



Tom Seay, Managing Director, Research

## Don't Dwell on the Curve

BY TOM SEAY, MANAGING DIRECTOR, RESEARCH

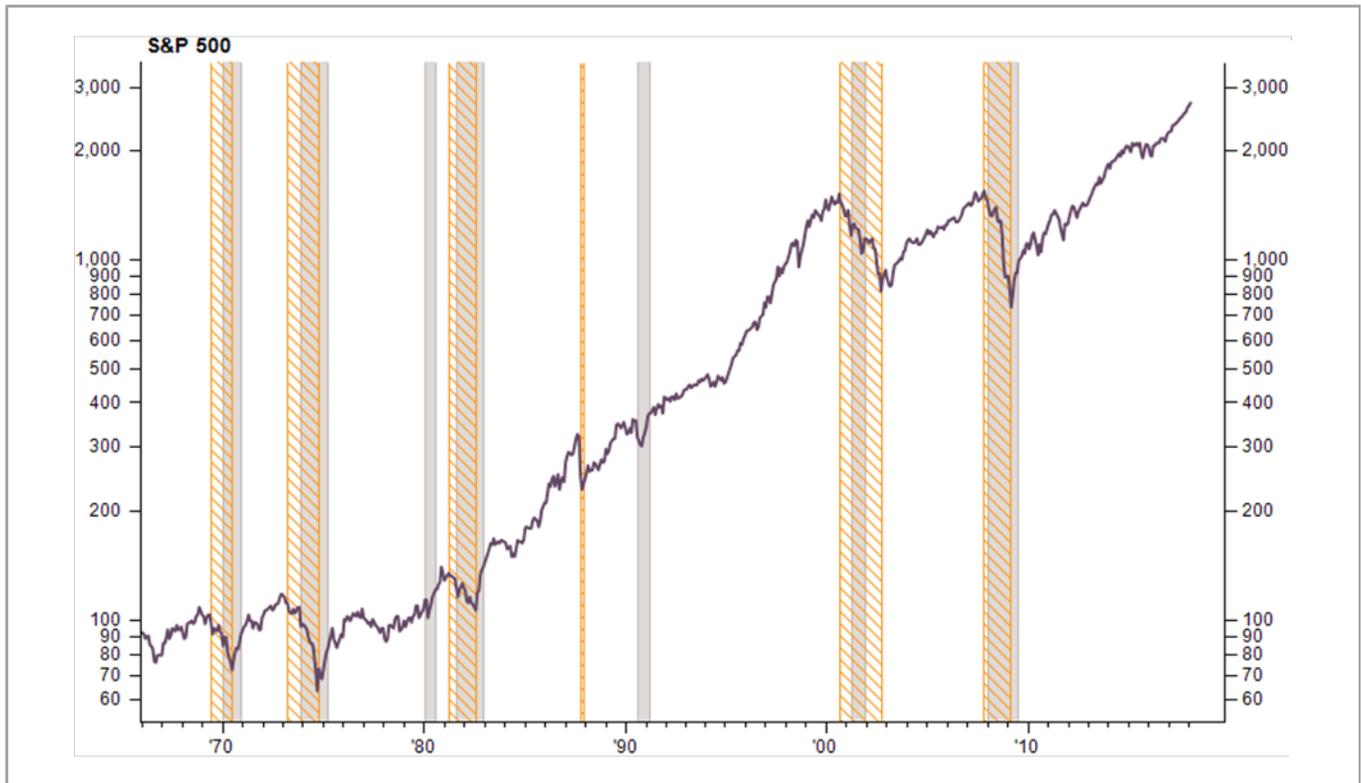
When one has witnessed a 36-year decline in interest rates combined with the soon-to-be 9-year anniversary of a U.S. equity bull market one begins to believe that the end must be near. Bubbles pop, monetary policies go awry, and geopolitical events erupt, all of which can bring the good times to an end; but, bull markets simply don't die of old age. 2017 ended on solid footing as global growth appeared to be shifting into a higher gear, monetary policies in general remained accommodative, and U.S. tax policy and regulatory changes were expected to unleash a wave of corporate spending. The fundamentals remain supportive for investors to remain committed to the financial markets.

