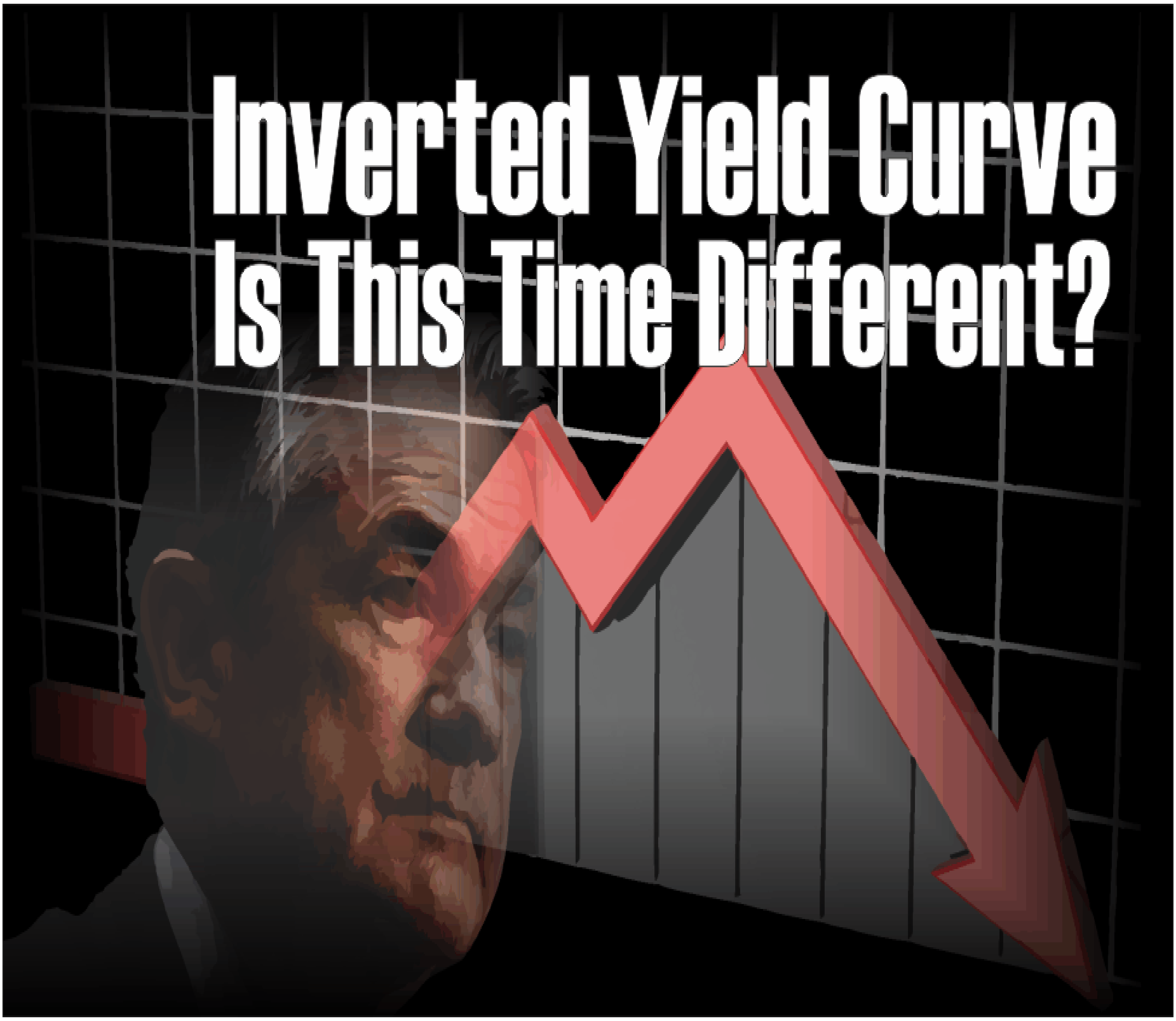
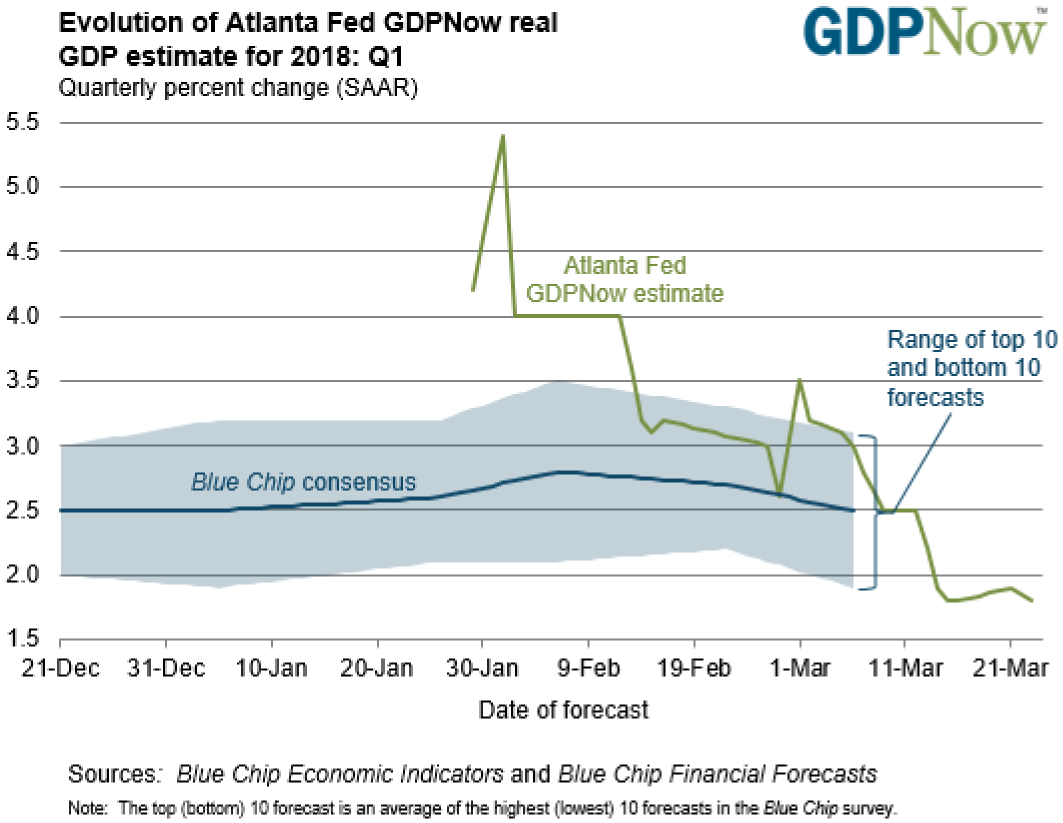
Inverted Yield Curve - Will This Time Be Different?



