INSIGHT & PERSPECTIVE
Checking the Gauges

March 27, 2019

Historically, when the 3-month Treasury bill yield exceeds the 10-year Treasury note yield, a U.S. recession often follows.

This "inversion" of the yield curve has just occurred again and it has a lot of market participants talking.

Is This Time Different?

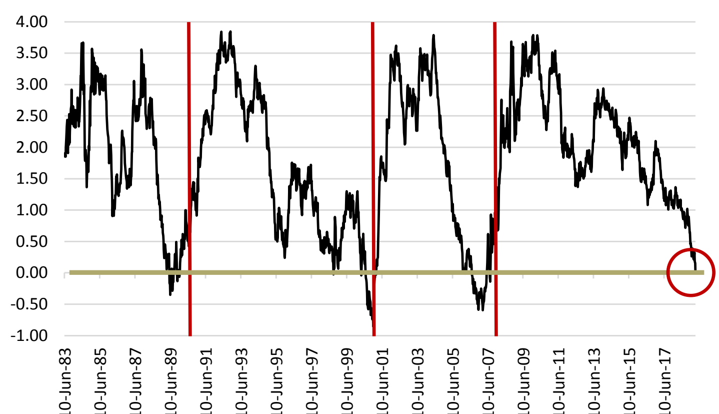
We must admit, the work of a macroeconomic strategist and asset allocator can be boring at times. After all, the work entails sifting through reams of data, some of which can change infrequently, over the course of a business cycle. Still, the effort involves discipline as constant review of the same data sets is a must to gauge changes in trend and/or mark when important thresholds are crossed. Lately, our job has gotten very interesting; so much so that the financial media has begun to highlight some of the data sets in which we find significant value. Why?...because some of these data sets can be telling in terms of their historic probability of foretelling an economic recession.

The data on the tip of the media's tongue lately is the yield spread or yield differential between the 3-month Treasury bill (Tbill) and the 10-year Treasury note (Tnote). Historically, when the 3-month Tbill yield is higher than the 10-year Tnote (in this case, the yield curve is labeled as "inverted"), this has often pointed to oncoming economic recession in the U.S. For this reason, we doggedly pay close attention.

Some market forecasters have labeled the current inverted state of the yield curve as somewhat of an anomaly or "technical" in nature, and thus giving limited credence to the indicator's present-day forecasting power. As such, some are saying "this time is different." And while this business cycle has

Figure 1: 3-month Treasury Bill vs. 10-year Treasury Note Yield Spread (%) - Weekly
Source: Bloomberg

The red lines in Figure 1 mark the onset of a U.S. recession as defined by the National Bureau of Economic Research (NBER).



certainly been unique, we are less sanguine around completely discounting a data set with a high probability of pinpointing an economic downturn.

Paying Attention

A Treasury yield curve inversion has preceded every U.S. recession since 1960.

On average, there is an 11-month lag between an inversion and the start of a U.S. recession.

Given that every recession since 1960 has been preceded by a Tbill/Tnote yield inversion, we are indeed paying attention to this indicator, and we expect the Federal Reserve is as well. The latter point speaks to the growing anticipation among market participants that the Fed may in fact cut its funds rate to offset the risk of sustained economic weakness. Indeed, economic data globally has been trending lower since early 2018 and forecasts for U.S. and global GDP next year point to a decline in economic activity. While a future Fed policy move remains to be seen, the data itself and the historical pattern visible in Figure 1 serves as an important reason why the 3-month/10-year inversion has been a hot topic of late.

The good news is that history has shown there has been material passage of time between a yield curve inversion and the onset of a U.S. recession. Since 1960, the average time between inversions and recessions is eleven months. Meanwhile, the S&P 500 Index has averaged a 2.8% return in post-1960 occasions between inversion and recession. Unfortunately, there has been a wide range of S&P 500 Index performance over these times...i.e. we have seen both double-digit losses and double-digit gains historically. Given that risky asset markets have been on a 10-year run, we are not inclined to suggest investors hold tight for those last few percentage points. Our preferred strategy is to reduce risk in portfolios.

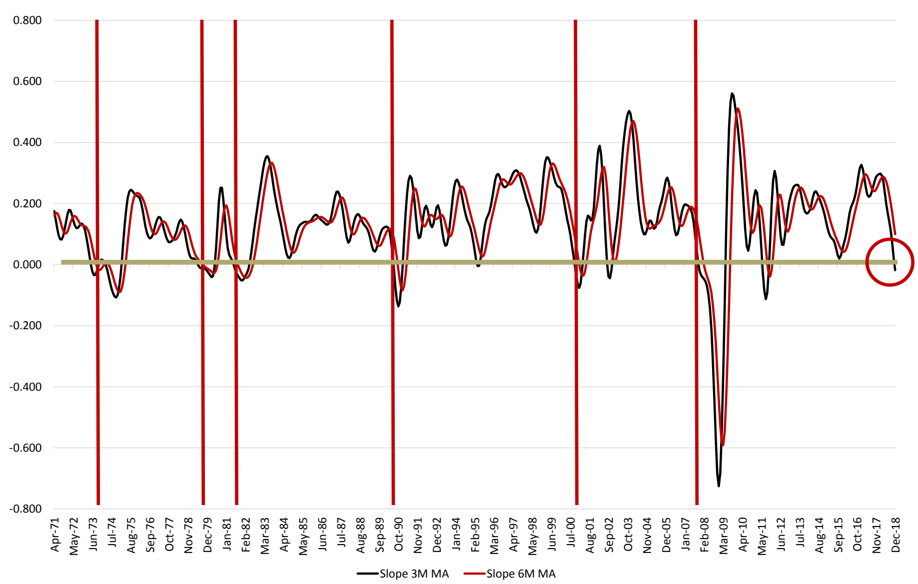
Historically, there has been notable consistency between the 3-month LEI moving-average slope crossing below zero and the onset of recession.

The red lines in Figure 2 signify the onset of a U.S. recession as defined by the National Bureau of Economic Research (NBER).

Some LEI signals have been false, but the probability of a recession following a zero line cross has us paying attention.

Figure 2: U.S. Leading Economic Indicators - Slope of Moving Averages

Source: Organization for Economic Cooperation and Development



Meanwhile, our call for more investor vigilance is enhanced by another important data set we also constantly monitor. That is the Organization for Economic Cooperation and Development's U.S. Leading Economic Indicators (LEI). Again, this data series (Figure 2) has a long track record of foreshadowing recessions, which makes the current position of the U.S. LEI another worrying sign.

What Now?

We want to be clear here: We are not simply making a call that a recession, due to the data that is before us, is on the near-term horizon. That is not the primary focus of our work. We are not seeking to be "right" or "wrong" in forecasting a recession. However, we are emphasizing that the macroeconomic data found in this commentary, and the probabilities they have historically presented, should be taken into account when making investment decisions. The information highlighted, we believe, should be prudently incorporated when allocating an investor's financial assets. To that end, we are raising a bit of a yellow flag here because economic conditions have deteriorated, and absent any new policy shifts, we may be at risk for further weakness. This is something we will continue to monitor and account for as we manage client portfolios.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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