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An inverted yield curve, a pig that can fly, and the tail end of a bull market:

Three big market themes happening right now, what to make of them and what to do next.

Part 1: The inverted yield curve

It happened – the dreaded 'inverted yield curve'. Late in March, financial media lit up with word the yield curve had 'inverted'. Market pundits hit the air to issue dire warnings for days ahead. ***So, what's the big deal?***

COMING SOON

Part 2: China's Year of the Pig – Is the economy ready to fly again?
Will the U.S be aligned or at odds with China's economic and market outlook?

Part 3: Riding the backside of the U.S. bull market – It ain't over 'til it's over!

All data is current as of April 15, 2019.

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An inverted yield curve (occurs when shorter-term bond yields rise higher than longer-term bond yields) has frequently been heralded as a predictive signal of an economic recession and stock market downturn (see Exhibit 1.1). History may rhyme, but it never repeats – **there are two big differences in today's market place we see as game changers: 1) the cause of the overall low interest rate environment**; and, **2) the degree of credit still flowing within the economy and available to individuals and businesses**. As a result, we don't interpret this development as a signal to dramatically alter a well-built balanced portfolio by overreacting to this signal.

In **Parts 2 and 3 of this "Three Big Market Themes" series**, we'll dive into two other market themes that have us feeling better, not worse, about our outlook for equities.

The inverted yield curve that occurred late in March is not flashing a red signal for equity markets. It's more of **an amber light to investors on the road to long-term investment goals saying, 'proceed, but with caution'**.

For today's market conditions and outlook, we don't advocate that investors stretch to the edge of their risk-tolerance, nor do we think investors should be unduly pessimistic, or overly defensive. We have been advocating a 'neutral stance' for long-term investment portfolios since June of 2018 and continue to **see a balance between equities and fixed income (in alignment with your risk tolerances) as most appropriate right now**. Investors with shorter-term time horizons (less than three to five years) and/or those who have specific capital requirements in the near term (or recurring), should look to have those near-term needs allocated in cash, or cash equivalents.

North American yield curves have been on a steep downward trajectory for over two years, culminating in 10-year bond yields falling below 3-month bond yields on March 22, 2019, thereby inverting the yield curve. Notably, only a small portion of the yield curve has inverted, and the inversion was brief. However, this did mark the first inversion of this segment of the yield curve since July 2007, and much ink has been spilt discussing what this means for the future of the economy and stock markets.

We do believe yield curve inversions merit attention. They intuitively tell us something about economic growth expectations and, because they come at the hands of central bankers, the inversion of the yield curve can shed light on future central bank policy motives. But before jumping to dramatic conclusions about this one yield curve 'signal', let's do some objective analysis of the situation at hand.

PRO TIPS

All about the yield curve

The **yield curve** is the plotted measurement of bond yields across different maturities of bonds (with time plotted on the x-axis and interest rates plotted on the y-axis). You can plot a curve for many types of bonds, but the yield curve most commonly referenced is the 'U.S. yield curve', referring to the yields on various maturities of sovereign government bonds of the United States.

What is a term premium? It's the difference between the yield an investor is willing to accept to own a single long-term bond versus the yield they believe they would achieve by rolling over short-term instruments for the same amount of time. The term premium reflects the buffer that investors need to account for two key risks: The first is a change in bond values through time due to changes in the supply and demand for bonds; and, the other is changes in the rate of inflation through time. When investors feel more uncertain on either point, they demand a higher premium.

The **'slope'** of the yield curve refers to the angle of the line drawn between the yield at two different maturity points along the curve. It's this slope that's historically been interpreted as a signal about future economic growth; a positive slope suggests future growth while a flat or negative (inverted) slope suggests weakness, or contraction's on the way.

