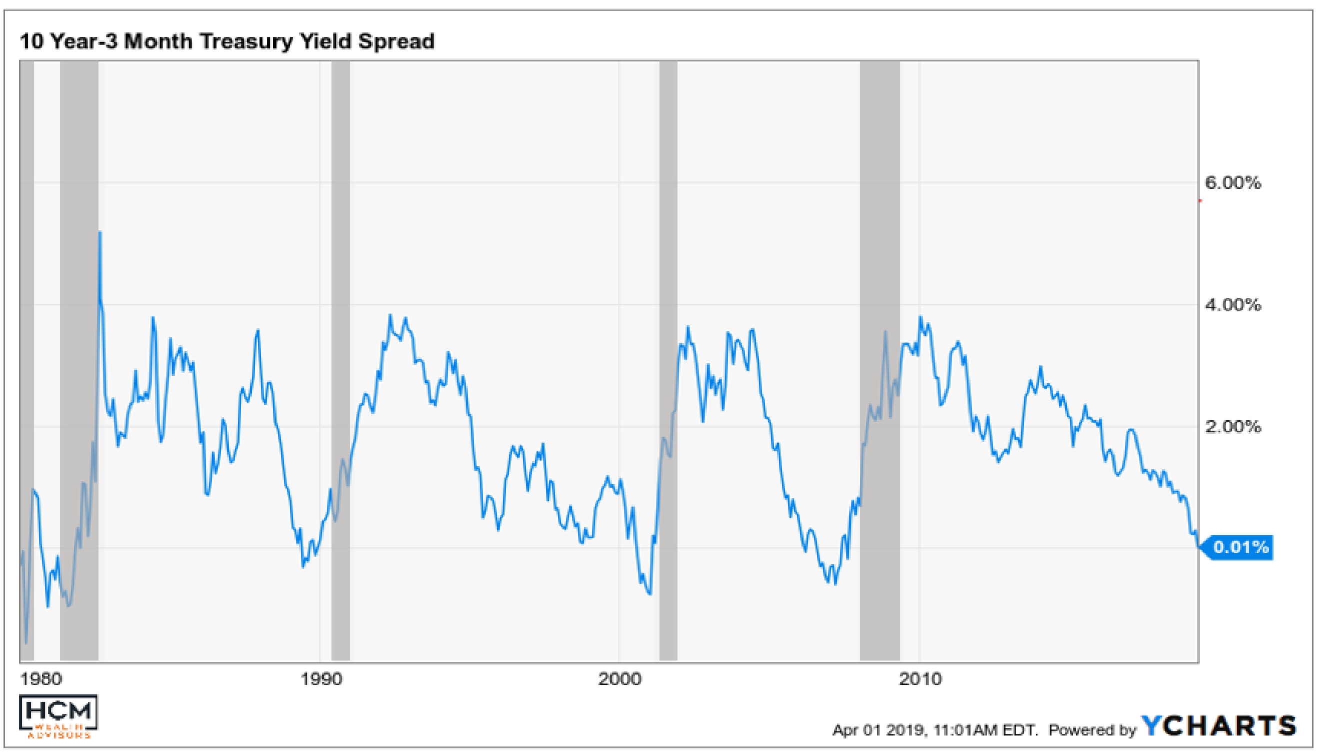
Market Insights for Week Ending March 29, 2019

"The Yield Curve Has Negotiated World Peace!"

As you might have suspected, the title above isn't *entirely* true. I guess it is the best we can do for April Fool's Day. But even if this wasn't being penned on April 1st, the irony of the title wouldn't be entirely lost. If you have attempted to view, read or listen to any version of financial media over the past two weeks, there is a pretty good chance you came across the topic of the yield curve. More specifically, how the yield curve has recently inverted, and why or why not this should concern us. Our hope is to come at this topic from a different angle and explain that while the yield curve is important, it is simply one piece of a much bigger puzzle.

