Market Meditations

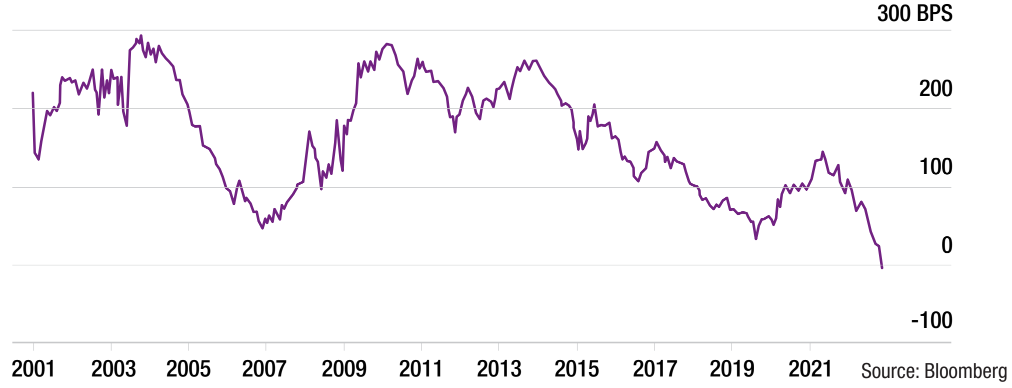
INSIGHT: **Yield Curve Inversion**

While the financial news has been fixated on the dramatic collapse of crypto exchange FTX and the increasingly bizarre behavior of its once-lauded founder SBF, the global yield curve has been quietly inverting.

Global Downturn

World view curve inverts for first time since at least 2000

— Bloomberg Global Agg 10+ year yield spread to 1-3 year yield



Source: Bloomberg

In finance circles at least, it's common knowledge that this is a big deal. Recessions tend to follow in the wake of an inverted yield curve. Financial reporters are always quick to reference this correlation but often neglect to explain just why this matters so much.

First of all, what does it mean for the yield curve to invert? We say that the yield curve is inverted when short-term interest rates are higher than long-term rates. This is considered strange because in normal market conditions investors usually demand higher rates for longer maturity bonds. This only makes sense, right? If you are going to loan someone money for

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10 years they better pay you a higher rate than if you only loan them for 1 year. It's a function of the mathematics of risk and opportunity cost.

Interestingly, it's not altogether clear why there's such a strong correlation between an inverted yield curve and a recession. It's not like there's this great causal connection between the two. All it really means is that people who want to borrow on a short-term basis have to pay more than those who have longer time horizons.

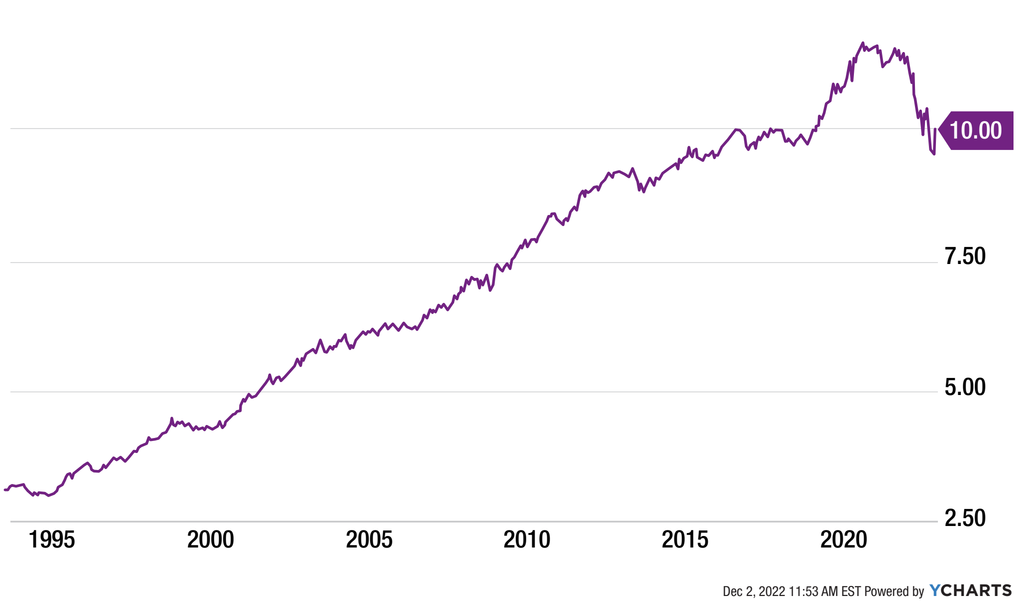
What's happening here is really a function of the sometimes magical forecasting power of the market. You see, the yield curve is really just a giant sentiment indicator and when it inverts what it's saying is that investors are forecasting worsening economic conditions. The only reason you would buy a 10-year bond yielding 4% when you could buy a 1-year bond yielding 4.5% is if you believed that the price of that 10-year bond is likely to go up. For that to happen the Fed would have to be cutting rates. And when does the Fed cut rates? When the economy is struggling (and inflation isn't a problem).