The stock market?s positive tone quickly evaporated after the expected quarter-point hike in the Fed Funds rate on March 21st. Markets love certainty; the latest rate increase was the sixth since the FOMC started raising rates in December 2015 and baked into the market cake. As such, a short relief rally ensued. With certainty past, focus shifted to Jay Powell?s first press conference as Fed Chairman. Powell?s message wasn?t as dovish as markets hoped. A fourth rate hike was too close a consideration for this year. Projections for three rate hikes, more aggressive than expected for 2019, sent the averages negative for the day. President Trump?s proposed protectionist policies along with a hawkish Fed proved too much, a one-two punch for markets. The S&P 500 after last Friday?s routing sat slightly above long-term support ? the 200-day moving average. On Monday, markets closed improved. However, there?s still substantial follow-through required before sounding an all clear. Next test is the 100-day moving average. Can it provide support for the S&P 500? As we mentioned at RIA last year, 2018 would be a year of volatility. Combined political and monetary-policy risks have created big moves in market volatility so far in 2018. The VIX has experienced seven sessions of one-day moves of 20% which already *rivals the full calendar year of 2014*. Don?t rule out the Facebook debacle?s contribution to volatility; the stock is one of the pillars of this late-cycle bull market. The tech sector is 25% of the S&P 500 and a formidable contributor to market momentum and animal spirits. Similar to Yellen?s optimistic stance back in December 2015 about the U.S. economic growth trajectory (which ostensibly proved false), Powell is convinced the U.S. economy is poised to require and handily absorb a faster pace of interest rate normalization. **The data screams he?s incorrect.** First quarter estimates of real GDP have fallen sharply; in synch with economic reality. The reality where prolific indebtedness burdens governments, corporations, consumers and acts as a formidable headwind to economic momentum. My impression is that Powell is expecting ?escape velocity? or acceleration in growth, productivity and wages, much like Yellen did. Odds are he?s going to be disappointed and need to ratchet down lofty rate hike expectations. Tremendous hope exists that the U.S. economy is going to take off. Not a strong possibility, at least in the near term when only the top 20% of the economy



