year Treasury yields go lower than those of 2-Year Treasuries—have a recession-predicting track record that has become something of legend in Wall Street circles.

The reason: having longer-duration bonds trade at lower yields than nearer-term securities is counterintuitive and rare. When it happens, it is a signal that something is awry in the economy.

The much-feared day arrived on March 29; when yield curve inversion moved the matter of this once-arcane subject to the top of the macro focus.

The problem is that even if the yield curve had a 100% accurate crystal ball—which it doesn't—you would still have to take a wild guess as to the recession's arrival date. More importantly for what we're doing here, there is a great unknown as to whether a curve inversion even signals whether it's time to exit stocks.

Consider the May 28, 1998 crossover of 10-Year and 2-Year Treasuries. Sure enough, stocks did peak and crash… 22 months later. Someone who heeded the yield curve's warning that day would have been forced to watch in dismay as the Nasdaq Composite ran from 1,794 to more than 5,000 in March 2000.

As for the recession itself, it did arrive…34 months after the inversion. Horrible timing.

The yield curve was more predictive when it went inverted in August 2019, with the COVID-19 recession arriving in Q1 2020. Skeptics are keen to point out that lockdowns had a little something to do with that, but then again, I don't think we can hold it against the yield curve. It made its "prediction," and that prediction did come true.

Nevertheless, I wonder if the yield curve is something like the opposite of the old riddle about the tree in the woods falling with nobody to hear it. What if the tree falls in the woods, but it's livestreamed as part of the Super Bowl halftime show? If everyone is hyper-focused on the yield curve, what edge can we gain in the stock market by focusing on it?

You couldn't hold a conversation of any length in recent months with someone who is "very online"—Twitterspeak for being highly engaged in the 24-hour news cycle—without getting into the subject of home prices and grocery costs. Since the March 29 inversion, the yield curve has joined these issues on the Serious People Topics list.

It was never supposed to be this way.

This is the exotica of fixed income desks, only to be assessed by odd ducks with green visors in the office's dark corners. But now it's the chitchat at soccer practice.

I think I know what happened.

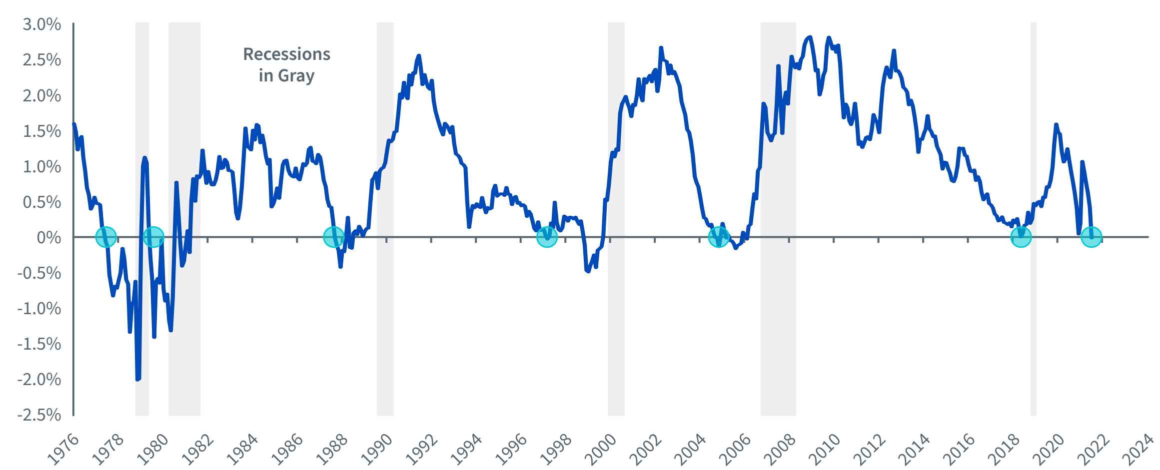
Unlike many years ago, most "weekend warriors" now have a 401(k). In an era such as the 1990s, unless you came home from work and put CNBC on the TV, you could easily go through your whole day without hearing or thinking about the market.

But now, someone who is passively interested in this stuff may be 20, 25 or 30 years into a daily ritual that entails something like a morning cup of coffee and a five-minute check of the Yahoo Finance headlines. When I think about my old pals from high school who went on to careers that have nothing to do with the stock market, most of them do something like this. They know what the yield curve is—and they know that its inversion is "the conversation."

This makes me wary of putting too much stock in the utility of an indicator that everyone is already watching—and watching attentively. That's not to say that I'm not checking on it every single day. But let's take a deep breath and acknowledge the yield curve's myriad flaws when it comes to gaining an edge in the market.

