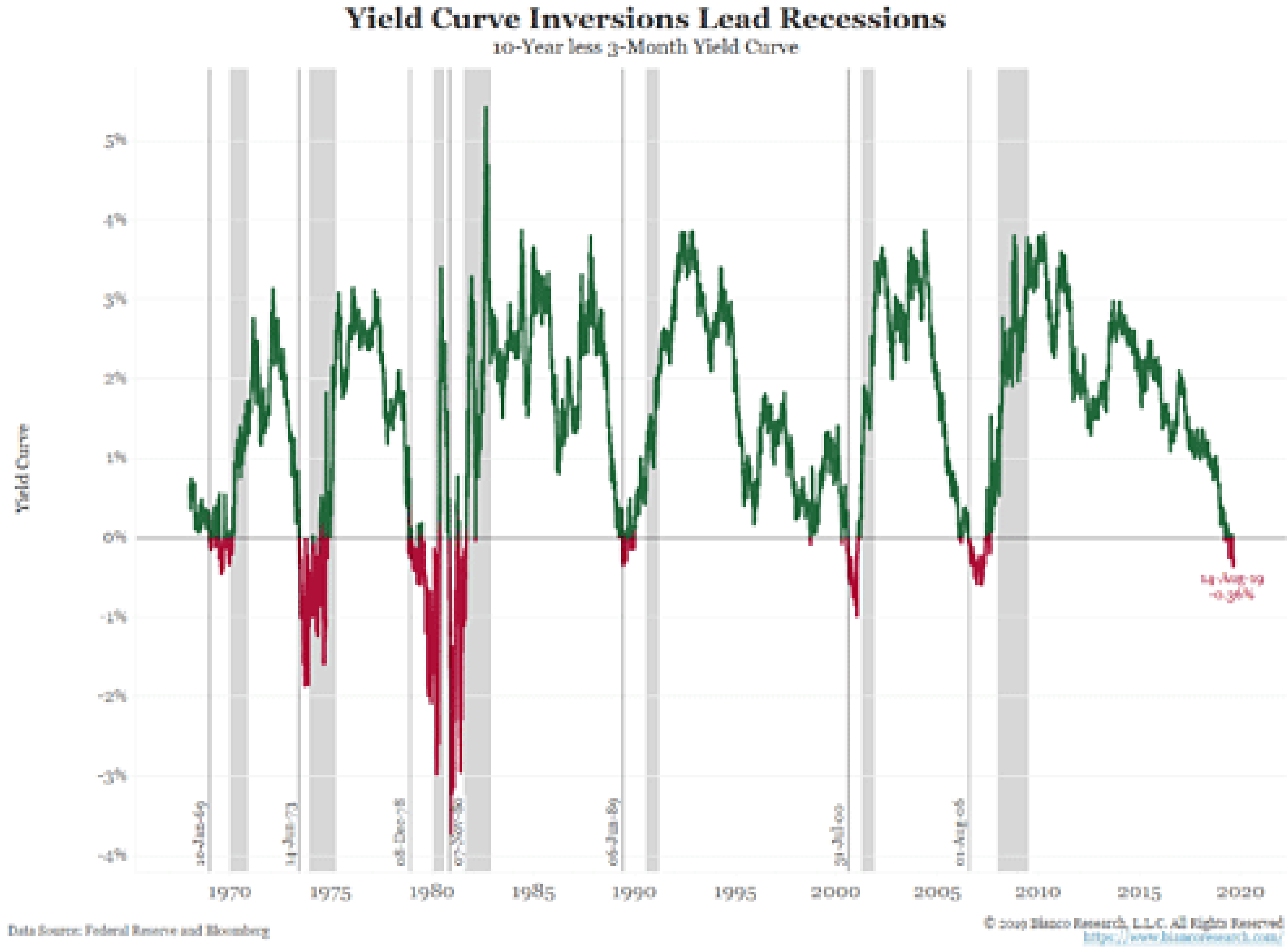
# FLASH COMMENTARY

August 16, 2019


*Recession is coming! Recession is coming!* Or is it? And when is it? Headlines have fueled volatility as they flash warnings about the yield curve inversion since the 10-year Treasury yield briefly moved below the 2-year Treasury yield (inversion) on Wednesday. *"The 800-point drop in the Dow on Wednesday was the 4th largest decline in history,"* as stated by hundreds of financial media pundits. The Dow was down 3.05% on Wednesday making it the 342nd largest daily decline in history in **percentage** terms. To break the top 20 largest daily declines in history the Dow would have needed to drop 7%. The fourth worst daily **percentage** drop in the Dow was -9.92% which occurred in 1929.

