Economic Views Brief

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IS THE YIELD CURVE SIGNALING A RECESSION?

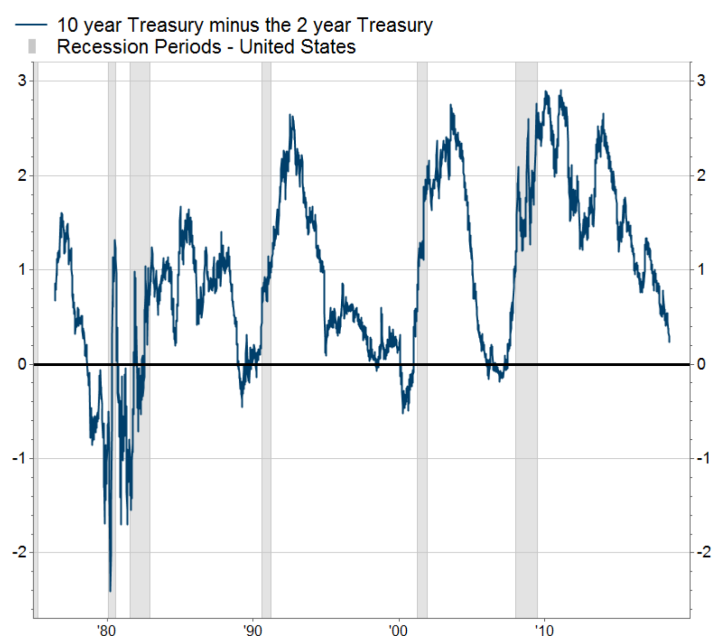
- The yield curve has flattened considerably this year, raising concerns that it could be signaling a recession on the horizon.
- For various reasons (that we will discuss in this report), <u>we do not believe the yield curve is currently a true reflection of underlying recession risks</u>. However, neither has the curve actually inverted (at the time of this writing).
- Rising trade tensions could yet cause an economic slowdown, but this scenario is an avoidable outcome, in our view. Nevertheless, adverse trade developments could cause a flight to quality in financial markets; leading to higher bond prices (i.e., lower bond yields) and a greater risk of inversion.
- Economic fundamentals do not suggest a recession to be a material near-term risk. High debt burdens represent the greatest risk to economic growth in the modern economy, and consumer finances remain in sound condition despite nine-years of economic expansion. Absent significant adverse trade developments, we believe the current economic expansion could be sustainable for a few more years, all else remaining equal.

Inversion getting close – but 'close' doesn't count.

Even if you don't pay close attention to financial markets, you may have heard about concerns of a pending 'yield curve inversion.' The term refers to the idea that when longer-maturity bonds offer less return (a lower interest rate) than shorter-maturity bonds, it has historically been a good predictor of a pending recession - with a lead-time of about a year or two.

Concerns related to the yield curve have risen quickly this year as the difference between yields offered on the 2-year Treasury Note and the 10-year Treasury have converged (see chart at right). The grey bars in the chart represent recessions. It doesn't take a finance degree to see that when the yield on the 10-year Treasury falls below that of the 2-year, a recession has usually not been far behind.

The yield curve, however, has also been known to produce false signals, or at least undue concern. As seen in the chart, the difference (often referred to as the "spread") between the 2-year and 10-year converged quickly in the mid-1990s (1994) without actually inverting. The curve also briefly inverted in June 1998, nearly three years ahead of the modest recession that started in April 2001. If investors had responded to these signals and sold their equity market exposures, they would have missed-out on considerable gains in that cycle. The curve did invert materially in early 2000 for what proved to be a legitimate signal (given the benefit of 20/20 hindsight).



