We Are the World

Does the current inversion in the U.S. yield curve spell trouble ahead? These days, it's the global yield curve that matters.

By Kenneth L. Fisher

CHECK ALL OF THE FOLLOWING THAT are true:

a) An inverted yield curve in the U.S. hardly matters.

b) Correctly calculated, the yield curve is not inverted.

c) Long-term interest rates remain benign with no real uptrend.

d) All of the above.

Correct Answer: d) All of the above.

Since the U.S. yield curve inverted in December, an incredible amount of ink has been spilled about how that will lead to dismal stock markets in 2006 and a subsequent recession. But I'm here to tell you that the notion that this flat-to-inverted yield curve spells bad news is simply wrong. America's yield curve used to matter. Now it hardly does at all—as I will explain. What matters today is the global yield curve, and it isn't inverted at all, as we'll see.

Let's start with some fundamentals. You know that a country's central bank controls its short-term interest rates but not its long-term rates, which are set by the free market. Forty years ago, long rates were set by national free markets in each country individually. But in those days, there was limited computer capability, no systems for high-speed electronic accounting and processing of transactions and no financial futures or fancy derivatives for hedging. Currencies were fixed rather than flexible, and the biggest banks were at best partially national, not global.

Back then, as today, the U.S. yield curve inverted when the central bank raised short-term rates to cool off a heated economy. When short rates rose above long-term rates, banks became reluctant to lend because a banker's core business is borrowing relatively cheap short-term money and lending it out long-term at higher rates. An inverted yield curve implied that on a credit-comparable basis, banks couldn't make a profit. The only way in that environment for banks to make big money was to lend to a worse credit source than it borrowed from—a risky practice that's bound to backfire.

As a result, banks would tighten up on lending and credit dried up. Those in need of bank or debt financing were forced to pull in their horns, forgo expansions and pay off debts by liquidating existing assets. As a result, the economy contracted.

GOING GLOBAL

Today we live in a world of fully global banks, which can borrow in one country and lend in another faster than you can read this sentence. Long rates for any country are set not by that country's central bank, but by bidders from all over the world who compete to buy a single country's debt and thereby set its long-term interest rates.

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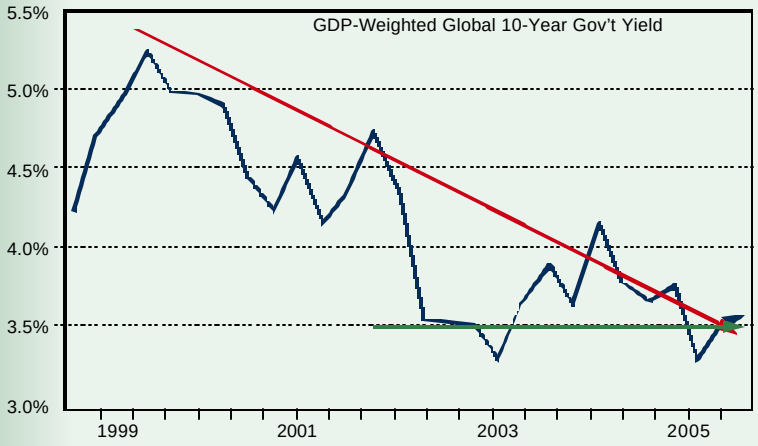
Three Faces Of U.S. Interest Rates

You can view this fever line of the U.S. 10-year government bond rate since 1999 several ways: as a downtrend since 2000; a relatively flat trend since mid-2002; or a slight uptrend since early 2003.

Source: Thomson Financial DataStream. Note: Index returns are stated as total returns.

The Global View

When we take each country's 10-year rate in proportion to its GDP as a percentage of the world's GDP, and combine them into a global rate, the chart shows a downtrend since 2000. Since mid-2002, there is no lasting uptrend.



Source: Thomson Financial DataStream. Note: Index returns are stated as total returns.