That being said, yield curve inversions have preceded every recession since WW2. However, most experts cite the relationship between the 3-month Treasury and the 10-year Treasury as a more accurate indicator of a recession on the horizon (chart below). As a side note, this is the first time the 3-month/10-year curve has inverted before the 2-year/10-year curve which means we have no historical precedent for this. While we recognize that *"but this time it is different"* logic has tripped up many investors in the past, there are some differences about the current environment that are worth consideration. The yield curve has not been the only accurate predictor of recessions over the past 50 years; fiscal tightening has also preceded and predicted every recession over the past 50 years. Additionally, historically, an inverted yield curve has been accompanied by a variety of other ominous economic signals including layoffs and credit deterioration. So, while the yield curve is signaling an impending recession, the expansionary fiscal conditions of the past three years are telling us there's no recession in sight. Since at least 1965, these two important indicators have never been out of step in predicting a recession. It is also worth remembering that while every recession has been preceded by a yield curve inversion, not every inversion has been followed by a recession.




The yield curve inversion is the bond market flashing a warning about the economic future. Stock market volatility is a reaction to the bond market's warning. In that regard, consider one significant factor contributing to the inversion—negative interest rates (table below).

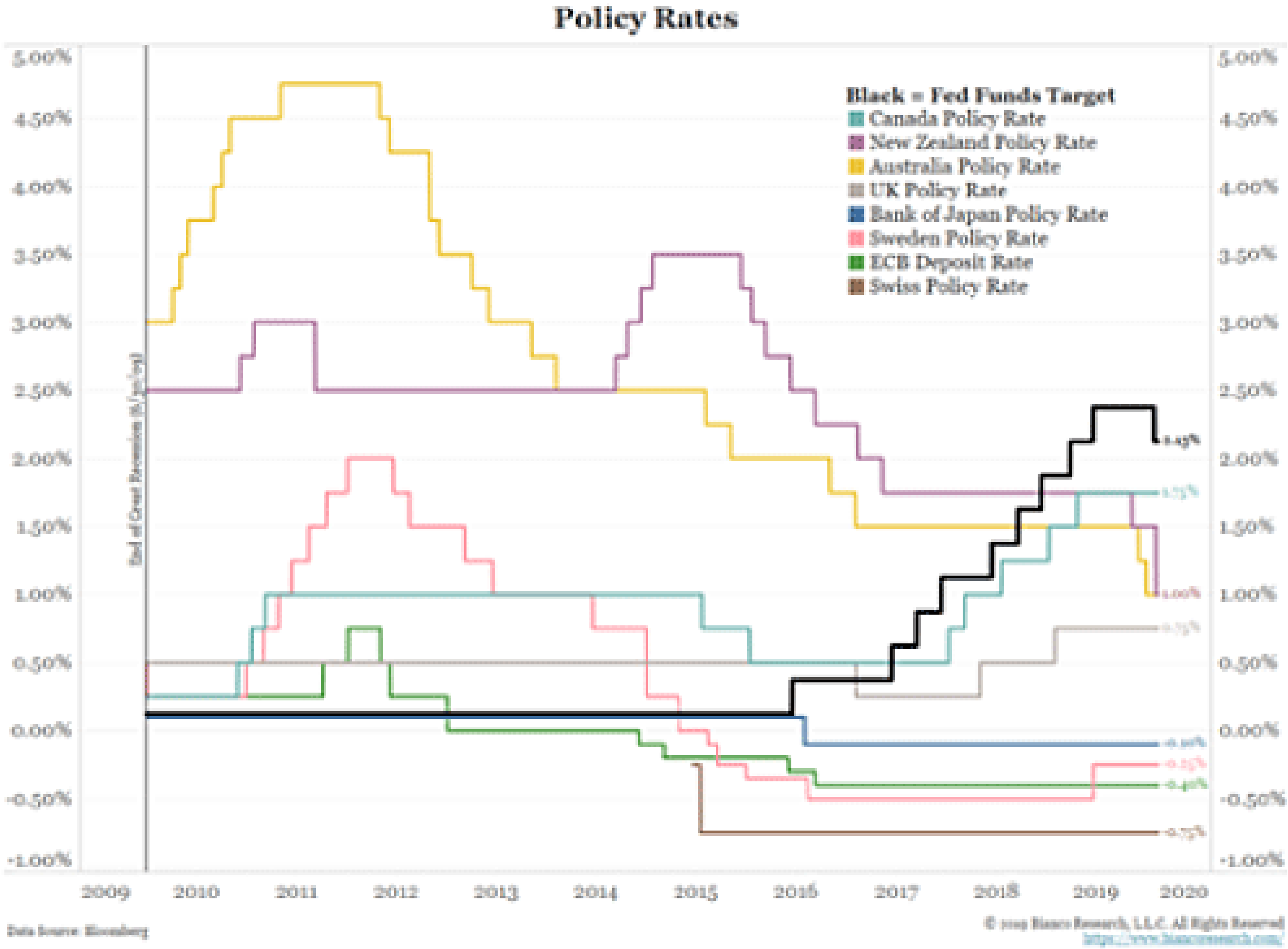
**Interest Rates in the *Developed* World**