One factor that has gained the attention of naysayers has been the flattening of the U.S. Treasury yield curve in 2017, which could morph into an inverted yield curve. The historical implications of an inverted yield curve appear to be ominous; over the past 40+ years an inverted yield curve has always preceded a recession<sup>1</sup>, and recessions generally foretell bear markets in stocks<sup>2</sup>.

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CHART 1:



Source: FactSet, as of 12/31/2017. Grey shaded bands indicate recessions as designated by NBER. Orange shaded bands indicate bear markets as defined by equity market losses of 20% or more.

A cursory examination might suggest that we cash in our chips and sit on the sidelines to protect gains accumulated since the Great Recession. But what if the curve does not invert? What if the inverted yield curve's predictability has diminished? What if the next recession/bear market doesn't happen until 2020? BCA Research Inc. analysis reveals that, "The S&P 500 has delivered an average annualized real total return of 14.2% since 1950 in the 13-to-24 months prior to past U.S. recessions."<sup>3</sup> Those are hefty returns investors may miss if trying to time the market based on anticipation of an inverted yield curve.

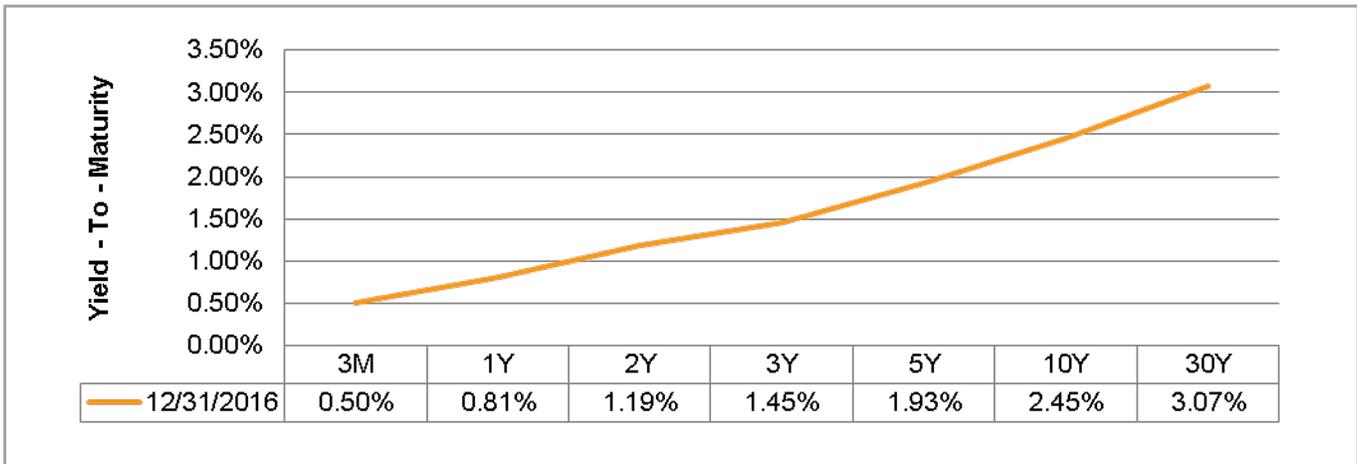
## What is an Inverted Yield Curve?

U.S. Treasuries range in maturity from three months to thirty years. At the time of purchase, the price of a Treasury security is a function of the coupon and the maturity of the security, which is quoted as the yield-to-maturity, or simply the "yield." If you were to plot the Treasury yields from three months to thirty years on a piece of graph paper you would have just created a yield curve like the one shown in Chart 2.

