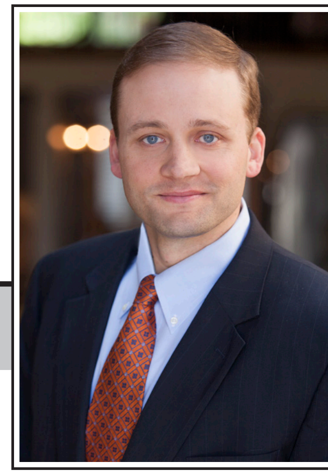
Sterling Advisors

THE MARKET MATTERS



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What's In an Inversion?

For the better part of the past five years, the yield spread between 2-Year U.S. Treasuries and 10-Year U.S. Treasuries has narrowed from more than 250 basis points (2.50%) to the 15 basis points (0.15%) that separate the two today. As of this writing, a 2-Year U.S. Treasury note (UST 2Y) and 10-Year U.S. Treasury note (UST 10Y) yield 2.24% and 2.39%, respectively (Bloomberg). We have been tracking this relationship closely for years. In the previous seven economic cycles, inversions of the 2Y/10Y portion of the U.S. Treasury curve (i.e., where UST 10Y yields fall below those offered by the UST 2Y) have reliably predicted the end of the expansion within the subsequent 6-24 months. Thus far, we have narrowly avoided this inversion.

However, back on Aug. 27, 2018, Federal Reserve Board of San Francisco economists Michael Bauer and Thomas Mertens published a paper that complicated matters. The two analyzed the efficacy of yield curve inversion in predicting future economic downturns concluding, "The yield curve has been a reliable predictor of recessions, and the best summary measure is the spread between the 10-year and 3-month yields" (Bauer & Mertens, FRBSF Economic Letter, Aug. 27, 2018). In other words, their findings suggested it was not an inversion of the spread between the UST 2Y and UST 10Y that counted, but rather the spread between the 3-month U.S. Treasury bill (UST 3M) and the UST 10Y. At the time, expanding the scope of the curve to include the additional 21 months between the UST 3M and the UST 10Y added roughly 55 basis points (0.55%) of cushion between the curve's then-present state and an inversion, when compared to the 2Y/10Y UST curve on Aug. 27, 2019. Was the Fed trying to ease the growing fears of recession by moving participants' focus away from the 2Y/10Y UST curve to the 3M/10Y UST curve? At the time, we stated the exercise equated to the Fed moving the goalposts to create policy flexibility and boost the market's deteriorating growth outlooks. By emphasizing the 3M/10Y UST curve through its empirical work, the Fed asked us to use their "preferred" yield curve measure that – at the time – wasn't flashing strong warning signs. The attempt was a success; many followed the San Francisco Fed's lead to the 3M/10Y UST curve for its recessionary signals. Be careful what you ask for.

On March 22, the 3M/10Y UST curve inverted for the first time since 2007. That was the inversion that preceded the financial crisis. Meanwhile, the 2Y/10Y UST curve's slope – the one traditionally followed by market-watchers – remained positive. The Fed's "look here, not here" attempt backfired. The UST 2Y/10Y inversion remains today. By the Fed's own account, it's one of the best predictors of recession. In fact, their research suggests a predictive power with almost 90% accuracy that a recession will take root within 12 months of a 3M/10Y inversion. Unsurprisingly, market-based measures of recession probability have spiked higher. The 3M/10Yr inversion has been too historically impactful to ignore. The fact the Fed placed it on a stage, alone, under a spotlight last summer only exacerbates its impact.

With this inversion, the curve now aligns with our belief that the risk of a notable economic slowdown in the next 6-24 month timeframe is significant. We still believe the U.S. will achieve the longest U.S. expansion in this nation's history at the end of June – and then extend that record. Our base case scenario is for the U.S. to grow near 2.0% for the next several quarters. In our view, the downturn is neither imminent nor likely to mirror the extreme disruption the U.S. endured in 2008-2009. However, our conviction that U.S. growth will decelerate over the next year has grown over the first quarter of 2019. The 3M-10Y curve inversion supports a more downbeat narrative.

Now, the important part. What to do about it. If history is any indication, it's best not to overreact. In past cycles, equity performance has been fairly resilient leading up to the inevitable downturns. For instance, the sustained inversion of the 3M/10Y UST curve that predated the 2008 financial crisis began in mid-July of 2006. The official recession began at the end of November 2007. Over that period, the S&P 500 Index rallied 19.75% (Bloomberg). There can be substantial opportunity costs by heading for the exits prematurely. Of course, waiting too long to prepare for the negative reaction to emerge in risk markets is usually even more costly. Over the course of The Great Recession, the S&P 500 Index declined almost 36%, with a drawdown of -56% at its worst point. As we stated before, it is unlikely the next downturn will carry the same wallop as 2008. Though more prolonged, the expansion has been far more muted this go-round and more systematic safety nets are in place to prevent such an economic blindside. One new risk this time, however, is the limited arsenal available to global monetary policymakers. Virtually all central banks remain in a historically accommodative posture, leaving little "dry powder" stimulus at their disposal. That said, we do believe there is more room for risk performance in the time between now and the arrival of an official contraction in GDP. Strong corporate earnings, a decade of robust hiring, palatable borrowing costs, slowly rising wages, and decent household spending create a reasonably sturdy fundamental foundation for further growth that translates into more positive returns in U.S. equities. A U.S.-China trade agreement could restore some of the global growth optimism that has been lost as progress has come only in fits and starts. There are reasons to be constructive on near-term prospects in risk assets.

Chart 1. S&P 500 Index performance (white line) before during and following The Great Recession (green line) in 2007-2008 Source: Bloomberg

But we also believe now is a time to start taking measured precautions in investment portfolios that better position them for increased risk and volatility. Many of the portfolio analyses we perform on a daily basis show an overconcentration in equities versus less risky assets such as fixed income. That is unsurprising. We have spent a decade in an ultra-low, unprecedented interest rate environment. Many investors were compelled to use dividend-paying stocks to achieve their income objectives. Fast forward to today, and those same investors have not only aged 10 years (which tends to make more conservative risk profiles appropriate), but they are also no longer positioned for today's fast-evolving landscape. Over the past several months, those portfolios we have positioned more defensively by adding fixed income exposure have benefited from the asset classes positive performance thus far in 2019. The Bloomberg Barclays US Aggregate Bond Index is up 3.11% year-to-date or 13.87% annualized. Another aspect to consider is the importance of diversification. The Federal Reserve's massive stimulus efforts to stave off catastrophe in the wake of the financial crisis boosted virtually all asset classes – from equities to bonds to real estate to commodities. But that support came at the cost of the power of diversification. When all asset classes are moving in the same direction – up or down – it is difficult to defend against volatile periods. As the Fed has reduced its accommodation, the traditional inverse performance relationship between stocks and bonds has started to normalize. Simply put, fixed income is doing a better job of insulating portfolios from equity underperformance than it has in years.

Therefore, we believe there is opportunity to capture recent equity gains and perform a measured rotation into fixed income, which are still offering elevated yields in the front end of the curve relative to where we have been since the last downturn. It is a practical time to perform diagnostics on portfolios and acknowledge the recent escalation of risk.

We do not seek to be alarmists. Only prudent.