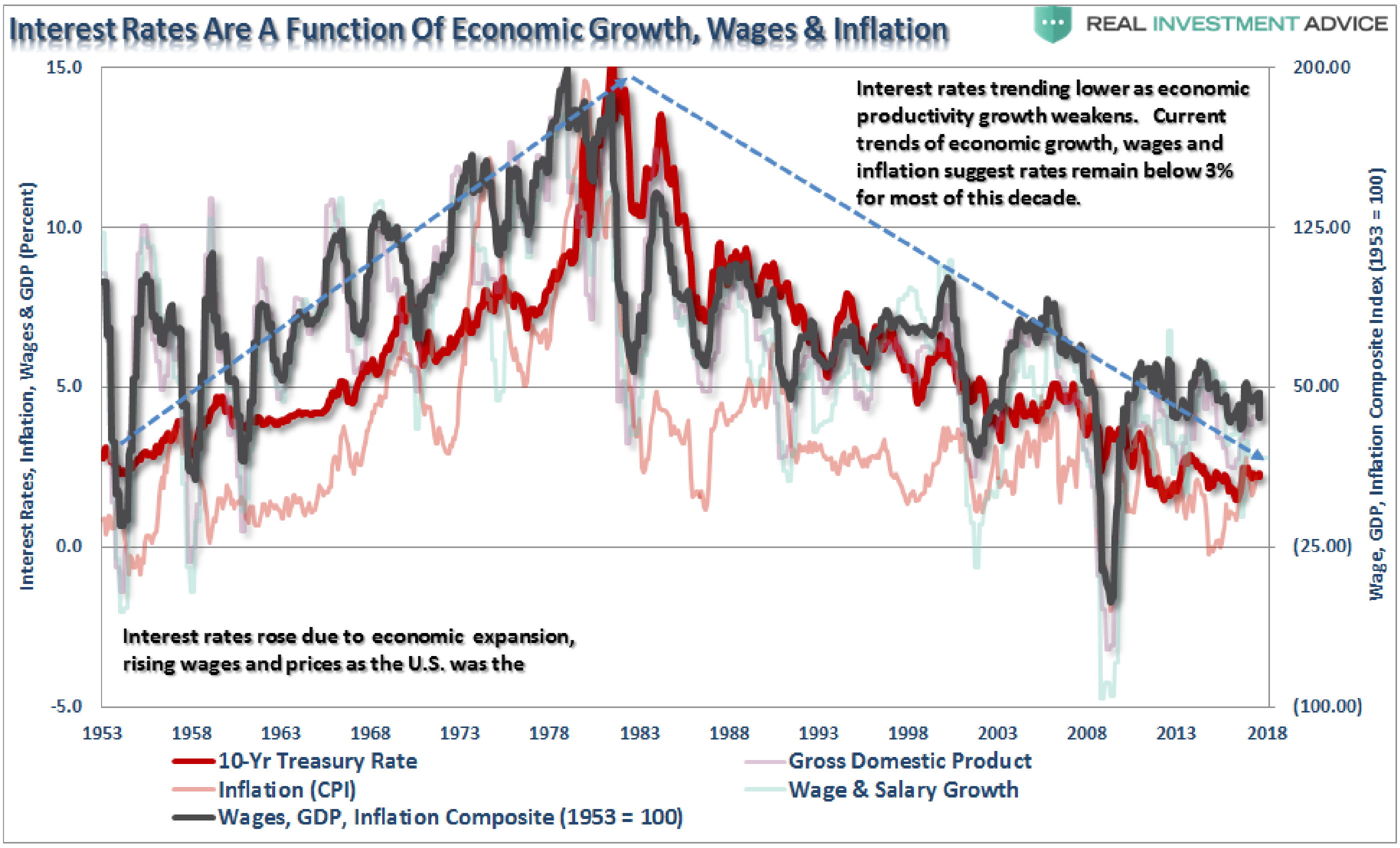
tax reform. According

ck announcements

$76 billion Corporate

At the press

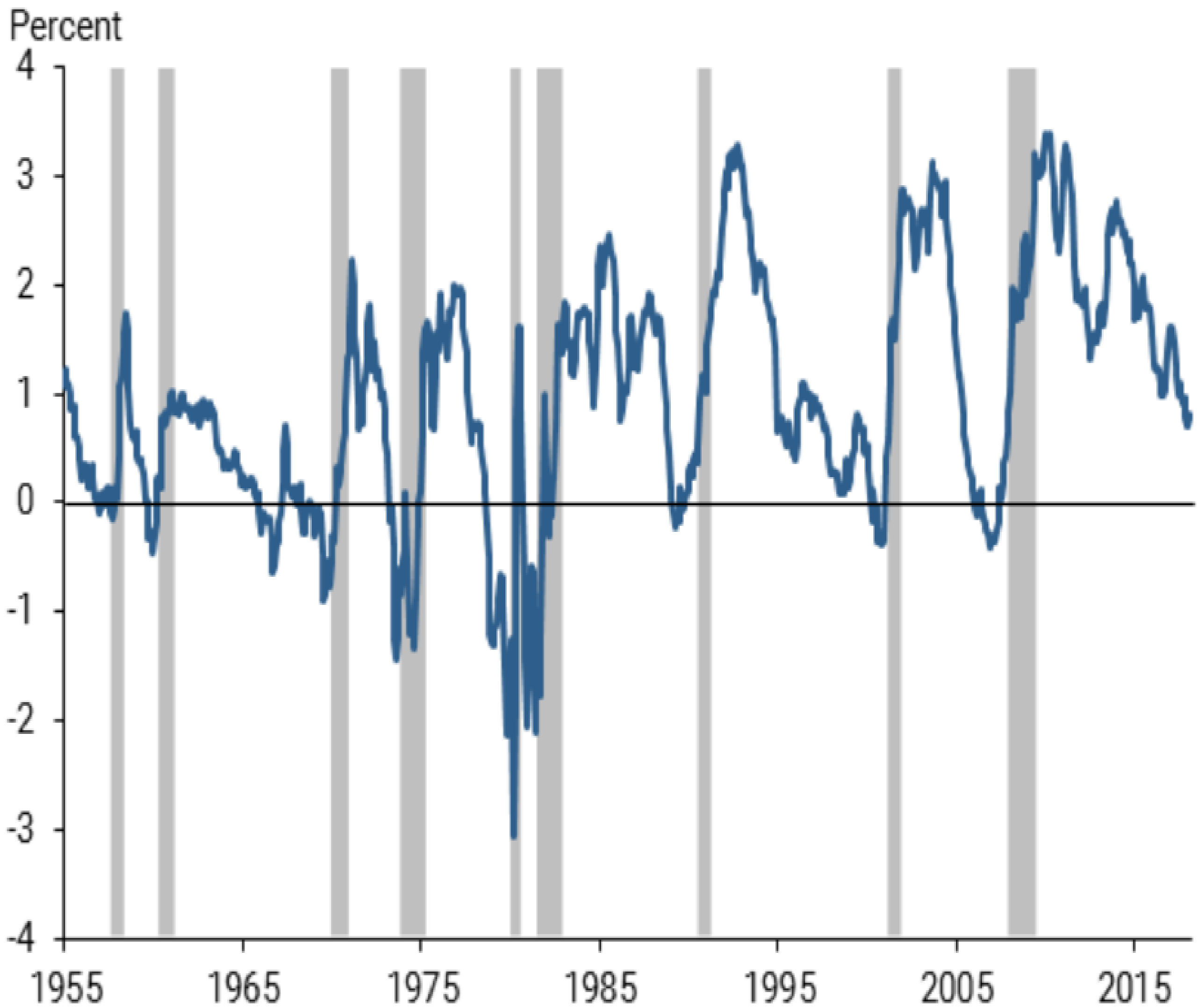
conference, Powell wasn?t concerned about the impact of an inverted yield curve. Just the opposite. His objective instead is to temper the economy without pushing it into recession (good luck); an inverted yield curve this go around would not hold the same relevance as it did in the past. A plausible theory is Powell is pushing normalization of interest rates so there?s something to work with (cut) in case of slowdown or recession. Powell gave the impression that a recession followed by an inverted yield curve would be unlikely during his tenure. In my opinion, it was a disturbing ?it?s different this time,? moment for the new Fed head honcho. I hope he?s correct. I have my doubts. So, what?s this inverted yield curve, why is it important? What does it mean to you? An inverted yield curve occurs when short-term rates exceed long-term rates. During economic expansions the Fed tightens monetary policy or increases short-term rates. Currently, we?re ?normalizing? as rates have been historically low. In contrast, longer-term rates are driven by economic growth, wages and increasing demand for capital (not the Fed).