As of 8/14/2019

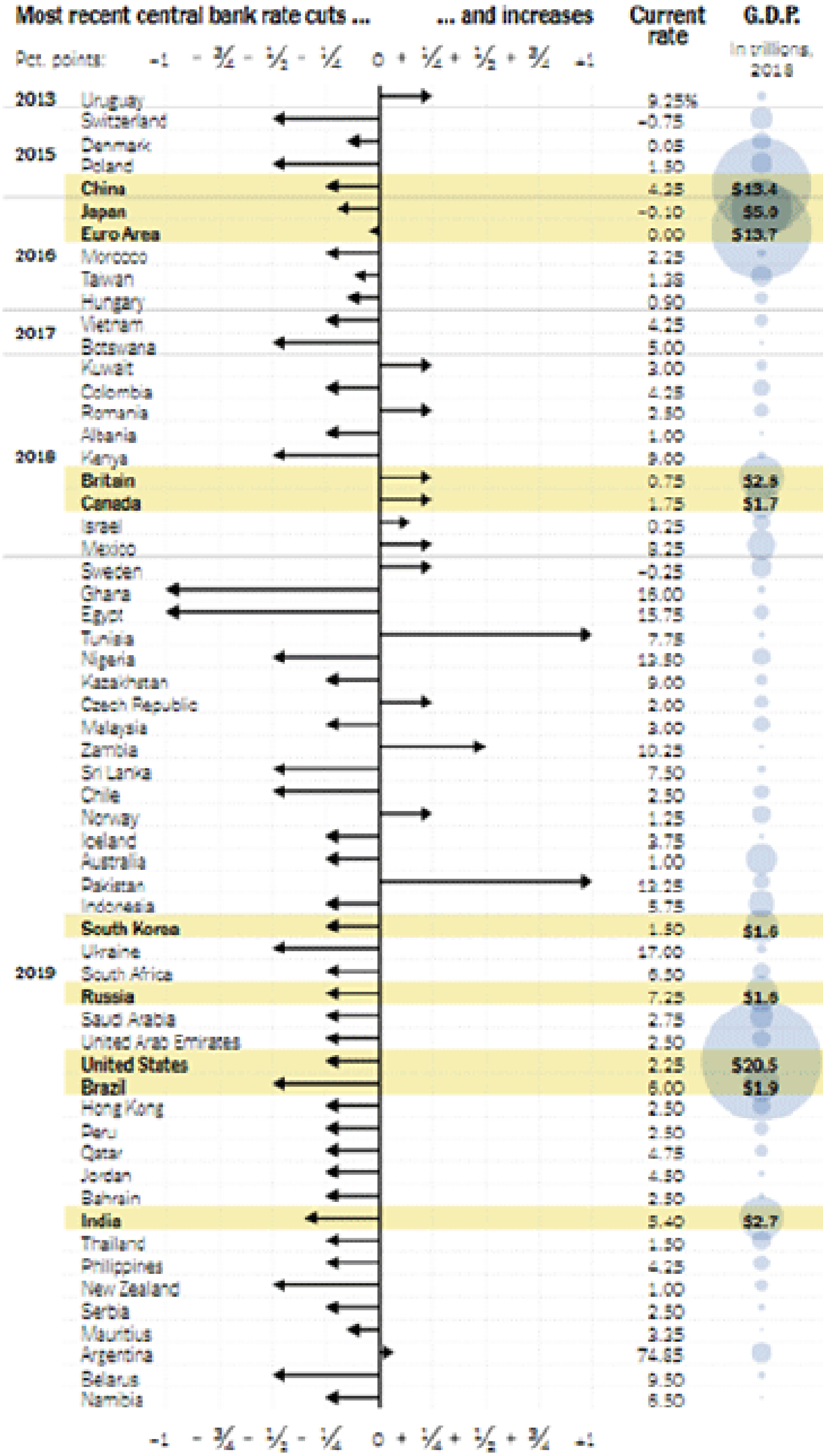
| Country | Policy Rate | 6-Month | 1-Year | 2-Year | 3-Year | 4-Year | 5-Year | 6-Year | 7-Year | 8-Year | 9-Year | 10-Year | 15-Year | 30-Year |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Switzerland | -0.75 | -1.16 | -1.12 | -1.12 | -1.13 | -1.12 | -1.12 | -1.10 | -1.08 | -1.08 | -1.13 | -1.03 | -0.80 | -0.52 |
| Germany | -0.40 | -0.75 | -0.79 | -0.88 | -0.94 | -0.92 | -0.87 | -0.87 | -0.83 | -0.78 | -0.71 | -0.65 | -0.51 | -0.18 |
| Netherlands | -0.40 | -0.81 | | -0.86 | -0.89 | -0.87 | -0.81 | -0.74 | -0.70 | -0.63 | -0.58 | -0.52 | -0.40 | -0.16 |
| Sweden | -0.25 | -0.50 | | -0.65 | | -0.71 | -0.68 | -0.61 | | -0.53 | -0.44 | -0.33 | -0.17 | |
| Denmark | -0.65 | -0.75 | | -0.88 | -0.90 | | -0.88 | -0.83 | | -0.74 | | -0.60 | | |
| Finland | -0.40 | | -0.76 | -0.81 | -0.81 | -0.78 | -0.75 | -0.65 | -0.61 | -0.51 | -0.47 | -0.38 | -0.20 | 0.06 |
| Japan | -0.10 | -0.22 | -0.23 | -0.28 | -0.28 | -0.30 | -0.31 | -0.33 | -0.34 | -0.33 | -0.28 | -0.23 | -0.05 | 0.19 |
| Austria | -0.40 | | -0.71 | -0.79 | -0.79 | -0.77 | -0.71 | -0.66 | -0.57 | -0.55 | -0.49 | -0.39 | -0.13 | 0.19 |
| France | -0.40 | -0.71 | -0.71 | -0.78 | -0.82 | -0.81 | -0.74 | -0.67 | -0.60 | -0.52 | -0.45 | -0.37 | -0.06 | 0.47 |
| Belgium | -0.40 | -0.80 | -0.72 | -0.78 | -0.80 | -0.74 | -0.66 | -0.61 | -0.54 | -0.46 | -0.39 | -0.32 | -0.04 | 0.53 |
