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CARGO CULTS AND THE YIELD CURVE

During World War II, both the Allies and the Japanese militaries operated vast logistics networks across the Pacific. The airfields and depots they built in Melanesia brought the Islanders in touch with manufactured goods they had never before seen. The Islanders believed that tents, ropes, canned goods, knives, medicines were gifts from their ancestors. When the war was over and the airfields were abandoned, the Islanders were dismayed. Whence arose one of the odder phenomena of cultural anthropology. A number of spiritual cults arose dedicated to bringing back western goods. Spurred by charismatic leaders the cults developed rituals that mimicked the outward appearances of airfield operations. They fabricated elaborate facsimiles of control towers, radio apparatus, antennas – using local materials. The leaders - wearing faux military insignia and carrying rifles made from sticks – would conduct drills and military parades. Early scholarship of the cargo cults focused on the naïve rituals and primitive obsession with material goods. Later studies emphasized the cults as the reaction of societies under severe stress of colonialism. The important observation was that magical thinking is a characteristic of people faced with tumultuous change.

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For the past decade, investors in U.S. stocks and bonds have enjoyed a kind of cargo-drop of returns. For the 10 years ended December 31, 2021, the S&P 500 returned 16.5% annualized. But we have experienced a bout of turbulence since then. U.S. Treasury yields have almost doubled, from 1.52% at the beginning of January to a recent high of 2.93%. The Nasdaq-100 touched down 20% as of March 14th. So naturally pundits start casting about for the omens that would explain our troubles. Sure enough, the yield curve has inverted – meaning borrowing rates at short tenors (2 years) have exceeded those at longer horizons (10, 20, 30 years). Many read this phenomenon as a sign of impending recession. I think that view merits circumspection. First the current economic backdrop is very different from the past. The Federal Reserve has a stock of $8 trillion of U.S. Treasury and agency securities, of which $4 trillion have been purchased in the last two years. For argument's sake, let's assert that the Fed's balance sheet actions have induced an abnormally low term premium. That same premium over the reference period was typically 100 bps. That implies that whatever signal we might infer from the yield curve has to account for the new backdrop.

But there is another more insidious distortion. Investors spend billions of dollars looking for associations between variables and prices. Most are spurious. Many disappear within months. But some endure. And perhaps the enduring ones are really elucidating some fundamental causal mechanism. Indeed, the yield curve inversion has an appealing theoretical justification. And that is, paradoxically, exactly its weakness. It may be such a good signal that investors who believe in a recession begin to use it to wager on their outlook. The organic causality is reversed, and the signal becomes the expression. It may still work in a kind of 'wisdom-of-the-crowds' way. But not because it reveals some deeper insight.

Many aspects of the investment landscape today are charged with uncertainty. We are experiencing a level of inflation that few of us have ever witnessed. Yet, nominal yields on safe assets are similar to levels we observed during a period of tranquil inflation. A sovereign European country has been invaded. And the pandemic still threatens to upend economic activity in the world's second largest economy. Yet, equity valuations are consistent with periods which seemed much more promising. The world is never stagnant, but it seems that many more variables are in play than normal. In short, it's an environment that is confusing. Amidst the cognitive dissonance, there is a natural craving for straightforward recipes.

In the best of times, investors are a superstitious lot. But when the situation is unfamiliar and unsettled, they seem to have a longing for simple formulaic relationships. "Banks do well in a rising interest rate environment." "Growth stocks are long duration assets that underperform in a rising rate environment." "We are experiencing inflation, so you should buy commodities." As sound bites, they appeal to our yearning for reducing complexity. Notice however that the formulas always take an existing condition as a given. One of my former colleagues had a nice aphorism: 'There is no present tense in the stock market. There is only past and future." It was a warning not to assume a continuing state of affairs. Traders – who live in the current moment – always refer to 'what is working.' For investors, there is only what has worked and what will work.

There is a presumption that asset allocators must predict the future. I think it's more accurate to say that our job is to understand what markets are predicting. Of course, the world is inherently probabilistic. So it's better to say we attempt to infer the probability distribution that the market is pricing. We then construct portfolios that are most resilient to the full range of potential outcomes. Mostly, the rewards for wagering on 'the present tense' will be modest to nil. Our biggest advantage will be guarding against the low probability events with very skewed payoffs. We recently reduced our exposure to Europe and Japan in favor of the U.S. We have also continued to add to our moderate overweight to secular growth in the U.S. If the global economy continues to expand robustly, these wagers will likely underperform modestly. If events turn out worse (either with respect to inflation or the geopolitical trauma of the Ukraine war), our expectation is that our portfolio biases will be disproportionately rewarded. There are no simple incantations for excess returns. No simple prescriptions based on dubious historical relationships. We can only reason from observation and consider carefully balancing the upside of being correct with the potential losses from being wrong.

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