Sterling Advisors

THE MARKET MATTERS

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The More Things Change

Information is everywhere and it has never been easier to access. The question is whether or not it's valuable. Is it reliable? Is it biased? Okay, so that's three questions. As humans, we're susceptible to fixating myopically on information that fits within our previously held beliefs. In the psychology world it's referred to as "confirmation bias." In investing, it can prove a costly logical error that prevents us from seeing the full picture. To combat it, we must force ourselves to consider incoming data that contradicts our expectations – a cognitively taxing and uncomfortable exercise.

My personal belief is we are in the very late stages of the longest economic expansion in U.S. history. As a student of global fixed income, the alarms being sounded by these markets are too loud to ignore. Global debt to the tune of $17 trillion is now trading at negative yield levels. The U.S. yield curve is fully inverted, meaning a 1-Month U.S. Treasury bill yields more (on an annual basis) than a 30-Year U.S. Treasury bond. That type of yield curve behavior has preceded every recession of the last 60 years. Global growth expectations are tumbling, which will likely exacerbate these issues. We anticipate the volume of negative-yielding debt to grow. That would force increased foreign purchases of U.S debt – and therefore lower U.S. yields – as overseas investors seek positive income. How low U.S. yields can go remains to be seen.

The concerning trends expand well beyond the realm of fixed income. The Conference Board's Leading Economic Index (LEI) has declined from 6.6% to 1.6% over the past 11 months (Bloomberg). When that metric has fallen into negative territory in previous cycles, the U.S. has typically entered a downturn within 18 months. If its recent deceleration is sustained, LEI will fall below zero in late 2019 or early 2020. Global manufacturing activity is plummeting. The U.S.-China trade standoff is the primary culprit. The uncertainty it has unfurled on the global economy is preventing businesses from investing in their futures through capital spending, which is taking a toll on industrial demand. The negative impact of the dispute is emerging in global economic data – and its scope is widening.

But to perform a balanced evaluation of the U.S.'s economic health, the counterevidence to my held concerns must be given equal time. Let's take a hard look at the positives. The domestic jobs picture remains an undeniable bright spot. The U.S. Unemployment Rate (3.7%) is basically at a 50-year low. After a brief deceleration, U.S. Average Hourly Earnings has returned to its longer-term trajectory of steady growth, currently up 3.2% year-over-year (Bureau of Labor Statistics). While these statistics typically deteriorate closer to the onset of a downturn – or once a U.S. GDP contraction is well underway – these stats suggest any recession is not imminent. In fixed income, high-yield credit spreads are still historically tight (i.e., the yield offered by below-investment grade corporate debt is low relative to the yield offered by U.S. Treasuries with similar maturities). In periods of economic stress, these spreads tend to expand as investors question lower-rated issuers' abilities to meet their debt obligations. Though 26% higher than the 2017-2018 average, high yield spreads are still quite subdued. That's a good thing. Quarterly U.S. GDP, while slowing, remains positive at 2.0%. The U.S. Federal Reserve is likely to ease monetary conditions over the coming months. That is a supportive development for risk assets in the near-term.

These are reasons to believe 2019 is safe from a recession. But we are also working through our clients' portfolios to ensure they are appropriately positioned for potential medium-term challenges. Given the rising concerns, we believe it's prudent to be proactive while U.S. equity indices remain within 3% of their all-time highs.

There's no shortage of bullish economists, asset managers, and media personalities suggesting "this time is different," particularly with respect to the meaningfulness of the U.S. yield curve's recent inversions. Even former Fed Chair Janet Yellen said on Fox Business in mid-August, "Historically, it has been a pretty good signal of recession…but I would really urge that on this occasion it may be a less good signal." Based on the yield curve's success as a predictor of future downturns, we believe "this time is different" is a risky stance to take. Instead, we believe while the reasons behind the yield curve inversion may be different, its implications are as meaningful as ever. Dismissing the bond market's signals leaves investors susceptible to undue risk.

