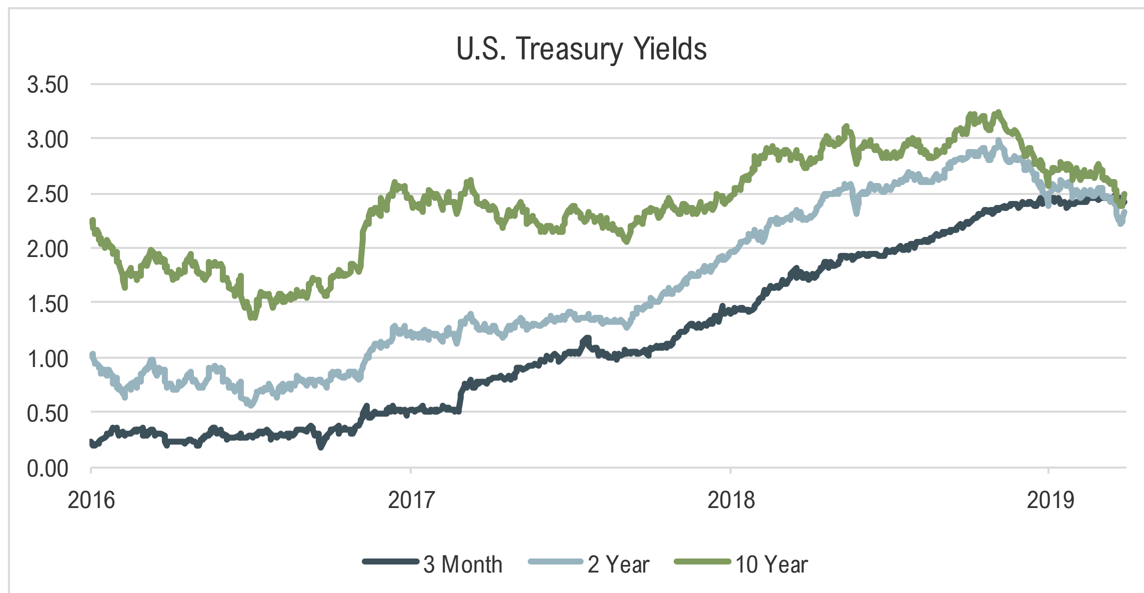
BRIEF MARKET COMMENTARY – YIELD CURVE INVERSION
April 2019

In late March, part of the U.S. Treasury yield curve "inverted" for the first time since 2007. Specifically, the yield on the 3-month Treasury note rose above the yield on the 10-year Treasury bond. Over the last several months, there has been a lot of angst about the potential risk of an inversion and what it might signal about the health of the economy.[1] Historically, yield curve inversions have been a fairly reliable predictor of economic slowdowns. In fact, every recession since 1957 has been preceded by an inverted curve. Yet, there have been multiple instances where the curve has inverted without a recession. We believe the current inversion will prove to be another exception to the rule. In our view, the economy remains in decent shape and the risk of an imminent recession is still relatively low as technical factors have largely contributed to the recent inversion.



Source: Federal Reserve Bank of St. Louis as of April 1, 2019

The Treasury yield curve is often referred to as a proxy for investor sentiment on the direction of the economy. Structurally, the shorter end of the curve is largely influenced by monetary policy (the U.S. Federal Reserve raising or lowering interest rates) and the longer end of the curve is driven principally by inflation expectations. The shape of the yield curve can be measured by comparing the difference in yield, or "spread," between bonds with different maturities, such as the 3-month versus 10-year, the 2-year versus 5-year, etc. It's a way to illustrate the difference in compensation investors demand for owning shorter-term or longer-term bonds. Most of the time, shorter-term bonds carry lower yields than longer-dated bonds, reflecting the lower risk. So, yield curves usually slope upward, which makes inversions unusual. In gauging the health of the economy, market participants tend to focus on the spread between the 2-year and 10-year Treasury, as historically it's been the most reliable precursor of a downturn.[2] While the 2/10 spread has narrowed over the past couple of years, it has not gone negative or inverted. It's interesting that other parts of the yield curve aren't following the

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inversion trend. If you look only at Treasuries maturing in three years and longer, the shape of the curve almost seems normal.[3]

We believe the recent inversion of the Treasury yield curve is largely being driven by technical factors and, therefore, not a harbinger of imminent recession. In the aftermath of the 2008 financial crisis, the U.S. Fed pursued a quantitative easing (QE) program, also known as large-scale asset purchases, that has had a significant impact on the shape of the yield curve. As part of QE, the Fed purchased a few trillion dollars' worth of Treasuries and mortgage-backed bonds, keeping longer-term yields artificially low. So, despite the increase in short-term interest rates over the past three years as the Fed has steadily raised its policy rate from zero to 2.50%, the longer end of curve has risen at a much more subdued pace. Also, at its policy meeting in March, the Fed announced that it would stop its balance sheet reduction process before markets expected, which added to the recent downward pressure on yields. Ultra-low interest rates outside the U.S. are another factor impacting the Treasury curve. For example, the slower growth and lower inflation profiles of Germany and Japan have resulted in 10-year government bond yields of about 0%. This effectively limits the degree to which U.S. long-term interest rates can rise as foreign capital flows into the U.S. bond market.

Our view remains that the U.S. economy is in decent shape. Certainly, headwinds exist from trade tensions with China and the fading impact of fiscal stimulus, while the 35-day partial government shutdown had a direct negative impact on economic growth during the first quarter. Yet, a solid labor market should continue to underpin consumption—the most important driver of U.S. economic activity. The Fed's recent pause and easing monetary conditions should also provide some support. We acknowledge there will eventually be another recession as they remain a normal part of the business cycle—but, for now, the odds favor a continuation of the current economic cycle. For slowdowns to take root, there typically needs to be an underlying imbalance in the economy. For example, the 2008 Great Recession resulted from the collapse of a housing bubble that had far-reaching effects thanks to lax lending standards and "advancements" in securitization. The previous recession in 2001 was triggered by the so-called Dot-Com Bust when the stock market bubble burst for speculative internet companies.[4] At present, we do not see a similar catalyst. The build-up in corporate debt over the last several years bears monitoring—it might not cause the next recession but will likely exacerbate it.[5]

In terms of our current market outlook, we continue to expect volatility to remain elevated and near more "normal" levels. Yet, positive (albeit slower) economic growth and tame inflation should provide support to corporate profits and equity valuations over the intermediate term. In portfolio strategy, we recommend maintaining a defensive tilt—a slight overweight to cash/short-term fixed income as "dry powder" and a slight underweight position in U.S. equities with an emphasis on quality. We also recommend an overweight position to certain flexible/alternative strategies that can provide valuable diversification benefits versus traditional stocks and bonds.

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[1] *According to Bloomberg, in December 2018, Google searches for "yield curve inversion" shot up to their highest level ever.*
[2] *Eddy Vataru, Osterweis Capital Management, "Don't Believe the Hype: An Inverted Yield Curve Does Not Guarantee a Recession," March 21, 2019.*
[3] *Alexandra Scaggs, Barron's, "The Weird Yield Curve Shows the Next Recession Could be Different," March 26, 2019.*
[4] *Eddy Vataru, Osterweis Capital Management, "Don't Believe the Hype: An Inverted Yield Curve Does Not Guarantee a Recession," March 21, 2019.*
[5] *Bill Priest, Epoch Investment Partners, "Capital Markets Outlook," April 4, 2019.*

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