Source: FactSet

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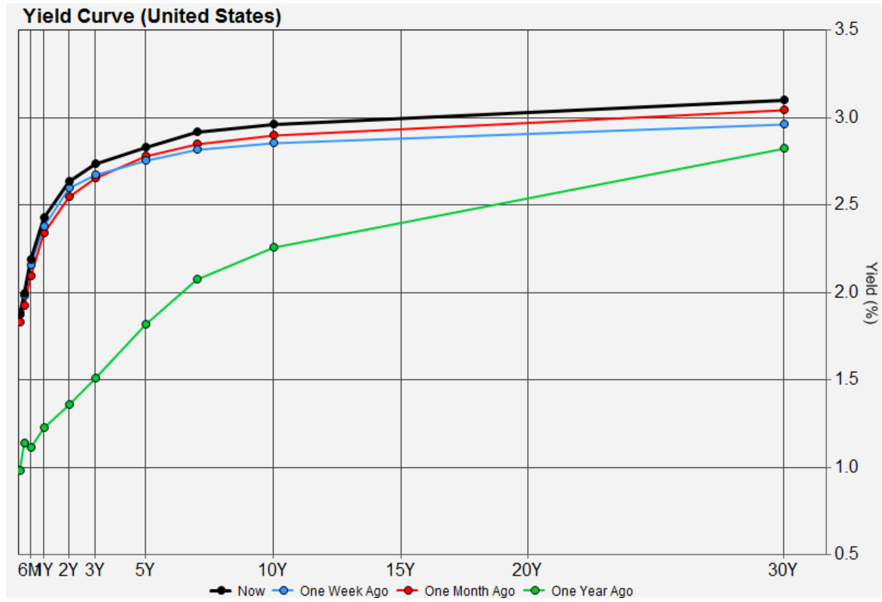
Normally, the yield curve should be "upward sloping," simply meaning that people require a greater return (interest rates) on their money to take the risk of lending for a longer period.

So, when longer maturity Treasury bonds offer interest rates that are lower than shorter-term Treasury rates, it's a very unusual phenomenon and a signal that something is not quite right.



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Why does the yield curve invert?

During times of economic expansion, the Federal Reserve often raises interest rates at the very low-end of the maturity spectrum (i.e., over-night lending rates between banks) as to contain inflation pressures. By pushing up the rates that banks charge to other banks to meet reserve requirements, it sets a floor on the interest rates that banks are willing to lend to consumers or corporations. Higher borrowing costs usually ease borrowing demand, which slows the pace of economic growth and thus inflation pressures.

Throughout this process, interest rates for bonds across the maturity spectrum usually shift higher, by varying degrees.

The yield curve can 'invert' however, when longer-term rates come down while the Fed is still pushing rates up at the very low-end. Even if the Fed is not pushing short-term rates higher, longer-term interest rates could still fall below short-term levels. Why? Historically, bond investors have purchased longer-dated bonds when they see financial conditions starting to deteriorate. Keep in mind that as bond prices go up, yields come down.

Bond investors buy longer maturity bonds when they sense economic trouble because they anticipate the Fed may eventually be inclined to lower rates if the economy stumbles. When rates come down, longer-dated bonds typically see greater price gains.

Does the recent flattening of the yield curve tell us a recession is eminent? Not necessarily.

Although the yield curve does have a good track record, investors should keep in mind that unlike measures of actual economic health, the curve is a reflection of bond market sentiment. Bond investors are usually more conservative and cautious than equity investors, but certainly their ability to predict the future is limited. There are also other factors influencing the curve presently that we detail on the next page.

Greed can often cloud the perceptions of equity investors, particularly late in an economic cycle when underlying financial conditions start to deteriorate. Bond investors, meanwhile, with less opportunity for capital gains, are usually more in-tune with market risks and the potential implications for changes in interest rate policy.

There is a causation aspect to an inverted yield curve, however. When the interest rates that banks can charge their customers for loans drops below their cost of funds, there is no incentive for banks to lend. This is an over-simplification of market realities, but lending can dry up in such circumstances thus slowing the pace economic activity.

Why might the current yield curve be less meaningful?