And today, banks use an infinite array of derivatives and other securities to offset their risks, including the risk of the varying country bonds they hold. For example, banks with loans in France can sell euro futures to eliminate their currency risk. If they have long-term loans to a specific industry, they can buy credit derivatives on that market to mitigate industry risk. And anyone with long-term loans outstanding can issue financial futures to lock in their interest rate for the remainder of the loan to minimize interest-rate risk. This is one reason why the 2000-to- 2002 recession wasn't preceded by the usual major bank or brokerage implosions. Financial institutions had offset their biggest risks and were able to weather the storm more easily. Long-term rates are also much more stable from country to country, because banks can borrow in one country and lend in another much more easily than they could 20 or 30 years ago.

Today when a country's yield curve inverts—or even when it doesn't—you have to keep your eye on the global yield curve. To arrive at a global curve, let's start with the U.S. and build a global long-term interest rate. In "Three Faces of U.S. Interest Rates," left, you can see America's 10-year government bond rate since 1999. You can view it several ways: as a downtrend since 2000; a relatively flat trend since mid-2002; or a slight uptrend since early 2003. Still another perspective is to envision that the U.S. constitutes about 38% of the world's GDP, and hence this interest rate should constitute about 38% of the world's 10-year interest rate.

To build the global 10-year rate, we take each country's 10-year rate in proportion to that country's GDP, then compare them by relative weight to derive a percentage of the world's GDP. Hence, the U.S. has the biggest single effect at 38%, Japan is next at 15% and so on down to the smallest countries. When we do that, we can plot a history of the world's 10-year rate since 1999 (see "The Global View," left). Although since 2000 the chart shows a downtrend similar to that of U.S. interest rates, since mid-2002 or so there has been no major uptrend—merely a fairly flat period with a temporary spike around 2004.

AN ANCHOR AROUND OUR NECKS

A better way for Americans to think is to get out of our own skins and contemplate foreign long-term interest rates. If you look at the whole world outside of the U.S. and put it together on a GDP-weighted basis (see "What Do Foreign Rates Tell Us?" on page 91), we again see the downtrend starting in 1999. But there's no real uptrend or flat period. The basic downtrend endures, accompanied by a fairly steady amount of volatility.

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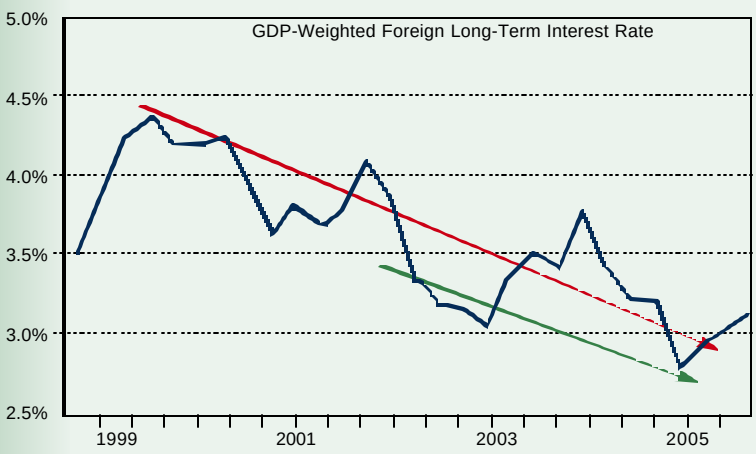
What Do Foreign Rates Tell Us?