As the economy peaks and the outlook begins to temper or grow pessimistic, long-term rates stall out; short-term rates begin to exceed, thus creating a negative term spread (the difference between long and short-term interest rates). These term spreads are measured by the difference between two and ten-year Treasury yields.

At .54 as of March 16, the positive spread between the two and ten year is at a level not witnessed since October 2007. Jay Powell should consider the Federal Reserve Bank of San Francisco?s [March Economic Letter.](#) Michael D. Bauer and Thomas M. Mertens outline how the connection between an inverted yield curve and recession remains viable; claims by observers that hikes in historically-low short-term rates will not have the same dampening effect on economic activity as they did in prior rate-tightening cycles, are not substantiated by statistical analysis. Per the paper, the delay between the negative term spread and beginning of recession has ranged between 6 and 24 months. Since 1955, negative term spreads have correctly signaled all nine recessions. Judge for yourself:

The term spread and recessions



Note: Gray bars indicate NBER recession dates.

Except for the one false positive in the mid-1960s when inversion was followed by slowdown, not official recession, negative term spreads have an impressive record of foreshadowing recessions. At Real Investment Advice, we believe Bauer and Mertens? research is relevant. Recently, contributor Jesse Columbo undertook a deep-dive analysis into the yield curve here. An inverted yield curve is characteristic of a late-stage economic cycle. Unfortunately, there?s no such thing as perfect timing between the genesis of negative term spreads and official recessions. The rule of thumb is two years on average. As I shared with financial journalist Simon Constable for a recent article, investors should adjust their portfolio holdings if the yield curve inverts. High-quality (not junk), short-duration fixed income would offer attractive yields over long-term debt instruments. In response to an economic slowdown, one of the Fed?s responses would be to reduce short-term rates; consequently, existing holders of short-duration should experience capital appreciation as new investors look to pay up for higher yields. Equity investors should favor defensive sectors such as consumer staples. Think food and beverage companies. Sectors that offer attractive dividend yields like utilities may also be considered. Certainly, Jay Powell can believe it may be different this time. As investors, we cannot afford to ignore the inverted yield curve as one of the most reliable predictors of future economic activity.