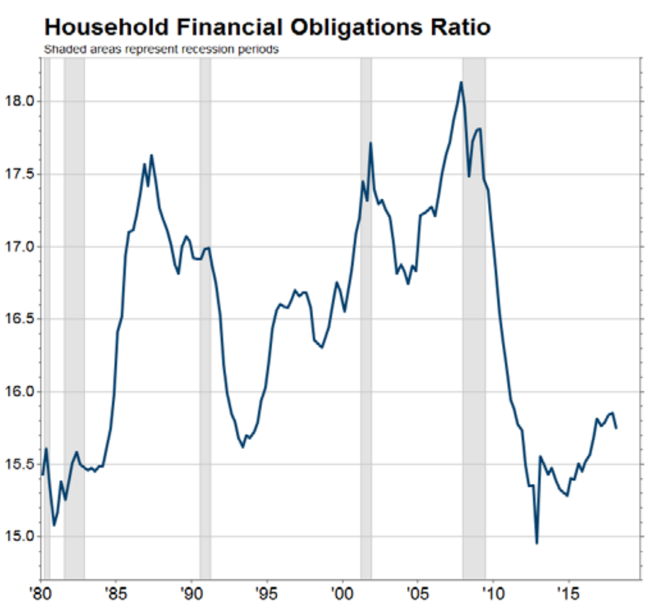
- Economic fundamentals remain sound and thus supportive of economic prospects, in our view.
- Global interest rates are still under significant influence from unprecedented central bank crisis-response policies.
- The curve has not yet actually inverted, and given recent comments from Federal Reserve officials, we believe the Fed is cautious of pushing it over the precipice.
- Investors should keep in mind that the yield curve is, after all, a reflection of bond market sentiment. The curve can have a direct causation impact on financial conditions, but it is far from absolute.

Fundamentals suggest strong support for economic prospects.

Most importantly, recent yield curve flattening is inconsistent with the supportive nature of current underlying economic fundamentals, in our view. Most prominently, consumers have been cautious in their financial habits throughout this economic expansion, many having learned a lasting lesson of caution during the financial crisis. Consumer debts in relation to consumer income are no longer at the all-time lows (since the Federal Reserve began measuring such in 1979) as reached just after the financial crisis, but they are still well-below historical norms (see chart at left below). Consumer default rates on mortgages, credit cards, auto loans and other forms of credit, also remain well below their historical averages (see chart at right below). The income side of consumer finances has also benefited from a tightening labor market and slowly rising wages.

The Federal Reserve's Financial Obligation Ratio (FOR) has long been our favorite measure of consumer financial health. The ratio, simply and logically, looks at the payments individuals are required to make each month in comparison to their income. So rather than just looking at the dollar amount of debt (with no consideration for income), it looks at whether consumers can afford it. Obligations considered in the ratio include mortgage or rent payments, property taxes and property insurance, automobile payments, and required payments on credit cards, student loans and personal loans.

Consumers account for 70% of U.S. economic activity, so their financial health matters greatly to the economic outlook. This late in an economic expansion, consumers have often grown confident in their financial situation. Confidence, however, can lead to over-spending and debt accumulation, and as debts grow, people eventually have to pull-back on their spending to get their finances back in order. When such conditions describe consumers in aggregate, slower spending can result in weaker economic expansion or even a recession. The economic expansion of the last nine years, however, has been distinguished by a much more cautious consumer.



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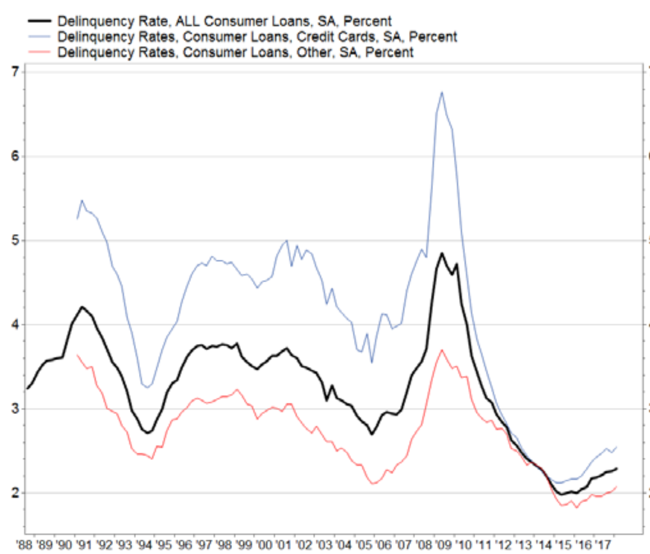

Source: FactSet

Global monetary conditions remain a significant influence on rates.