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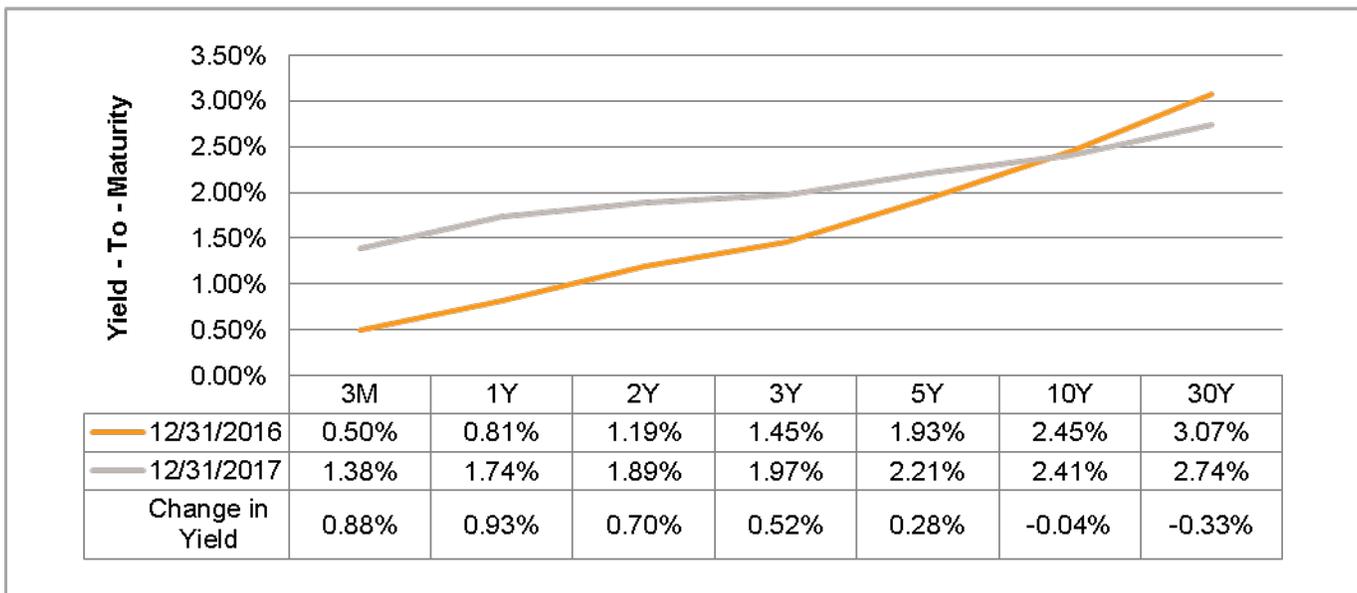
CHART 2:



Source: Bloomberg.

Normally, the yield of a thirty-year Treasury is higher than a three-month Treasury bill – a positive sloping yield curve. Since December 31, 2016, short-term yields have been rising while long-term yields have held steady or gone lower; this type of activity is described as a “flattening” of the yield curve.

CHART 3:



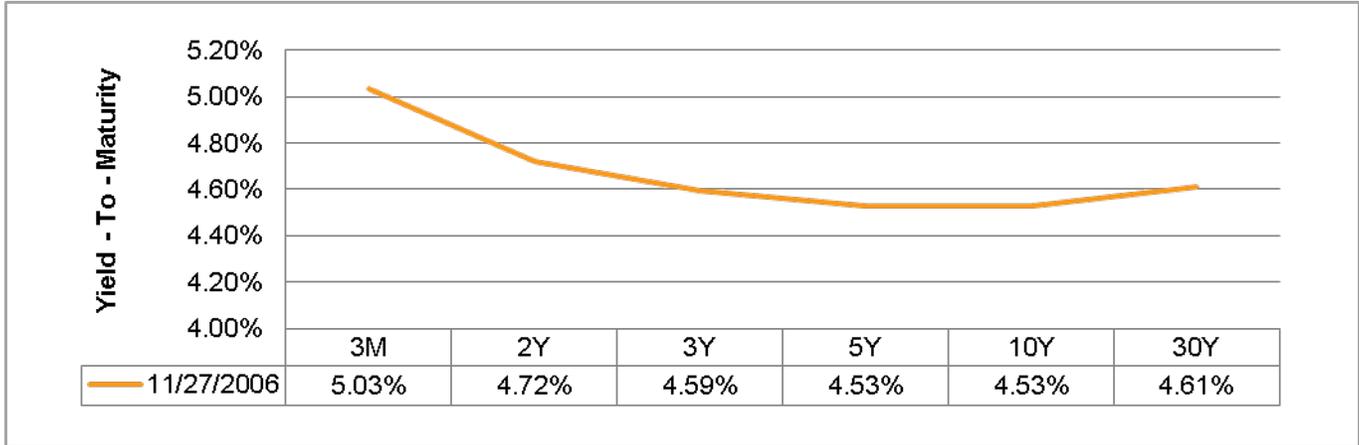
Source: Bloomberg.

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When short-term Treasury bills have yields higher than long-term Treasuries the yield curve is deemed to be “inverted.” The last time the U.S. Treasury curve was inverted was the 2006-2007 time period when the curve reached its maximum inversion on November 27, 2006.