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There are at least two scapegoats being used to explain away the downward-sloping yield curve. The first is the unprecedented monetary stimulus over the past decade. Central banks slashed global rates and bought massive amounts of government debt in the wake of the financial crisis. It pushed yields to historic lows. There's no question these machinations distorted yields around the world. But that level of stimulus should have inspired more energetic growth and inflation expectations. Now, global growth is slowing despite much of these stimulus measures still being in place in many parts of the world. Plus, we're seeing monetary policy is clearly subject to the law of diminishing returns. The majority of central banks' traditional policy weapons have already been fired. There is only so much more that accommodative monetary policy can do to protect the world's largest economies, especially from "outsider" threats like geopolitics and trade protectionism. Yes, rate cuts and quantitative easing affect global yields, but the fact these yields are now lower than ever – a decade after these policy measures were first implemented – is a problem.

A second scapegoat is the world's widespread foray into negative yield land. It's fueling a flight to U.S. debt from Europe and Asia, where negative yields are most prevalent. A 10-Year U.S. Treasury note yielding 1.44% looks great next to the -0.72% offered by the 10-Year German bund (Bloomberg). It's true that forces other than the usual suspects – falling inflation and growth expectations – are at work on the U.S. curve. But thanks to light-speed technological and logistical progress, the world's economies are more globalized, more intertwined than ever. If one major economy catches a cold, the others all sneeze. Multiple EU countries are either in or on the verge of recession. China's growth is slowing significantly. The U.S.-China trade drama is doing real harm. This is more than just international yield arbitrage. Plummeting global yields underline the rising risk of a synchronized global recession.

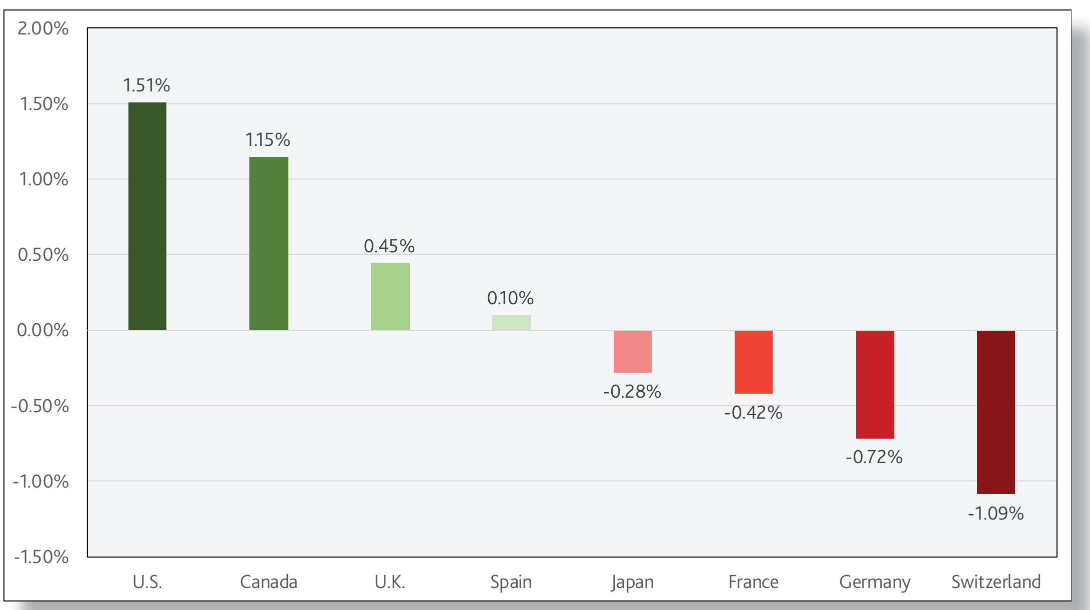

Chart 1. 10-Year government debt yields from around the world (as of August 30, 2019) Source: Bloomberg

A U.S. downturn appears unlikely in 2019. A deterioration in jobs and wages is needed before a recession, and that's not happening right now. Also, the U.S. yield curve typically steepens just ahead of a recession because the Fed starts lowering short rates as it moves into a fully accommodative stance. That process may have started this past June, but it will take time to complete. However, a balanced evaluation of domestic and global activity suggests that medium-term threats to the U.S. expansion are on the rise. They must be addressed now to ensure we stay equipped to meet our long-term investing goals.

To that end, this time is certainly not different.