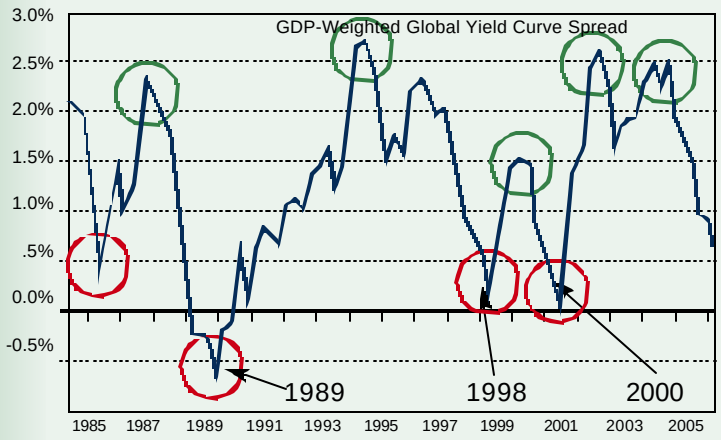
The yield curve for the world outside U.S., on a GDP-weighted basis, shows a downtrend starting in 1999. There's no real uptrend or flat period—just a continued basic downtrend accompanied by a fairly steady amount of volatility.



Source: Thomson Financial DataStream. Note: Index returns are stated as total returns.

Near Misses

In this GDP-weighted global yield curve spread, most uninverted yield curves led to strong markets (green). But in 1985, 1995, 1998 and 2002 (red), the yield curve started to invert, only to turn around and go the other way.



Source: Thomson Financial DataStream. Index returns are stated as Total Returns.

Since U.S. long-term rates are set on the world market and foreign long rates aren't rising much, foreign rates act like an anchor holding our rates lower than they would be otherwise—even if domestic forces might point to rates rising markedly. Traders who otherwise might not want to hold our long-term debt like it better when the rates of other countries fall, making ours relatively higher.

Forecasters in America have continuously gotten this wrong. At some point during the first two weeks of each year, there's a story in *The Wall Street Journal* in which a long list of professional forecasters predict where U.S. rates should be at the year's end. In 2004, most forecasters predicted an increase in 10-year rates of about 1 percentage point. Rates actually dropped by five basis points in 2004. The same group made the same mistake again in 2005, when U.S. 10-year rates rose a meager 15 bp, from 4.24% to 4.39%, far short of forecasters' 100 bp consensus. And in 2006, they're predicting a 100 bp increase yet again.

These forecasters have been so wrong partly because they're all thinking as though U.S. long rates were set domestically, the way they were 20, 30 and 40 years ago, when most of these guys were trained. In fact, in more than 30 years of the *WSJ* survey, the middle of the bell curve created by the forecasts has never matched the real thing.

I'm not saying that long rates can't rise. But they won't unless foreign long rates rise materially, too. Foreign rates are like the canary in the coal mine. As long as they are singing sweetly, U.S. rates are relatively safe. If they stop singing—then, it might be time to flee the depths of the mine.

FOREIGN GUIDANCE

So now we come to the yield curve with its dreaded inversion/perversion in the U.S. I'm guessing that you all know its recent history. Periods in which the yield curve is upward-sloping, with short rates far below long, typically have been followed by better times in markets and the economy at large. Flat or inverted yield curves, with short rates at or above long rates, have typically been followed by bad markets and weak economies. So with inversion, should we still expect disaster?

Let's look at the global yield curve again. We put together each individual country's yield curve in proportion to its percentage of the world's GDP (see "Near Misses," left). The U.S. has the biggest single effect, as it should, with Japan next and so on. Here, the global yield curve has been flattening, led by the U.S., but it isn't flat. In certain past years (1985, 1995, 1998 and 2002), the yield curve started heading toward inversion—only to turn around and go

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The First-Quarter Tipoff

The Morgan Stanley World Index reflects the developed global stock markets. In the 15 times during its 37-year history that its first quarter was up more than 4%, every single year ended with double-digit returns ranging from 12% to 43%.

