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FINANCIAL PLANNING NOTES

CLIENT NEWSLETTER

"If you lend someone $20, and never see that person again, it was probably worth it."

—Author Unknown

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THE TOPSY TURVY WORLD OF BOND YIELDS

The market is going to go down! You heard it here first. Well, actually if you pay even slight attention to the financial news, you heard it here one millionth. We are in our eleventh year of a strong bull market and prognostication on the coming bear market has been rampant for approximately all eleven of those years.

That is not to say the market will never go down again. I stand behind my opening prediction. The market *will* go down. But I can't tell you when the market will peak (maybe it already has), and how far the drop will be, and those little tidbits are kind of important for turning that market prediction into an actionable plan for your investments.

The latest evidence of the coming downturn is the inverted yield curve. Last month, for several days the one-year treasury note rate was higher than the rate for the ten-year note. This doesn't happen often, and basic financial theory says it shouldn't happen at all!

Your MBA Degree In Three Paragraphs

Financial theory says a dollar today is worth more than a dollar tomorrow. And a dollar tomorrow is worth more than a dollar the day after tomorrow, etc. When you loan money to someone, you expect to be paid back with interest, and the longer the loan period, the more interest you expect to receive, because you are taking more risk allowing someone else to hold on to your money longer. When thousands of borrowers and lenders come together in the bond marketplace each day, the laws of supply and demand work to set the proper interest rates for short-term and long-term bonds. And inevitably, long-term bonds end up paying more interest than short-term bonds. If short-term rates were higher than long-term rates, demand would shift from long- to short-term bonds, impacting their price until short-term rates were lower than long-term rates. That is true because investors want the most reward as quickly as possible, so higher short-term rates will draw more investors, who in turn will push the price of short-term bonds up, which in effect lowers the interest rate those bonds pay.

So what happens when the yield curve inverts and short-term rates don't just pop up for a few seconds, but stay higher for several days? Why would that happen? The answer is because investors have decided they prefer long-term bonds over short-term, even if

they aren't getting paid as much for them. And they would only make that determination if they found short-term bonds to be too risky to invest in, even with an interest rate premium available.

Some economists believe that if investors fear a recession is imminent, they would have that type of fear of investing in the short term. The reasoning is that even if they get a premium for a one- or two-year bond today, the economy could be in a full-blown recession by the end of that term, and then they may not have a good reinvestment option available. If the Federal Reserve lowers interest rates, as they often do during a recession, the rates available on bonds in a year or two could be far below what they are today. With that threat looming, investors turn to safety and put their money in the ten-year bond. If a recession does come and interest rates fall, the bonds they hold will rise in price, and they will not have to worry about reinvestment for a long time.

Back to Our Story (Of Impending Doom?)

While rare, yield curve inversion does happen. Before last month's occurrence, it happened nine other times since 1966, and some time after seven of those inversions, a recession occurred. According to a recent article on AdvisorPerspectives.com, the lag between the yield curve inversion and the recession was anywhere from 7 months to 19 months.

The last yield curve inversion occurred in June, 2006. A whole lot was going on back then. The housing market was tanking. Consumer debt was soaring. Job growth was slowing. The market was definitely going to go down, said all of the experts (except for the experts who said it wasn't). And it did. It went way down … starting 17 months later.

But before the stock market slide that accompanied the Great Recession began in November, 2007, the S&P 500 *rose more than 23%.* That's a lot of gain to miss out on if you tried to time the market based on the yield curve.

Other periods from yield curve inversion to recession weren't as robust—in fact some periods had small declines in the U.S. market index—but on average *there was a 7.3% rise in the S&P* before the start of the recession. And given that the beginning of a recession usually can't be determined until we are well into it, you've got an abundance of complications with a market timing strategy.

Nevertheless, we are hearing a lot of talk today of moving out of the market, lessening exposure to risky equities, going to cash or fleeing to safety. They all mean the same thing: "We are going to try to time the market to limit losses from the coming recession." But portfolios don't make money sitting on the sidelines. Sure, they don't lose money either (other than purchasing power loss due to inflation), but as Admiral Grace Hopper said: "A ship in harbor is safe, but that is not what ships are built for."

