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YIELD CURVE INVERTS. WHAT NOW?

SUMMARY

- **MACROCAST™ indicates major bear market risk remains low.**
- **The yield curve has inverted, and historically, that has been a negative for the economy. However, we believe recent Fed commentary and negative German bond yields are the driving forces behind it.**
- **Historically, one year after the curve has inverted, the median market return was more than 10%.**
- **One area that could boost the economy is the housing market. 10 years into the expansion and data has remained sluggish, but several encouraging factors are coming together that could provide a major lift.**

THE YIELD CURVE HAS INVERTED FOR THE FIRST TIME SINCE 2006

A yield curve inversion occurs when the rate on long-term treasury bonds drops below short-term rates. This usually happens because the Federal Reserve is raising the interest rate it has direct control over, the federal funds rate.

Why does this matter? Yield curve inversion has preceded every economic decline over the past 50 years. There are thousands of economic and market indicators, and few have a better track record in terms of signaling a recession.

While every recession since 1960 has been preceded by an inverted yield curve, *not every inversion has been followed by a recession.* The yield curve inverted in 1966, and again briefly in 1998, and neither instance was followed by a recession within two years.

We attribute the recent inversion to two main drivers, and as a result, we <u>do not</u> believe recession is a foregone conclusion:

1. **The interest rate on the 10-year German Bund, considered the safest fixed income asset in Europe, went negative.** If you want to invest in long-dated German bonds, you now have to pay for the privilege. And it's not the first time this cycle that the Bund has gone negative (from WSJ):

The Bund yield was negative in 2016 but rose sharply as both the US and global economy recovered. The US and German 10-year bonds tend to move in parallel. In simple terms, the yield curve inverted because German bonds are dragging their U.S. counterpart lower.

2. **The Fed did a complete 180° turn on monetary policy.** Last October, Fed Chairman Jerome Powell suggested that interest rates were "a long way from neutral". Next thing you know, the market dropped 20% and the Fed quickly changed its tune. Following the Fed meeting last week, they said they are fine with the current rate of inflation and want the economy to keep growing as long as possible. Now, the market is pricing in a rate cut by the end of the year. After their ill-advised December rate hike, it does not surprise us that the Fed took a break from further rate increases, but the amount of "dovish" language last week drove long-term bond yields down. Why would that occur when the Fed doesn't directly control long rates? Long-dated treasuries derive part of their yield by pricing in expected future rate hikes, which the Fed has suggested are off the table for now.

Does an Inverted Curve Spell Doom for the Market?

Our primary focus when viewing economic data is how an individual indicator might affect the market. This is especially true for any indicator with as successful a track record as yield curve inversion.

The below table highlights market performance after the first yield curve inversion in at least 500 days (from Bespoke Investment Group):