| Ireland | -0.40 | | -0.64 | | -0.63 | -0.61 | -0.55 | -0.42 | -0.34 | | -0.20 | -0.09 | 0.22 | 0.74 |
| Spain | -0.40 | -0.53 | -0.50 | -0.52 | -0.51 | -0.38 | -0.31 | -0.19 | -0.09 | -0.03 | 0.05 | 0.15 | 0.56 | 1.03 |
| Portugal | -0.40 | -0.55 | -0.53 | -0.60 | -0.45 | -0.33 | -0.28 | -0.13 | -0.07 | -0.02 | 0.10 | 0.18 | 0.52 | 1.04 |
| Italy | -0.40 | -0.21 | -0.06 | 0.12 | 0.52 | 0.69 | 0.96 | 1.00 | 1.23 | 1.29 | 1.31 | 1.58 | 2.07 | 2.59 |
| United Kingdom | 0.75 | 0.73 | 0.55 | 0.47 | 0.36 | 0.36 | 0.35 | 0.31 | 0.34 | 0.38 | 0.36 | 0.46 | 0.76 | 1.07 |
| Australia | 1.00 | 1.04 | 0.88 | 0.72 | 0.67 | 0.67 | 0.67 | 0.73 | 0.79 | 0.85 | 0.92 | 0.94 | 1.18 | 1.55 |
| New Zealand | 1.00 | | 1.73 | 0.80 | | | 0.86 | | 0.98 | | | 1.10 | 1.28 | |
| Canada | 1.75 | 1.64 | 1.56 | 1.33 | 1.29 | 1.23 | 1.17 | | 1.17 | | | 1.15 | | 1.37 |
| **United States** | **2.13** | **1.93** | **1.80** | **1.60** | **1.54** | | **1.50** | | **1.54** | | | **1.59** | | **2.03** |

Concept courtesy of @CharlieBilello https://www.biancoresearch.com

In a manor unprecedented in history, Central Banks of many developed economies adopted zero or negative interest rate policies following the Great Financial Crisis. Since mid-2018, the U.S. has offered the highest policy rate in the developed world (chart below).