First, a little technical stuff. The yield curve is simply a series of current yields for the various US Treasury maturities that run from as short as 3 months to as long as 30 years, with 1, 2, 5, 7, 10 and 20-year maturities commonly referenced. The curve is just the line that connects these dots. Most of the time, the curve is sloped positively or "steep". This means that the longer the maturity, the higher the yield as investors are given additional compensation for taking on inflation risk. However, there are times when the curve becomes "flat" or is even "inverted". This means that one or more of the longer maturity yields has dropped below the shorter maturity yields. For example, on March 27th the 10-year US Treasury rate was at 2.39% while the 3-month Treasury rate was at 2.44%, resulting in a spread of -.05% and the beginning of the hysteria surrounding this topic.



The chart above shows the spread between the 3-month US Treasury rate and the 10-year Treasury rate going all the way back to 1980. As of April 1st, the spread has moved slightly back above zero. You will also notice some vertical, darker grey bars around 1980, 1983, 1991, 2002 and 2007. These bars represent periods of recession in the US.

Why Do We Care?

For all the attention paid to the yield curve, few actually take the time to discuss why an inverted yield curve is important. In both life and financial markets, we like to create short cuts in order to facilitate decision making. These short cuts or "Rules of Thumb" allow the brain to avoid having to process large amounts of data and enable us to reach a conclusion quicker and more efficiently. That is not to say that these "Rules of Thumb" are always accurate. Sometimes they can be wrong and there is certainly a danger in blindly living or investing this way. This brings us back to the chart above. You can see that each recession since 1980 was preceded by a yield curve inversion. The timing of how quickly the recession follows an inversion remains a hot topic in the investment community, but the reliability of an inverted yield curve predicting a coming recession is pretty good.

So, what is it about this phenomenon that causes investors to fear slowing future growth? Think about how banks make money. They borrow at shorter/cheaper interest rates (deposits) and lend that money out at higher/longer rates (loans, mortgages). When the yield curve is steep (positively sloped), banks earn a higher interest rate when they lend money than when they pay interest to depositors. The difference is called an "interest rate spread" and it is where banks make their profit. With this positive spread, they will be more likely to lend to consumers because it is profitable for them. When the interest-rate spread narrows or inverts, banks are inclined to provide fewer loans and economic spending slows. In an economy where approx. 70% of activity is derived from consumer spending, a slowdown in loan growth will cause issues.

But it isn't just about bank lending. Investors have looked at the Fed's recent commentary as a sign that inflation will not be a concern for the foreseeable future. With the anticipation of slower growth and lower inflation, interest rates on longer-term bonds have been pushed lower as investors seek protection against a possible economic slowdown.

So while debate goes on as to whether or not an inverted yield curve is leading us into recession, stocks continue to advance, seemingly unconcerned. The tug of war between deteriorating fundamentals and central bank policy continues to play out, and for now, central banks seem to be winning. Their willingness to change course and return to the mantra of "lower rates for longer" has investors once again feeling giddy and asking themselves, "What could go wrong?" Who knows, maybe central banks could tackle world peace when they get a chance.

Weekly Focus – Think About It

"How soon 'not now' becomes 'never'."

-Martin Luther

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 1.33%
- Developed Foreign Markets (EFA) – Gain of 0.86%
- Emerging Markets (EEM) – Gain of 1.15%
- Fixed Income (AGG) – Gain of .41%

(Note: performance is based on the change in price plus dividends)

Last Week's Headlines

-Global economic data painted a mixed picture as consumer confidence in both the US and Germany fell while Germany's Ifo business climate index exceeded expectations.

-The Turkish lira experienced wild swings ahead of local elections

-The UK Parliament rejected Prime Minister Theresa May's Brexit deal for a third time, with growing likelihood of further delays to the Brexit process

Eye on the Week Ahead

-US employment data will offer clues about the health of the labor market and the overall economy. Consensus estimates point to a rebound in the March data.

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