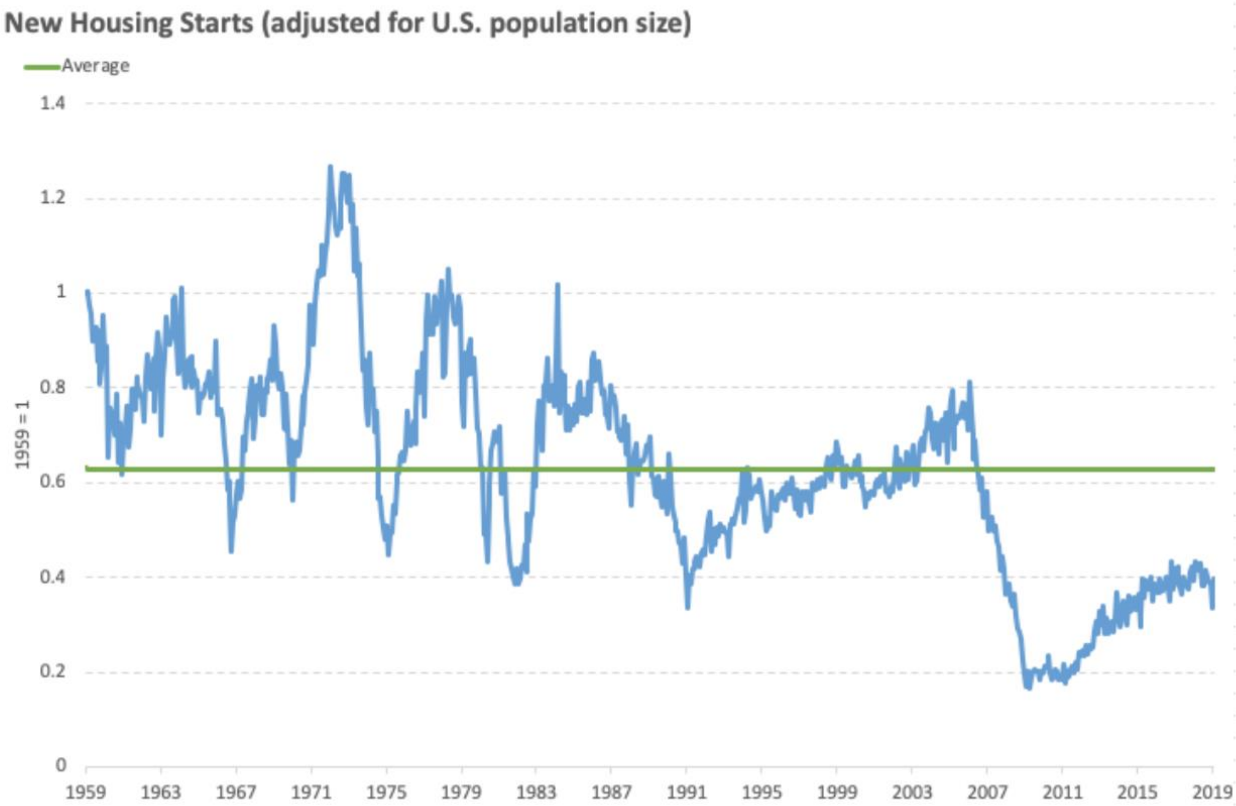
S&P 500 Performance After YC Inversions

First Day Curve	S&P 500 Performance (%)			
Inverted	One Month	Three Month	Six Months	One Year
1/11/66	0.43	-1.73	-6.38	-10.64
5/31/73	-0.66	-0.67	-8.57	-16.84
10/31/78	3.36	7.28	9.16	9.31
3/27/89	6.54	13.03	18.77	17.53
9/10/98	0.43	18.86	31.28	37.90
1/17/06	0.34	0.19	-3.78	11.51
3/22/19	?	?	?	?
Average	**1.74**	**6.16**	**6.75**	**8.13**
Median	**0.43**	**3.73**	**2.69**	**10.41**

The sample size is small, but the last four times the yield curve inverted the market was higher by at least 9% one year later. Overall, median gains were in double digits.

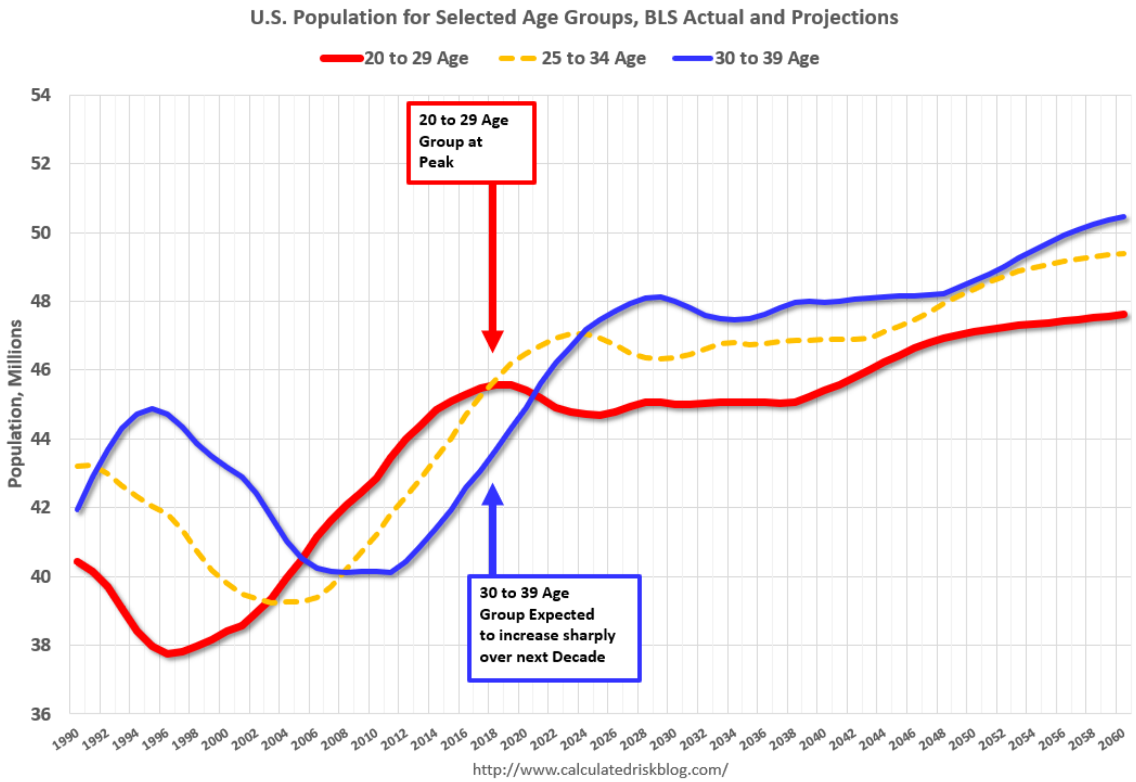
IS HOUSING THE KEY?

If the economy avoids a recession over the next 12-18 months, we think housing will play a big part. Let's look at the housing market framework from a basic supply and demand standpoint. First, a look at supply. The following chart depicts New Housing Starts, adjusted for the population (from Morgan Housel):



Ten years into the recovery and Starts are still near the bottom of their previous historical range. Even accounting for changes in lifestyle and demographics, there are still not enough homes being built.

Speaking of demographic changes, the Millennial generation is set to take over Baby Boomers as the largest living cohort. More importantly, they are entering the prime age for home buying, a potential increase from the demand side (from Calculated Risk):



Lastly, the recent drop in mortgage rates could entice a new round of buyers who have been sitting on the sidelines (from YCharts):

ONE LAST POINT REGARDING ANY SINGLE INDICATOR

We spent the majority of this article discussing the power of the yield curve as an indicator of recessions. And while it has a solid track record, it is still only *one* indicator.

MACROCAST™ is built on the principle that, by looking at multiple factors, we can better gauge market conditions and assess the probability of a major market decline. While the yield curve is one indicator we track, there are more than twenty others across the **VITALS** (**V**aluation, **I**nflation, **T**echnical Analysis, **A**ggregate Economy, **L**iquidity, and **S**entiment). We believe this broader view provides a more complete picture of the environment for risk assets.

As always, we greatly appreciate your business and the confidence you entrust in Corbett Road.