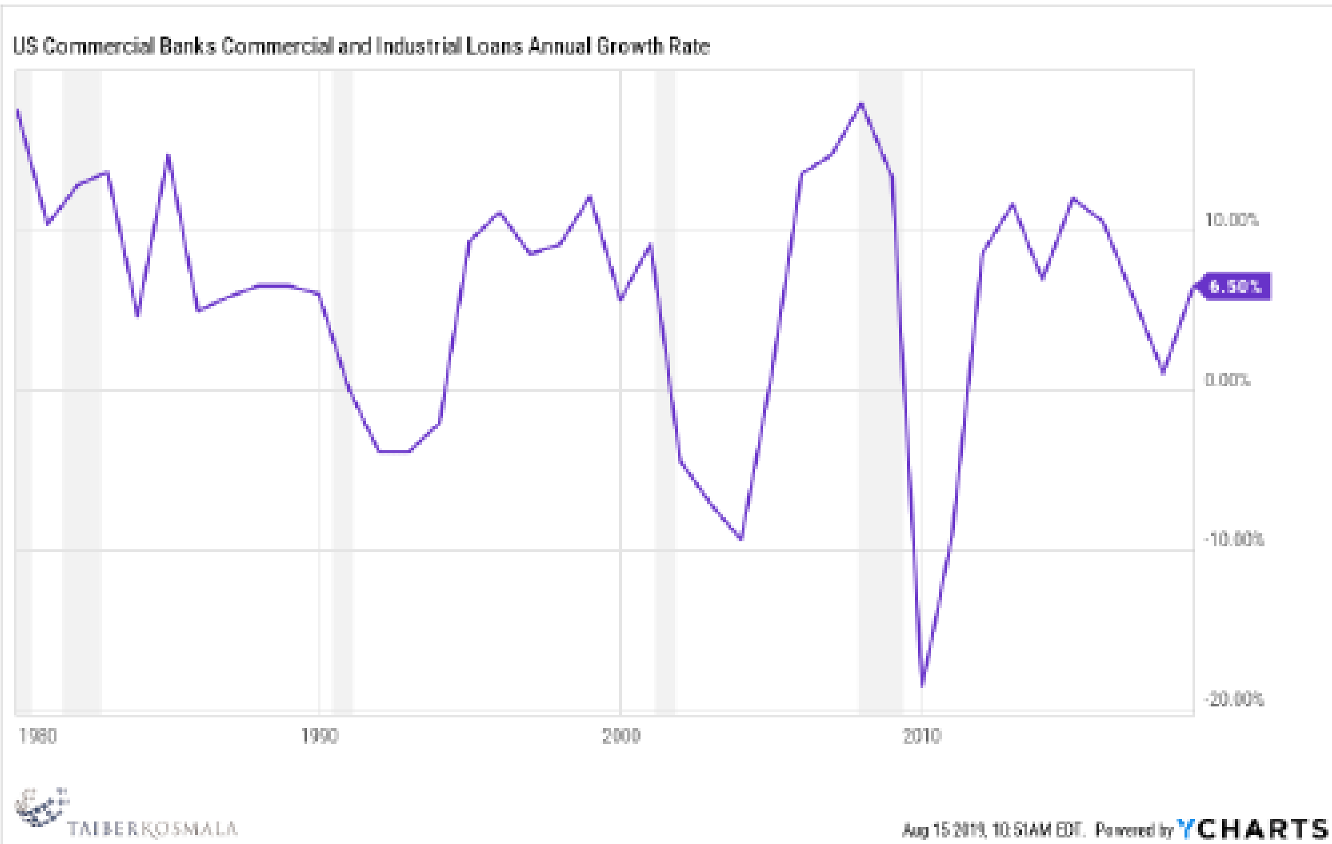



This has resulted in tremendous inflows of capital into the U.S. bond market putting downward pressure on longer-term bond yields and contributing to (if not causing) the inversion. As evidence of this flight into bonds putting pressure on long-term yields, the 30-year US Treasury bond yield dropped to as low at 1.96%, its lowest level on records that go back to the 1970s and the first time it has fallen below 2%. Why would a foreign investor pay a local institution for the privilege of lending the institution money if they could earn interest by lending to the U.S.? Even though the stock market is anticipating 50 basis points of rate cuts from a more dovish Fed between now and year end, there is evidence that U.S. yields will continue to be attractive globally as over 30 central banks around the world have cut interest rates this year (table below).