No matter how "sure" the signs are, market timing is a risky game. If you don't need that risk to reach your lifelong financial goals, it's probably a good decision not to take it.

—Steve Tepper

Sources:

A Historical Perspective on Yield Curves by Erik Conley, AdviserPerspectives.com, April 1, 2019.

The U.S. Economy in Review: 2006 by Christian E. Weller, Center for American Progress, December 21, 2006.

SAVE EARLY, SAVE OFTEN

You're 25 years old. If you're actually anywhere near my age, you probably want to pause for a minute and enjoy that thought. Okay …

Maybe another minute …

All right, snap out of it. You just got your first decent paying gig and you've (wisely) decided to start saving for retirement, which you've already got marked on the calendar for mid-2054, thirty-five years from now.

You start out modest, putting $100 into a brokerage account, and buying a moderately aggressive portfolio of stocks and bonds, which you expect to return 8% per year on average. You plan to increase your deposit each year by 3%. You've accounted for taxes, which you expect to be 15% of your gains, payable once a year. You won't trade much, so you only figure on about $50 in transaction fees a year.

Whew, a lot of assumptions just to get to the question: How much money will you have in the account in 2054? Answer: You will have deposited $72,555, which will grow to $239,017. That money can supplement other sources of retirement income (Social Security, money you've invested in your employer's 401(k) plan through payroll deduction, etc.) to fund a comfortable retirement.

The fun part of the exercise (okay, maybe just fun for math and money geeks like me) is to play with the assumptions and see how it impacts the end-result:

- Maybe you want to play it more aggressive and try to get a 10% annual return. Hey, you're young! Why not? Now you're looking at $348,156.
- *Or* maybe you deposit more to start ($150) and increase your deposits a little more each year (4%). That gets you to $413,980.
- *Or* maybe you want to see what happens if you add a few more working years and retire in 2059. That would get you to $357,022.
- And don't forget to consider the "all of the above" option: **$957,037!** Find yourself an equally savvy and disciplined partner in life who does the same and you've got close to $2 million.

[Please keep in mind this is just a math exercise. I believe these are reasonable assumptions based on historical returns and tax law, but actual results will vary and of course all investments carry the risk of loss.]

The most important factor in this exercise isn't the rate of return or the tax rate or the deposit amount. It's getting started! *Pass this thought along to your favorite millennial:* Save early, save often. It doesn't have to be a huge amount. Just start saving and establish the lifelong discipline of saving.

And you know there's an advisor just a phone call or email away to help them get started.

—Steve Tepper

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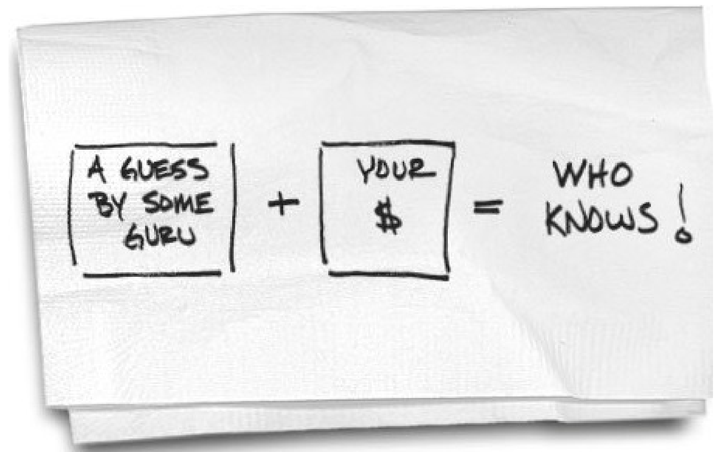
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT

"My investing club has been meeting for four years. So far we've invested $500 in stocks, $100 in bonds and $3000 in coffee and cake."

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