The years of curve inversions over the last half-century are 1978, 1980, 1981, 1988, 1998, 2000, 2005 and 2019 (figure 1). I used some judgment in labeling the blue dots on the chart. For example, consider the 1998 inversion that I referenced above. Notice that it went "uninverted" for a few months, only to invert again in 2000. I didn't put a second blue circle on that one. There is some art and some science to this stuff.

Figure 1: U.S. 10-Year Minus 2-Year Treasury Yield

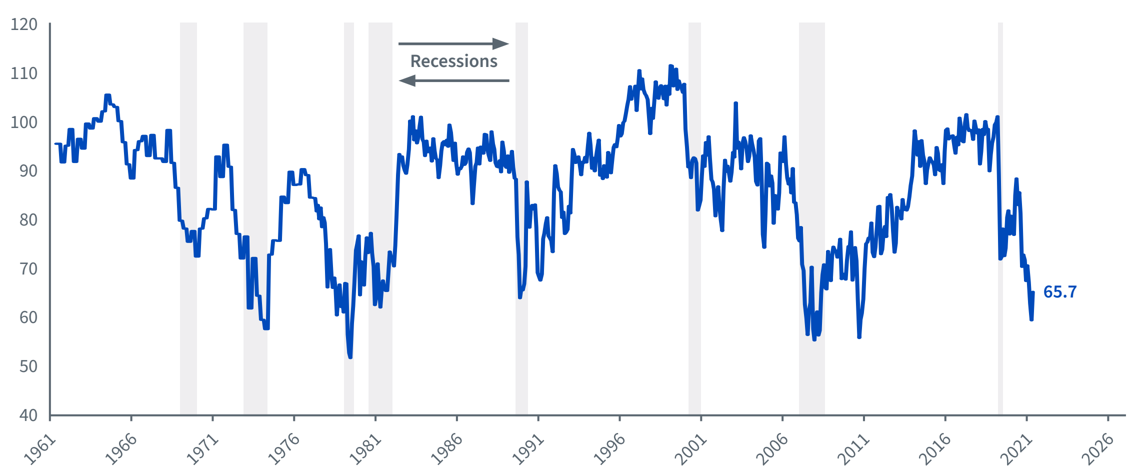


Source: Refinitiv, as of 4/29/22 (1/1/1976–4/29/22). Past Performance is no guarantee of future results.

Looking at the chart, you must respect recession risk. The problem is that maybe it hits this summer, or maybe it could be as distant as 2025. That's no help.

The University of Michigan Consumer Sentiment Index (figure 2) may offer some guidance. Keeping it ambiguous, let's go with "it looks like a recession is coming sooner than later." Ugly.

Figure 2: University of Michigan Consumer Sentiment Index



Source: Refinitiv, as of 3/29/22. Greater results indicate more positive consumer sentiment.

Here's an analogy for timing any forthcoming recession: it's like if the Uber app lets you book a car but doesn't tell you if the driver is two minutes or 30 minutes away. Should you grab your coat and run out the front door, or is there still time to check your e-mail, hop in the shower and choose an outfit?

Let's take a stab at figuring out stock market implications. Standard & Poor's has some commonly followed factor-based indexes that date to the mid-1990s. I looked through a bunch of comparisons; one of the better ones I could find was the immediacy of engaging the low volatility factor relative to high beta (cyclical) stocks.

The timing is rough, as you would expect, but the series does at some point make its way higher in the months or years after inversions. Even the 1998 inversion, one of the generally false signals of the lot, eventually earned its stripes when the market fell out of bed from 2000 to 2002.

Figure 3: S&P 500 Low Volatility Index Relative to S&P 500 High Beta Index

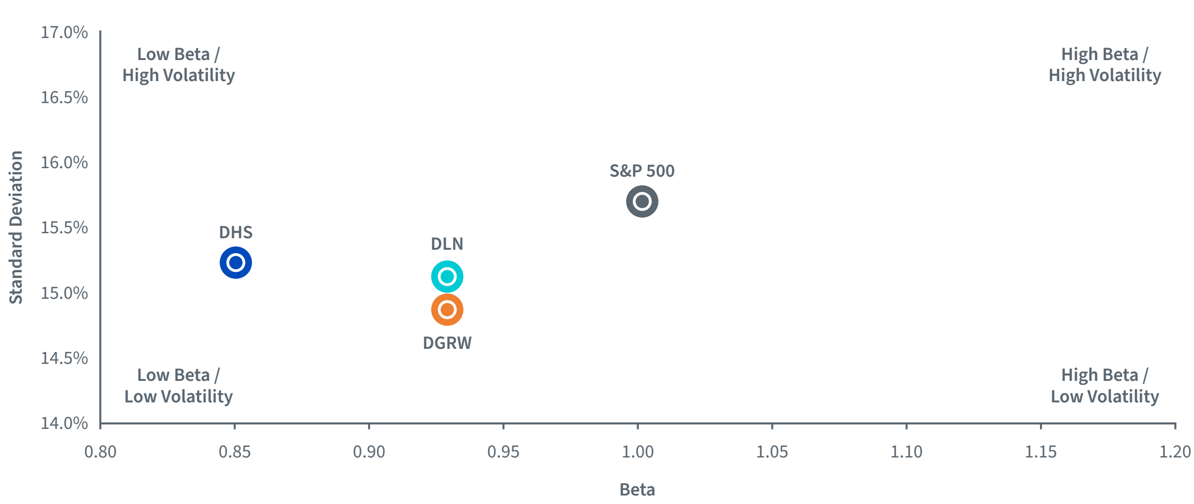
Source: Refinitiv, as of 4/29/22 (1/1/1993 – 4/29/22). The chart shows the performance of the S&P 500 Low Volatility Index divided by the S&P 500 High Beta Index. When it is rising, Low Volatility is outperforming. When it is falling, High Beta is outperforming.