Year	Q1 Return	Q2 Return	Q2-4 Return	Annual Return
1971	10.6%	2.1%	8.1%	19.6%
1972	9.4%	1.2%	12.9%	23.5%
1975	26.0%	8.3%	6.7%	34.5%
1976	9.7%	0.9%	4.6%	14.7%
1979	5.2%	1.3%	7.1%	12.7%
1983	8.3%	9.7%	13.9%	23.3%
1985	9.6%	6.9%	29.4%	41.8%
1986	21.6%	6.7%	17.5%	42.8%
1987	22.7%	6.0%	-4.8%	16.8%
1988	11.7%	-0.8%	10.9%	24.0%
1991	10.0%	-3.2%	8.2%	19.0%
1993	8.7%	6.2%	13.2%	23.1%
1995	4.8%	4.4%	15.7%	21.3%
1996	4.2%	3.0%	9.4%	14.0%
1998	14.4%	2.1%	9.1%	24.8%

Source: Thomson Financial DataStream. **Note:** Index returns are stated as total returns.

the other way.

Is that what it's going to do now? I don't know. But what I do know is that when the U.S. and the global curves both invert, that is inherently predictive of a credit crunch. But when the U.S. or any other country's yield curve points one way and the global yield curve points another, place your credence in the global trend.

Whenever someone tells you "this" causes "that" in the U.S. capital markets, a trick I learned is to search among the foreign developed nations for a place where "this" has gone on and see if "that" followed; if it didn't, it probably won't follow here, either. It's easy to look at other countries and check whether yield-curve inversions led to recession. One great example is Britain at the start of 2005.

The yield curve then looked almost identical to America's at the start of 2006. Note that while the British equities market lagged the world's 9.5% return in 2005, it still generated a positive 7.4% return and the economy did not suffer a recession. This is a perfect example of a flat-to-inverted yield curve not leading to recession when the global curve was otherwise adequately steep. You see the same effect in New Zealand in 2005 as well.

So given that the U.S. yield curve is flat to slightly inverted, the global yield curve is not inverted and domestic short and long rates are both above most other countries' yield curves, it is not surprising that, like Britain last year, our stock market's performance has been lagging that of the much stronger global stock market. But our domestic market remains positive, and the economy shows no imminent signs of recession.

> Materially, positive first quarters of 2% or more in the global stock market have always indicated a bull market ahead—no exceptions.

Our inversion and high rates are, though, an argument for underweighting the U.S. relative to foreign markets. The U.S. is acting just like Britain did last year, in line with how we theoretically should act in a largely global market.

ALWAYS AN UP MARKET

There's more evidence to support the argument for positive market returns ahead. The Morgan Stanley World Index is the best single benchmark reflecting the developed global stock markets, and it was up 6.6% in this year's first quarter. In the 15 times during its 37-year history when the index was up more than 4% in the first quarter, there was always, without exception, some more follow-through over the rest of the year (see "The First-Quarter Tipoff," above). Every single one of those 15 years ended up with double-digit returns ranging from 12% to 43%. Simply amazing! Only two had negative second quarters, and those were small declines. Only one year saw a negative back nine months of the year: 1987, which was a weird year anyway. But the second quarter of 1987 was very strong, confirming more follow-through.

To find a negative total calendar year, you have to link it to a first quarter return of less than 2%. Materially, positive first quarters of 2% or more in the global stock market have always indicated a bull market ahead—no exceptions.

This correlation breaks down when you look at single countries. And the smaller the single countries, the more it breaks down. In classic Markowitz terms, the world has more covariance in it than any subset. The Morgan Stanley EAFE follows this trend most closely since it is the subset that has the most covariance, but it's still a little hit or miss. The U.S., represented by the S&P, is even more hit and miss. When you get to smaller nations with less internal covariance, the trend weakens; in Finland, for example, it's always all about Nokia.

Still, whether you're thinking bonds or stocks, you will always see a truer picture of what's going on if you think globally before you think nationally. To see the U.S. or any other country correctly today, you must start from a global perspective. Thinking American first is defeatist. If you envision the world in its totality first, you can see clear trends and then fit the U.S. and other variant countries into them. This will aid you greatly even if you never invest outside the U.S. FP

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