The yield curve isn't always right though. Not every inversion signals an actual recession but its forecasting power is pretty solid. These days, inflation is the wild card. The most dangerous scenario for investors is the one where we have a struggling economy and persistent, high inflation at the same time. Here, the option to cut rates will be off the table and the Fed will have to find a new playbook. Let's hope this scenario doesn't materialize.

OPPORTUNITY: **Bonds might not be dead after all**

If you are looking for an investment opportunity these days, the bond market might be the most interesting place to look. The Fed's inflation fighting campaign has certainly challenged the multi-decade bull market in bonds. Right now it looks like the trend is actually already broken.

iShares US Aggregate Bond Index Inv P (BMOPX) Total Return Level



However, if all the negative sentiment behind the yield curve inversion turns out to be right, bonds could do quite well again.

ADVICE: **Savings is Not Always the Answer**

Let's assume for a second that you are trying to achieve financial independence. This is a big, bold goal. Almost certainly, the things you've been reading and listening to aren't helping you. Most of what's out there, while not necessarily garbage, isn't all that useful and certainly doesn't reflect the truth. Pick up any book or article offering financial advice and it's all the same. Work Hard. Budget. Save. Make sure your inflow is greater than your outflow… Look, this is all true and prudent but this is not how people actually become wealthy.

The idea that you can save your way to financial independence is one of the core myths of capitalist ideology. It sounds good of course but it's a story that was created to keep people from pursuing their real dreams. I know this may sound like a pretty extreme point of view but if you look carefully into the truth, it is undeniable.

If you have a bold goal like financial independence, you will be far, far better off focusing your effort in another direction. There are three pathways, legally at least, to generate money:

1. Labor (Have a Job)

2. Returns on Accumulated Capital (Have Assets)

3. Entrepreneurial Effort (Create Something New and Own It)

The problem with financial advice these days is that it is almost exclusively focused on 1 and 2. There's an almost universally recommended pathway that looks like this: if you work hard at your job and are financially disciplined enough to accumulate savings, then you can invest in assets and one day achieve financial independence. This is the dream that was so effectively sold to the Boomer generation. The truth though is that unless you happen to get some kind of unicorn job (e.g. become the CEO or play a professional sport…) this pathway almost never results in true financial independence. Yeah, you might have enough to retire but are you really financially independent?

While we've all been conditioned by our culture to think that it's all about getting that high paying job, if you actually pay attention to how wealth is created a different story emerges. What you see when you study the origin stories of the great fortunes in the world is entrepreneurial effort and ownership. I respect that this path might not be for everyone, but there's no denying that it is a much better way to pursue financial freedom. While it's hard to find data to support this proposition, my gut tells me that the ex-ante probability of success is actually even higher here as well—meaning, as risky as it may feel, you actually have a better chance of making it than you do working a job.

This, by the way, is why we are so culturally obsessed with entrepreneurs. These bold individuals are the heroes of our age. Psychologically, there's a part of us that just knows that the path these heroes have taken is a truer, more authentic path than the one that has been constantly advertised to us since we were children in school.

Something to consider as you are putting together your 2023 plans and goals. ▫