CHART 4:



Source: Bloomberg.

## Why Not Worry (at least yet)?

First of all, the U.S. Treasury yield curve is not inverted and, in general, bond yield forecasts are not predicting 2-year yields rising higher than 10-year yields.

|                           | 12/31<br>2017 | Q1<br>2018 | Q2<br>2018 | Q3<br>2018 | Q4<br>2018 |
|---------------------------|---------------|------------|------------|------------|------------|
| US 10-Year Treasury Yield | 2.41%         | 2.56%      | 2.69%      | 2.79%      | 2.88%      |
| US 2-Year Treasury Yield  | 1.89%         | 1.91%      | 2.07%      | 2.21%      | 2.34%      |
| Spread                    | 0.52          | 0.65       | 0.62       | 0.58       | 0.54       |

Source: Bloomberg, 1/14/2018.

A study by the Federal Reserve Bank of Cleveland hypothesizes that the spread, “...is quite good at telling you whether growth will be above or below average, it is not so good at predicting the exact number. It might tell you to expect below-average growth, but it seldom tells you that the economy will actually shrink. That is, it rarely predicts the negative growth characteristic of recessions and, conversely, rarely predicts the strong growth usually seen at the start of expansions.”<sup>4</sup>

So let’s review: the yield curve is not inverted, forecasters are not predicting an inverted curve, and a negative spread rarely predicts negative growth. Based upon yield curve, it does not appear now is the time to run for the exit.

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## The Yield Curve in the Era of Quantitative Easing Monetary Policy

Historically, the Federal Reserve (Fed) was always fighting inflation, and its sole weapon focused on managing the level of short-term interest rates. Paul Volker, as Chairman of the Board of Governors of the Federal Reserve System, entered office with a determination to squelch inflation, which was wreaking havoc on the economy. Volker took office on August 6, 1979, and in March of 1980 inflation peaked at 14.8%.<sup>5</sup> The Volker Fed raised the federal funds rate, which averaged 11.2% in 1979, to a peak of 20% in 1980 and 1981.<sup>6</sup> The dramatic rate hike on the short-end of the curve led to an inversion of the yield curve, which reached its maximum inversion of -242 basis points on March 20, 1980. This was followed by the 1980-1982 recession, during which the unemployment rate rose to over 10%.<sup>6 7</sup>

The 2018 environment is not one of rampant inflation, but instead we find inflation stuck below 2%, stable economic growth, and traditional monetary policy (low Fed Funds rate) ineffective in stimulating either GDP or prices. The Federal Reserve Bank of Cleveland's study states, "Roughly speaking, in the old days, fears of inflation meant the yield curve was steep, and investors demanded high rates to protect themselves against inflation. A yield curve inversion, then, meant that short-term rates had moved up a lot. And those high short rates signaled, or even caused, a recession. Now, with a credible Fed and a low risk premium, an inversion only signals moderately high short rates, and thus less risk of recession."<sup>4</sup>

The forces affecting the yield curve today were not even imaginable in the past. The U.S. Fed has recently ceased its quantitative easing activities and reduced purchasing long-term Treasury securities. Meanwhile, its counterparts at the European Central Bank (ECB) and the Bank of Japan continue to purchase long-term Treasuries. Lastly, the Fed no longer operates behind the curtain, but is transparent and vocal in informing the financial markets of its activities and goals to ensure investors are not surprised by its monetary management. Methodical, well-telegraphed, and predictable monetary policy has led to interest rates remaining low and stable, allowing investors to demand less of a risk premium in today's financial markets.

## The Yield Curve, Bank Lending, and Why I'm a Little Concerned

Even though I am not terribly troubled by the shape of the yield curve and what it may or may not be implying about the financial markets or the economy, the banking business model is fairly simple, and is reflective of the yield curve. Banks borrow short-term money (e.g. a 3-month certificate of deposit), lend long-term money (e.g. a 30-year mortgage) and the difference is their profit or in banking parlance their "net-interest margin." The steeper the yield curve, the more profitable the lending model and their desire to lend is insatiable. As the yield curve flattens, the bank's net interest margin erodes and there is a diminishing willingness to lend. When the curve inverts, bank profits evaporate, loan departments are downsized, and lending activities grind to a halt.