In 'normal' economic conditions, bonds of a longer duration pay more (i.e., offer higher yield) than those of a shorter duration. That's because holding debt, like owning a bond, for longer is riskier and therefore warrants a higher payoff to the lender for taking on more risk. When longer-dated bonds pay a lower interest rate than shorter-term bonds, the plotted curve slopes downward – known as an **'inverted yield curve'**. This happens when there's a disproportionate rise in shorter duration yields and/or longer bond yields fall. It's worthwhile noting the short-end of the curve is highly influenced by central bank policy rates; the mid-section, often called the curve 'belly', "tends to be influenced by where investors expect the central bank overnight-interest rate to move next; the curve's long-end is largely influenced by inflation expectations and long-run real economic growth potential.

The lingo: You can measure the difference in yield between any two bond maturities, but the most often talked about yield curves are the 30s/10s, 10s/2s, 5s/2s and 10s/3-month. The nomenclature is read as 'the thirties, tens' curve and refers to the difference between 30-year yields and 10-year yields, whereas 'the tens, three-month' is 10-year yield minus the 3-month yield.

1.1 | Yield Curve Inversions and Recessions

Prior recessions have been preceded by yield curve inversions, then re-steepening, followed by a final rollover to deeper inversion

Source: Bloomberg, April 15, 2019.

Which yield curve, the duration, scope and steepness of a yield curve inversion all matter, and yet opinions on the same differ widely. Specifically, there is little consensus among researchers and market experts as to which yield curve measure (the 10-year/2-year or 10-year/3-month for example) is most predictive of future economic and stock market performance, and therefore a wide variety of yield curves are frequently measured and reported on. Exhibit 1.1 highlights the 10-year/2-year yield curve, which importantly has not yet inverted – the recent hype surrounds the 10-year/3month curve inversion only. Much is said about the duration and extent of a yield curve that has inverted relative to its ability to signal a forthcoming recession. We focus on all these factors and the extent to which the entire curve may or may not be inverted. Only a small portion (the very front-end) of the yield curve inverted on March 22 and it was short-lived. This suggests to us a weak predictive signal. A stronger, broader and longer yield-curve inversion would give us much more to worry about. Additionally, it's common for the yield curve to initially invert and then re-steepen as we're witnessing now. In fact, for the last three yield-curve inversions, the second occurrence of inversion has been **the more powerful signal that the economy and equity markets are set to materially weaken – this has not yet happened**.

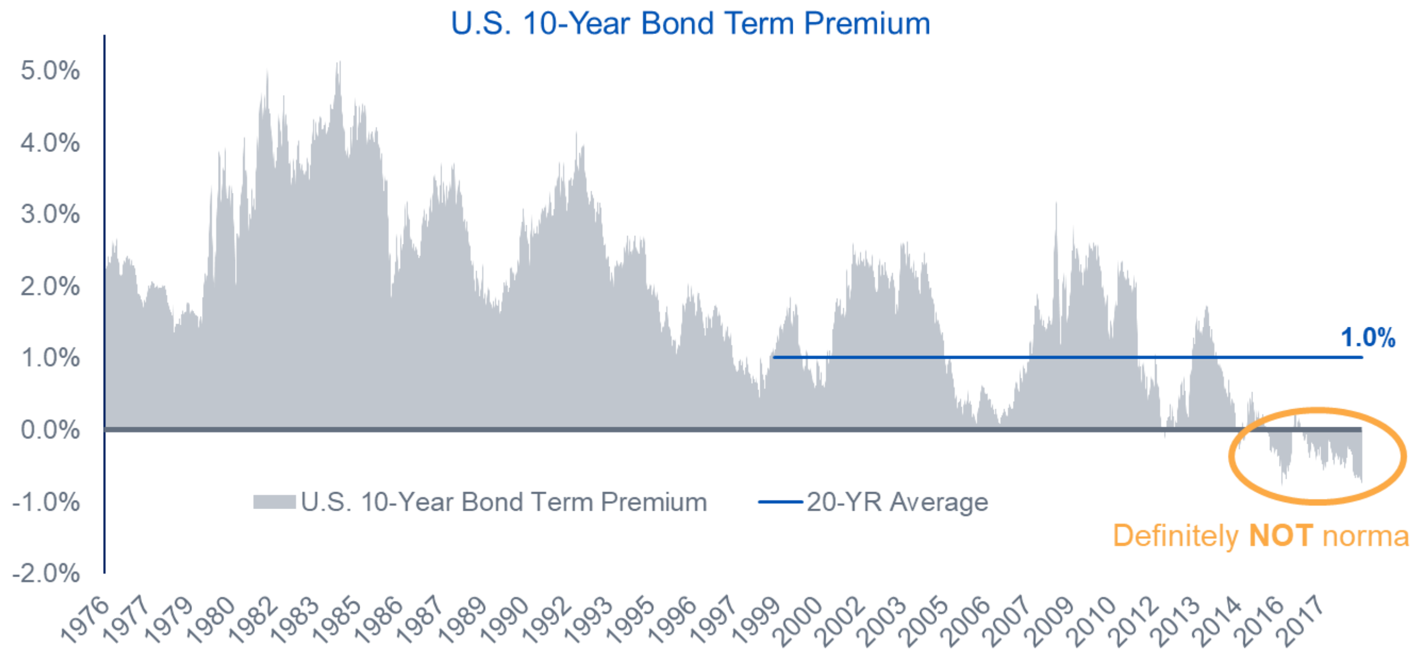
We also know that historically, a curve inversion has coincided with a pattern of specific monetary policy actions. Yield curve inversions tend to happen as a result of central banks raising their overnight rate. The current experience is no exception as the U.S. Federal Reserve (Fed) has been raising interest rates for three years (lifting the Fed Funds Rate a quarter point, nine times). In this case, however, what finally tipped the scale was fears of a global growth slowdown. This set off a decline in long-term yields, which in turn inverted a small portion of the yield curve (the 10-year/3-month).

