TJIM QUARTERLY INSIGHT

First Quarter 2019

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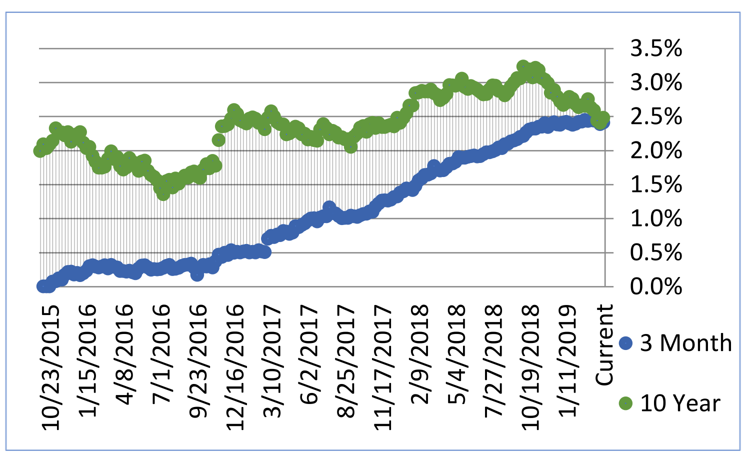
In recent weeks news media outlets, financial and mainstream alike, have been reporting in earnest about the infamous inverted yield curve. In a recent NPR article titled “Stock Indexes Drop as Bond Market Flashes Recession Warning”, the author describes the inversion as a “ominous warning sign…That’s often a signal that a recession is on the horizon.” (Horsley) As a topic of current consternation, a quick primer regarding the perils of an inverted yield curve seems to be in order.

You may be wondering what in the wide wide world of sports is a yield curve. The “yield curve” is a term that describes the percentage yield that an investor stands to receive by buying US Treasury Notes dependent on how far out into the future the investor is willing to commit their money. The shape of the yield curve can tell us many things; from what investors expect of inflation and future interest rates, to the premium investors require to commit to a long-term investment over a short-term investment.

The yield curve is also an important factor in determining the rates we pay on our homes, what kind of returns investors can expect from the stock market, and to some extent the cyclicality of the broader economy.

Under normal market and economic conditions, the yields on Treasuries that mature further in the future are higher than those that mature sooner. This condition generally facilitates the economy by allowing banks to borrow at short-term rates and lend at long-term rates, thereby increasing the profitability of lending activity and thus encouraging banks to make loans. Additionally, a normal “upward sloping” yield curve is a good indication of a healthy economy, as it typically indicates that businesses are willing to borrow for longer to finance projects and lenders require a reasonable return on their investment in order to entice them to vacate the safety of short-term maturities and lend to these businesses.

This brings us to what is an inverted yield curve and what an inversion implies for the broader economy. The yield curve is considered inverted when rates on bonds that mature sooner exceed the yields on bonds that mature further in the future. In order for the yield curve to transition from upward sloping to inverted, it must go through a flattening process. The yield curve has been in a flattening cycle since the end of 2014. The adjacent line graph reflects what has happened to the yield curve since the Federal Reserve began raising rates on the Federal Funds Target rate. As you can see, the yield on 3-month Treasuries (the blue line), has steadily converged toward the yield on 10-year Treasuries (the green line). The 10 year yield fell below the 3 month yield during the last week of March, marking the first yield curve inversion since 2006.



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This is an ominous signal for sure, as every recession since 1970 has been preceded by an inverted yield curve. As discussed above, an upward sloping yield curve is generally a sign of a healthy economy, and in some ways is crucial to facilitating a healthy economy. So, it would stand to reason that a flat or inverted yield curve is a sign of a slowing economy.

However, this condition does come with some major caveats. In some instances, the yield curve inverts without a recession to follow, it's rare but it does happen. More crucially, even though an inverted yield curve is a good sign that a recession is on the horizon, it doesn't tell us much about how far out in the future a recession may be or what market returns will be like between the point of inversion and when the recession occurs. For instance, on average a yield curve inversion precedes a recession by about 14 months, however a recession has occurred in as little as 7 months, or as long as 2 years after an inversion.

Finally, an inverted yield curve is no sell signal. According to J.P. Morgan Asset Management, in the 2 years leading up to a market peak on average the market returns about 41% to investors, conversely the 2 years after the market peak returns are typically -1%. In this scenario an investor attempting to time the market would give up 41% in order to save 1%. This reminds me of the old axiom, "it's not about timing the market, it's about time in the market."

Consider the first quarter of 2019, a quarter when the yield curve inverted, the S&P 500 returned 13.65% and high momentum stocks did much better than that returning 16.61%. In a good sign that we are in a "risk-on" market, the value index underperformed the growth index by about 3%. In an additional "risk-on" note, the borrowing cost of corporations also declined. For instance, the cost to borrowers in the high yield sector, these are the borrowers with the riskiest corporate credit in the public markets, fell by about 1.4% in the quarter.

Between the yield curve inversion reflecting a slowing of the economy, and the strong stock market returns and lower borrowing cost reflecting a growing economy, even the great Dionne Warwick would have trouble reading the tea leaves. Our yield curve may in fact not be telling us much at all about the direction of the economy. Between Federal Reserve manipulation raising the yields on short maturities, and the relative attractiveness of our yields to overseas investors pushing down the yields on longer maturities, we believe trepidation is prudent but we don't think investors should be headed for the exits either.

As always, we believe a portfolio of attractively valued, high quality securities that is properly diversified across stocks and bonds with an asset mix that is appropriately matched to risk tolerance is the best strategy for meeting long term goals across volatile markets. We just want to thank you for your trust in our firm, and we will continue to diligently, and prudently manage the investments that you have placed in our care.

Sincerely
TJIM Investment Team

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