From the desk of the CIO
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This month's focus:

1. Information from the Yield Curve Inversion and the bond markets.
2. It's all about earnings.

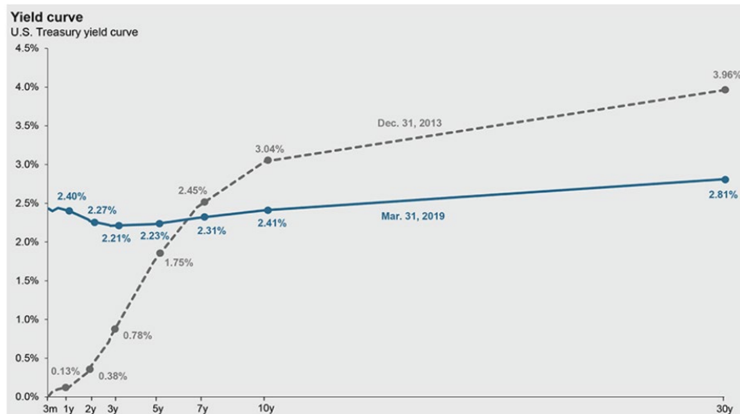
Yield Curve Inversion

Recently, the financial media pointed out that the U.S. Treasury Yield Curve had inverted. What does this mean? And, more importantly, what does it mean to you as an investor?

The yield curve is considered inverted when the yield on 3 month Treasury Bills exceeds the yield on longer maturity securities, usually the 10 year Treasury Bond. In this recent case, the yield on U.S. Treasury Bills is higher than the yield offered by two to five year U.S. Treasury Notes, and about the same as the 10 year Bond (see the chart below).

The media accurately pointed out that an inverted yield curve has preceded the past seven recessions. While this is certainly true, what pundits did not emphasize is that recessions usually occur one to two years or more after a yield curve inversion. There have also been cases where the yield curve inverted slightly and for a short time, which did not result in a recession.

The slowing of economic growth globally has resulted in some concern of a recession in the next year or two. After a 10 year economic expansion a recession should be considered very normal economic event. Keep in mind that a recession does not necessarily mean a full-blown financial crisis like we experienced in 2008 – 2009. Investors worried about the potential of a further slowdown will buy the very safe U.S. treasury notes and bonds on the hope these will rise in value as interest rates decline.



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.

The current yield curve indicates that investors are willing to accept a lower return over the next two to five years in exchange for the safety of their capital.

The fly in the ointment here is the unprecedented easy monetary policy instituted by central bankers to save the financial system during the Great Recession. Some experts say long running easy monetary policy has distorted yield curve dynamics this time around. In support of their assertion, and as I pointed out earlier, there have been a few times in history the yield curve inverted and the economy did not slip into recession.

It's All About Earnings

Asset (stock) prices reflect what investors are willing to pay per unit of future earnings or cash flows. It's really that simple. When a stock is trading at high multiples of its current earnings, it is a reflection of investor optimism of continued high rates of earnings growth. If those expected earnings don't materialize, these high-flying stocks fall back to earth.

With stock prices recovering approximately most of what was lost in the 4th quarter of 2018, company earnings will be key to sustaining the longest lasting bull market in history. As I've written previously, we expected slower growth in the U.S. and abroad through the first half of 2019. This stems from the negative impact of global tariffs and trade wars as well as geopolitical uncertainty caused by Great Britain's "Brexit" from the EU. Uncertainty has caused company management to put planned capital expenditures and ramp up for growth on hold, while they wait for a clearer future picture before committing to large future capital commitments.

In addition to our usual monitoring of trading activity and patterns in markets, we are also very much focused on reported earnings and sentiment among company leadership. The good news from last week is that operating results reported for a few of the major banking and financial institutions came in quite strong, lifting markets. If this pattern persists, conditions for stocks may be constructive going forward.

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