There are feedback loops at play here that drive responses from investors and central bankers.

- Given the now lower-yield environment, investment theory suggests money should be biased to flow away from bonds toward equities.
- All else being equal, lower yields support higher equity valuations (i.e., P/E multiples) and this tends to be positive for equity market performance.
- Following inversion, the Fed pauses their rate hiking – a move that eases financial conditions, which in turn is supportive of economic growth and equities.

1.2 | Central Banks Have Killed the Term Premium

If the term premium was at its 20-year average, there would be no discussion of inverted yield curves and recessions



Source: Bloomberg, March 29, 2019, Adrian Crump & Moench, 10-year Treasury Term Premium, Federal Reserve Bank of New York.

We must also consider the extraordinary amount of manipulation that has occurred, and continues to occur, in global bond markets. Quantitative easing by many central banks is having an impact on the global yield environment (i.e., artificially keeping rates lower than normal market factors would otherwise imply) and this has ramifications that are relevant to the yield curve inversion discussion. Consider what is the same about the current episode versus what is different from past yield curve inversions:

Same:

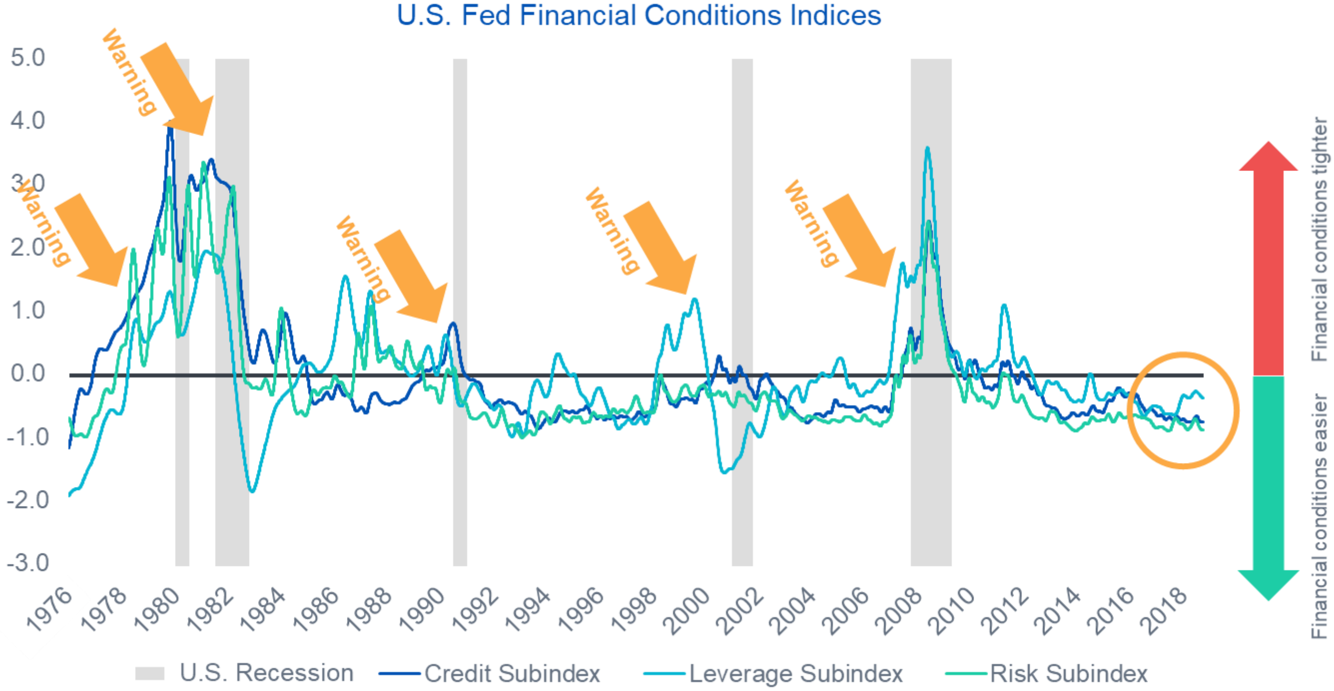
- The Fed hiking rates and a growth slowdown are the key drivers of this yield curve inversion.
- The Fed has signaled a halt to rate hikes and plans to curtail its other monetary-tightening strategies.

Different:

- The U.S. 10-year yield is experiencing artificial downward pressure from the extraordinary quantitative easing (QE) campaigns undertaken by the U.S., European and Japanese central banks that are distorting the global bond market. These QE campaigns are ongoing, such that we see negative 10-year bond yields in Germany and Japan.
- One sign of central bank distortion may be the disappearance of the term premium (see Exhibit 1.2). Absent this interference, if the term premium were back toward its average level of the past 20 years (~1%), the slope of the U.S. 10s/2s yield curve would currently be a full percentage point higher, and there would be no discussion of inverted yield curves.