Monetary policy at many of the world's largest central banks is still reflective of financial crisis responses. The Federal Reserve is in the process of rolling off its balance sheet while the European Central Bank (ECB), the Bank of Japan (BOJ) and the Bank of England (BOE) are still targeting abnormally low interest rates to further stimulate activity.

As seen in the table at right, U.S. government 10-year borrowing rates are currently well-above those prevailing for other major industrialized nations. The ECB is still purchasing bonds in the open market as to keep regional rates (for the 19 nations that utilize the Euro as their currency) exceptionally low (a program it has indicated will end in December), while the BOJ's current policy explicitly targets a 10-year government bond yield of 0%.

10-year Government bond Yields

United States	2.96%
Germany	0.39%
Japan	0.08%
Canada	2.23%
United Kingdom	1.27%
Australia	2.72%

As of July 23, 2018

Source: *Wall Street Journal*

Such policies have contributed to considerable rate disparity. Although U.S. inflation expectations are generally higher, real returns on U.S. government bonds still appear attractive for many global investors, in our opinion. Foreign demand for U.S. bonds could thus keep U.S. Treasury rates somewhat anchored, as opposed to the rise they might otherwise see given the federal government's significant near-term borrowing needs and the Federal Reserve's balance sheet reduction efforts. Put differently, as the Federal Reserve is pushing up rates at the low-end, the upper-end of the yield scale may be being held-down by the relative attractiveness of U.S. rates due to unprecedented foreign central bank programs.

Summary:

Absent an all-out trade war, we believe the odds of a U.S. recession over the next 12 to 24 months are relatively low. Furthermore, we believe odds of a 'worst-case scenario' in regard to the evolution of trade relations is also low, but it is a tangible probability nonetheless. Unlike economic downturns caused by poor economic fundamentals, a trade-war would be directly attributable to poor decision-making.

We believe a new North American Free Trade Agreement (NAFTA) will eventually be worked out, as will the trade issues between the U.S. and the European Union. In both cases, virtually all parties involved agree that there is room for improvement. However, closing small gaps in trade agreements is notoriously challenging - as exhibited by the length of time it often takes to negotiate trade deals. The administration's adversarial style in seeking concessions could also backfire, but then again, trading partners have shown little impetus to change under previous, friendlier approaches.

As we have written in recent reports, China is the key to resolving the most difficult trade threat. Trump administration officials have discussed a desire to narrow the trade gap between the U.S. and China (at $375 billion in 2017, according to the Commerce Department) but most observers agree that the real issue is China's unfair trade practices. The U.S., Japan and the EU have all filed trade complaints with the World Trade Organization this year over China's practices on market access, intellectual property theft and state-sponsored plans to dominate certain high value industries. Though efforts to get China to change its ways (in verifiable and transparent ways) is meeting stiff resistance, we believe they will ultimately recognize that the issue is not going to go away.

Additionally, high corporate debt levels present a potential risk to the Chinese economy should it experience a sudden deceleration due to lower exports. China's central party leadership has implemented numerous actions over the last few years to reign in corporate debt, particularly at state-owned enterprises. Maintaining operations, thus employment, and reducing risk to the financial sector are primary goals of Chinese authorities. To date, such efforts could be called a success as broad-based corporate defaults have largely been held at bay, but a sudden deceleration would present significant challenges and raise the odds of a messy situation.

Please also see our Economic Views Briefs as dated June 28th and April 24th for more on the trade issue.

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