Data as of Aug. 14. A rate cut of 4.25 percentage points in Turkey this year is not shown. · Sources: FactSet (interest rates); International Monetary Fund (G.D.P.)

One may ask why an inverted yield curve is such a doomsday predictor of the economy's future—and the answer is quite intuitive. Banks *pay* depositors interest at short-term interest rates—banks *lend (charge)* borrowers at longer-term interest rates. In order to avoid paying out to depositors more than they are bringing in from borrowers, banks stop lending if an inverted yield curve persists. If access to capital dries up, economic growth stalls or retreats. The depth and the duration of an inversion matters. The 3-month/10-year segment of the curve inverted in May and has generally been only slightly inverted since. The 2-year/10-year segment of the curve was only slightly and briefly inverted on Wednesday. Through the end of July, we are not seeing evidence that bank lending activity has declined. In fact, looking back to the early 80s, growth in bank lending appears to be healthy (chart below). It is worth noting the dramatic drops in bank lending during previous difficult economic environments.




So, what should we expect from the stock market going forward? Well, even if the yield curve inversion is correctly predicting an impending recession, there is a time lag between inversion and recession (table below).

| How Long Until the Recession? | | | |
|---|---|---|---|
| When the 3-month to 10-year yield curve inverts for **10 consecutive trading days** | | | |
| **Date of Inversion** | **Consecutive Trading Days Inverted** | **Date of Next Recession** | **Calendar Days to Next Recession** |
| 1/10/1969 | 24 | Dec-69 | 325 |
| 6/14/1973 | 177 | Nov-73 | 140 |
| 12/8/1978 | 91 | Jan-80 | 389 |
| 11/7/1980 | 102 | Jul-81 | 236 |
| 6/6/1989 | 30 | Jul-90 | 390 |
| 7/31/2000 | 135 | Mar-01 | 213 |
| 8/1/2006 | 217 | Dec-07 | 487 |
| 6/6/2019 | 41 | ???? | ???? |
| **Average** | **111** | | **311** |

**1/10/1969** = inverted for 24 calendar days, went positive for 33 days, then inverted again for 53 days

**6/6/1989** = inverted for 30 calendar days, went postive for 9 days, inverted again for 26 days

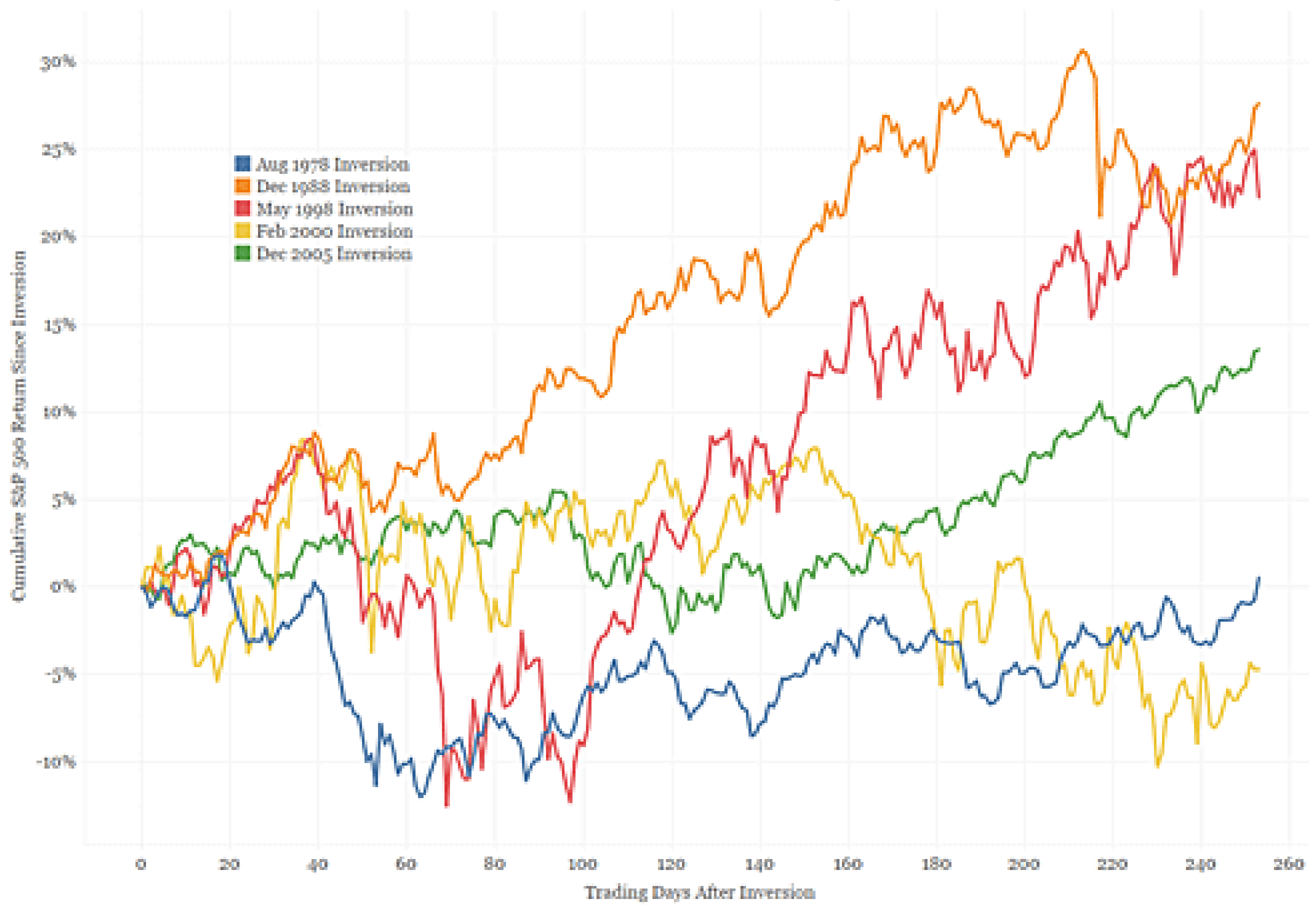
**6/6/2019** = As of July 31 the inversion has been 41 consecutive trading days.
Positive for 1 day, inverted since (17 days through August 14)