Borrowed money is the fuel that propels our economy forward, and whether it is for a new car, a larger house, or a business development loan, Americans have traditionally gone to their local banker to fund these expenditures. Although there has been considerable growth in non-bank lending activities, the basics of lending money remain tethered to the shape of the yield curve. As such, history informs us that when the yield curve inverts, money stops flowing, consumers stop spending, businesses stop growing, and America ends up in an economic recession. Lending activity remains positive, but as the chart on the next page indicates the pace has slowed.

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## U.S. Loan Growth (Percent change, seasonally adjusted, annual rate)

| Loan Types              | Q2<br>2016 | Q3<br>2016 | Q4<br>2016 | Q1<br>2017 | Q2<br>2017 | Q3<br>2017 |
|-------------------------|------------|------------|------------|------------|------------|------------|
| Commercial & Industrial | 8.6%       | 3.9%       | 5.4%       | -1.0%      | 1.0%       | 2.7%       |
| Real Estate             | 6.3%       | 7.0%       | 5.6%       | 3.0%       | 3.8%       | 3.8%       |
| Commercial Real Estate  | 9.6%       | 10.3%      | 9.1%       | 7.0%       | 6.8%       | 5.1%       |
| Consumer                | 7.5%       | 6.7%       | 5.4%       | 3.8%       | 2.5%       | 4.0%       |

Source: Federal Reserve System, Assets and Liabilities of Commercial Banks in the United States - H.8, December 29, 2017.<sup>8</sup>

## Conclusion

Washington has acted and ushered in sweeping tax reform that has the potential of unleashing corporate spending. Time will tell how much the tax reform accelerates GDP growth and extends the third-longest expansion in U.S. history.<sup>9</sup> According to the Wall Street Journal, "Most of the private-sector economic forecasters surveyed in recent days by The Wall Street Journal said the odds of a new recession by late 2020 were below 50%. The average probability of a recession in the next year was 14%, with the odds creeping up to 29% in two years and 43% in three years."<sup>9</sup>

Here at Hartland, we are aware of the flattening of the yield curve and the implications of an inverted curve; but, the yield curve is one of many economic indicators and signs of risk that investors must monitor. Our experience has taught us to develop long-term investment plans that lead us to stay fully invested and manage risk to achieve the financial goals our clients wish to achieve.

### Sources:

- (1) Northern Trust, Investor Insights, December 4, 2017.
- (2) Zacks Investment Management, December 1, 2017.
- (3) BCA Research Inc. Global Investment Strategy – Weekly Report, December 8, 2017.
- (4) Federal Reserve Bank of Cleveland, Does the Yield Curve Signal Recession? Joseph G. Haubrich, April 15, 2006.
- (5) Bureau of Labor Statistics Data.
- (6) Bloomberg.
- (7) National Bureau of Economic Research, US Business Cycle Expansions and Contractions.
- (8) Federal Reserve System, Assets and Liabilities of Commercial Banks in the United States - H.8, December 29, 2017.
- (9) Wall Street Journal, U.S. Economic Expansion Could Become Longest on Record, December 13, 2017.

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*Performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.*

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## MARKET BENCHMARK RETURNS

| December 31, 2017 |               | 1M    | 3M    | 12M   | YTD   |
|-------------------|---------------|-------|-------|-------|-------|
| US Large Cap      | S&P 500       | 1.1%  | 6.6%  | 21.8% | 21.8% |
| US Small Cap      | Russell 2000  | -0.4% | 3.3%  | 14.6% | 14.6% |
| Developed Intl    | MSCI EAFE     | 1.6%  | 4.2%  | 25.0% | 25.0% |
| Emerging Intl     | MSCI Em Mkt   | 3.6%  | 7.4%  | 37.3% | 37.3% |
| Real Estate       | NAREIT        | -0.1% | 2.4%  | 9.3%  | 9.3%  |
| Core Fixed        | BarCap Agg    | 0.5%  | 0.4%  | 3.5%  | 3.5%  |
| Short Fixed       | BarCap 1-3Yr  | 0.0%  | -0.2% | 0.8%  | 0.8%  |
| Long Fixed        | BarCap LT G/C | 1.9%  | 2.8%  | 10.7% | 10.7% |
| Corp Debt         | BarCap Corp   | 0.8%  | 1.0%  | 6.2%  | 6.2%  |

Source: Bloomberg

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