- Credit flows have not dried up. Ultimately, what a flat yield curve is supposed to signal is a shutdown of credit flowing in the economy. Surveying a variety of other credit cycle indicators in the U.S., none are flashing a ‘recession’ signal. For example, loan officer surveys remain unchanged from the fall. Similarly, surveys of bank lending standards remain unchanged, and some banks are reporting an easing of loan covenants and extending credit lines. Broad measures of credit, leverage and risk in the economy remain below levels historically associated with recessions (see Exhibit 1.3).

1.3 | U.S. Credit Conditions Not Signalling Recession

Prior recessions have been preceded by credit conditions that are much worse than today's levels



Source: Bloomberg, April 15, 2019.

We're also watching trade negotiations, geopolitics and Chinese and U.S. economic growth as indicators of whether this bull market still has life (more on this in **Part 2 of our 'Three Big Market Themes' series**).

Using any one market signal (including an inverted yield curve) as reason to try and time the markets is not advised. Market-timing requires getting two decisions right – when to get out and when to get back in (in **Part 3 of our 'Three Big Market Themes' series**, we'll argue why you won't want to get out right now). Empirical evidence suggests that investor emotions (greed and fear) are far too powerful for market timing strategies to be fruitful.

Bottom line

The brevity and weakness of the yield curve inversion, along with more optimistic outlooks for China and the U.S., give us reason to believe that the inverted yield curve is more a symptom of current central bank policy and less a harbinger of an imminent recession.

Putting views into action

Take a neutral position across both equities and fixed income (in proportions that align with your risk tolerance and time horizons). This will allow you to appropriately take into account both the opportunities and the risks that the current market backdrop presents.