The table and the chart below provide the S&P 500's performance following an inversion of the 2-year/10-year segment of the curve. The data shows that bailing on the stock market immediately after the signal flashed often meant missing out on double digit gains.

**S&P 500 Performance Following 10s/2s Curve Inversion**

| Date | 2-Year | 10-Year | Trading Days Since Last Inversion | Prior 3 Mths (%) | Next Week (%) | Next Month (%) | Next 3 Mths (%) | Next 6 Mths (%) | Next Year (%) |
|---|---|---|---|---|---|---|---|---|---|
| 8/17/1978 | 8.49 | 8.48 | 546 | 6.55 | 0.00 | -2.43 | -11.98 | -6.04 | 3.02 |
| 12/14/1988 | 9.16 | 9.16 | 1585 | 2.68 | 0.75 | 2.99 | 7.76 | 16.26 | 27.76 |
| 5/26/1998 | 5.58 | 5.57 | 2035 | 6.16 | -0.07 | 3.22 | -1.17 | 6.36 | 19.44 |
| 2/2/2000 | 6.59 | 6.57 | 380 | 4.55 | 0.18 | -1.27 | 2.64 | 2.10 | -3.06 |
| 12/27/2005 | 4.34 | 4.34 | 1247 | 3.36 | 1.35 | 2.28 | 2.92 | -0.84 | 12.76 |
| | | | **Average** | **4.66** | **0.44** | **0.96** | **0.03** | **3.57** | **11.98** |
| | | | **Median** | **4.55** | **0.18** | **2.28** | **2.64** | **2.10** | **12.76** |

How Do Stocks React to an Inversion in the 2Y/10Y Curve?