If the chart is to head higher, the play is an avoidance of high beta in favor of an over-weight in mandates that show up in lower volatility screens.

In large caps, we have lower historical volatility than the broad market in DLN, the WisdomTree U.S. LargeCap Dividend Fund. From its inception on June 16, 2006, to March 30, 2022, it registered annualized volatility, as measured by annualized standard deviation, of 14.5%, about a point less than the Russell 1000 Index (15.4%) and a point and a half less than the Russell 1000 Value Index (15.9%). It's in large-cap value, so it may benefit if the market's worried tone continues to favor that group at the expense of growth stocks.

In addition to DLN, I put two of its "cousins" in figure 4, owing to their philosophical similarities. One is the WisdomTree U.S. High Dividend Fund (DHS), which engages in more of a hunt for yield than DLN. That pushes it into the deep value section of a Morningstar style box. Another philosophically similar strategy is the WisdomTree U.S. Quality Dividend Growth Fund (DGRW). That one is a large-cap blend Fund, owing to its "growthy" profitability screens working in tandem with the value-oriented dividend-weighting methodology.

Figure 4: WisdomTree Dividends' 5-Year Beta & Volatility Profile



Source: WisdomTree Digital Portfolio Developer, as of 3/30/22. Performance is no guarantee of future results.

I'm not sure if a recession is coming tomorrow, a year from now, three years from now or not at all. Nevertheless, I think it's coming.

In investing, sometimes it's not so important what you do own so much as making sure to avoid the hot potatoes. Strategies like DLN, DHS and DGRW are light in high beta stocks, which I suspect will prove fortuitous if—and let's emphasize "if"—the yield curve's crystal ball gets it right.

Glossary:

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark. Cyclical stocks: Refers to stocks in the Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors. 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. Duration curve: The graphical representation of the trend in interest rates as it relates to the length of the loan. The plots on the graph will have an interest rate for a specific loan period, usually 2, 5, 10, or 30 years. Factor-based indices: Rules-based indexes that capture the returns of systematic factors that have historically earned a persistent premium over long periods of time—such as Value, Low Size, Low Volatility, High Yield, Quality and Momentum and Growth. 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. Large capitalization (large cap): A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization." Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share. Low volatility: Characterized by lower standard deviation of price over time. This term is also associated with the low volatility factor, which associates lower-volatility stocks with better risk-adjusted returns versus the market over time. Macro: Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies. Morningstar style box: A grid of nine squares used to identify the investment style of stocks and mutual funds. The vertical axis of the style box represents an investment's size category: small, mid and large. Recession: Two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment. Screens: A process to investigate stocks for potential investment according to a predetermined set of criteria. Smart beta: A term for rules-based investment strategies that don't use conventional market-cap weightings. Standard deviation: The measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return. Supply chain: In commerce, a supply chain is a system within organizations, people, activities, information and resources involved in supplying a product or service to a consumer. Treasury yield: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government. University of Michigan Consumer Sentiment Index: A consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in December 1966. Each month, at least 500 telephone interviews are conducted of a contiguous United States sample. Fifty core questions are asked. Volatility: A measure of the dispersion of actual returns around a particular average level. Yield: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value. Yield curve: Graphical depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Index Definitions:

Nasdaq Composite Index: The market capitalization-weighted index of more than 2,500 common equities listed on the Nasdaq stock exchange. Russell 1000 Index: A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index. Russell 1000 Value Index: A measure of the large-cap value segment of the U.S. equity universe, selecting from the Russell 1000 Index. S&P 500 High Beta Index: An index measuring the performance of 100 constituents in the S&P 500 that are most sensitive to changes in market returns. The index is designed for investors initiating a bullish strategy or making a directional bet on current markets. S&P 500 Index: A market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee, designed to represent the performance of the leading industries in the United States economy. S&P 500 Low Volatility Index: An index that measures performance of the 100 least volatile stocks in the S&P 500.

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DGRW: There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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