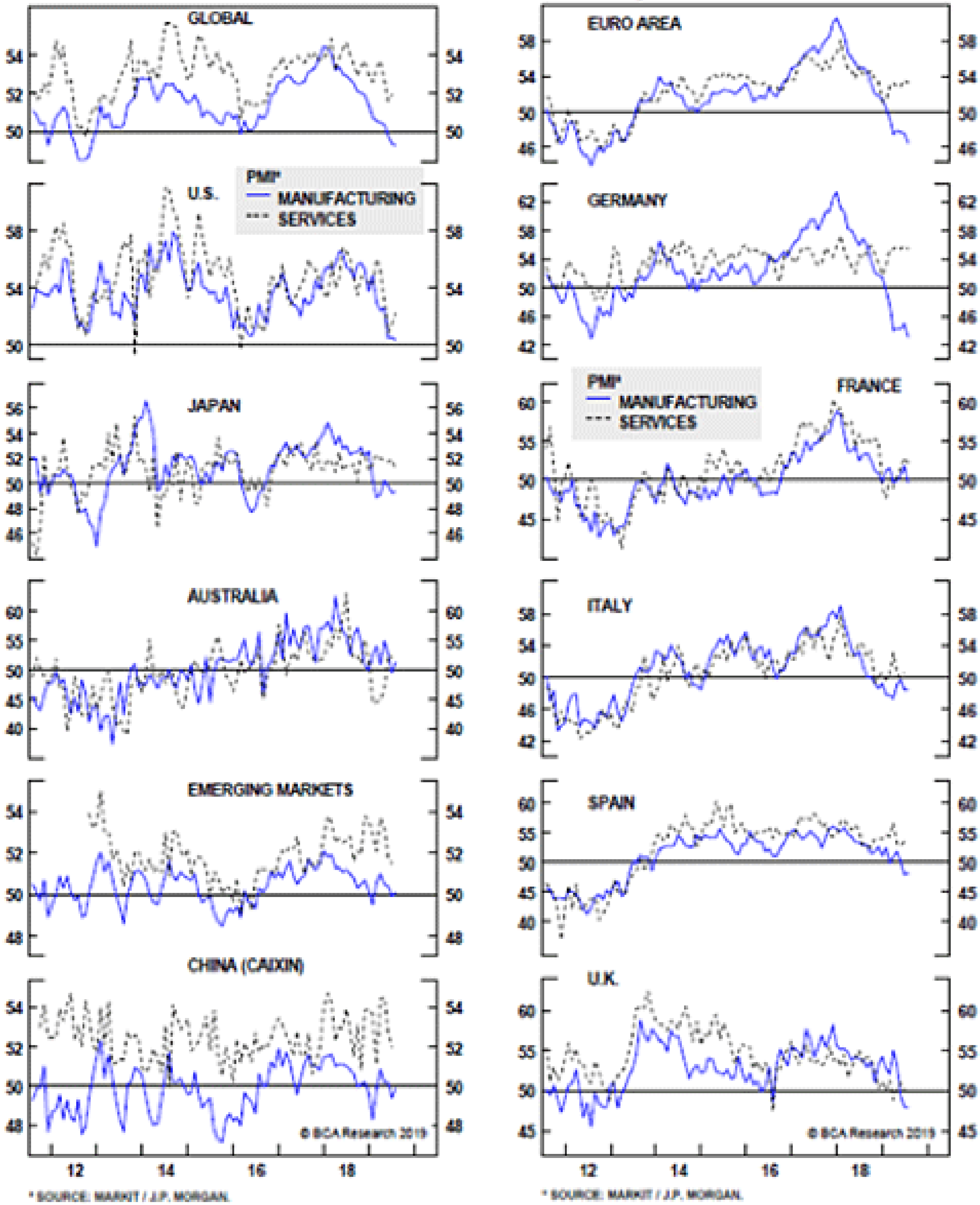



Source: Bloomberg



In addition to the yield curve inversion, investors have been spooked by headlines pointing at the slowdown in global manufacturing. To put this in perspective, developed economies around the globe have been migrating from manufacturing economies toward service-based economies. Today, almost 64% of U.S. GDP is driven by services rather than manufacturing. The charts below depict the slow-down in global manufacturing (solid line) vs. global services (dotted line) which have slowed to a much lesser extent. Germany, Europe's largest economy, has also been cited in the headlines and is much more susceptible to a manufacturing slow-down as services only represent 17.4% of Germany's GDP. China's slowing economy has also had a disproportionate impact on Germany as 47% of Germany's GDP is exports (compared to 11.7% for the U.S.) and China is Germany's largest trading partner.

The Service Sector Has Softened Much Less Than Manufacturing



In conclusion, we watch the yield curve and bank lending activity with heightened awareness. History tells us that an inversion of the 3-month/10-year curve has been a good predictor of a recession—but the lag time between inversion and recession has been very inconsistent. Historically, reacting to the inversion and bailing on the stock market has often hurt investors. Additionally, while an inversion has always preceded a recession, a recession has not always followed an inversion. The current environment is unprecedented in that fiscal tightening has always accompanied an inversion in the past—and we currently have had three years of fiscal expansionary stimulus. The near-term calendar contains several important mile markers that we are watching with keen interest. The Fed's annual Jackson Hole get-together starts on August 22nd. Formal trade talks with China are scheduled to resume on September 1st. Brexit is slated to be settled—one way or another—by October 31st (postponement very possible). Recognizing that geopolitical events are impossible to predict, we watch as these events unfold prepared to respond accordingly. In the interim, we continue to focus on market fundamentals and remain constructive on the stock market.



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