Blink and You Might Miss It

You certainly could be forgiven for having overlooked the event itself; we are, after all, talking about mere basis points here – in other words, hundredths of a percentage point. You're much less likely, however, to have missed the dramatic headlines and blaring sirens set off in its wake over the past week-and-a-half, notifying investors everywhere that the yield curve had finally inverted – if only very slightly and, for now, briefly – for the first time since the Great Recession (see Chart 1, below). If you've been following our thinking over the past several years, you'll know, on the one hand, that this is really just an ominous-sounding way of saying that longer-term interest rates have moved below shorter-term rates; you will also likely recall, however, that we have spent an awful lot of time talking about it, given how reliable an omen it has proven, historically, of a recession looming in the not-too-distant future.

Chart 1: Inverted Yield Curve Historically a Good Predictor of Recession

Although the spread between the US 10-year Treasury and 3-month T-Bill turned negative back in May, the slope of the curve between 10-year and 2-year bonds managed to remain positive before just barely going negative in mid-August. While the presence of a so-called "inverted yield curve" has been a very reliable predictor of recession in the past, there are a couple of things to keep in mind as we look to react to these developments. First of all, there's a strong possibility the sharply negative term premium currently evident – a result of years of quantitative easing and strong investor demand for safe haven assets – may be artificially depressing the longer-end of the yield curve (and, thus, its slope), triggering an inversion sooner than would otherwise be the case. Even if we assume a timely signal, however, there has, on average, been a gap of roughly 18 months between the time the curve inverts and the onset of recession, leaving us with our standing view that we are unlikely to actually see recession until some time in 2021.

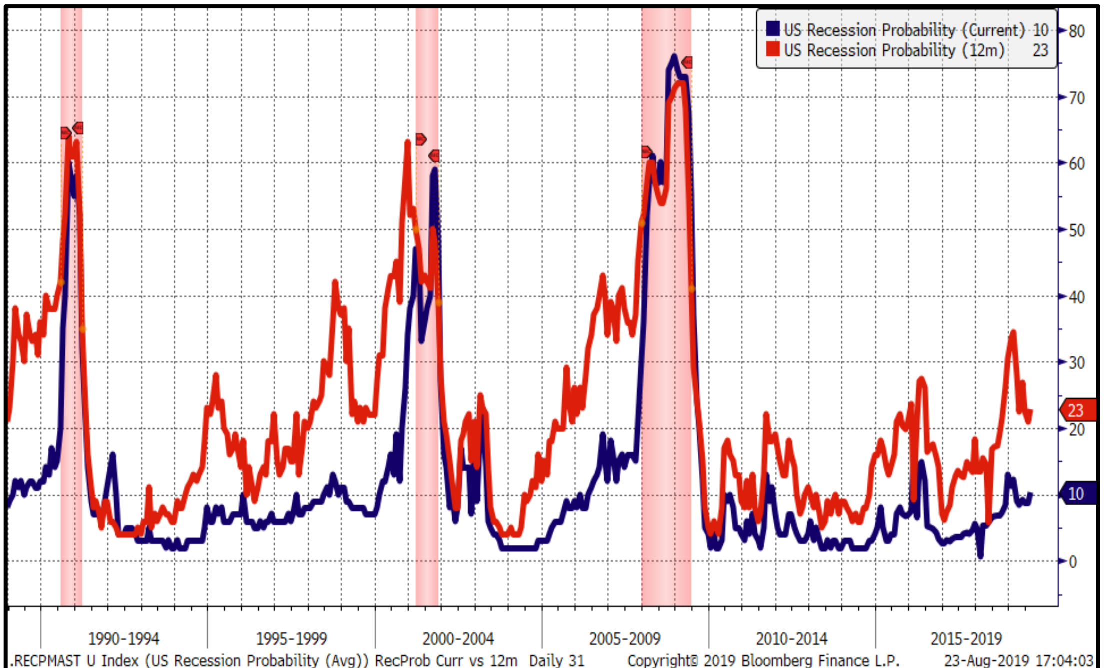
So, is that it then? Should we all just resign ourselves, stop looking over our shoulders and, instead, simply stare straight ahead into the economic abyss that must certainly be barreling down on us as we speak? In our view, such a reaction would be a mistake; certainly, we believe recent bond market developments warrant our attention, but there's no shortage of conflicting evidence out there, leading us to believe the yield curve may currently be more of a misdirection for investors and that things may not necessarily be as weak as the inversion would otherwise imply.

For now, we just don't see meaningful signs of doom and gloom on the immediate horizon. Nonetheless, as we begin to explore where we are in the cycle and what these recent developments mean, it's a good idea to remain pragmatic and keep sight of the "big picture," economically speaking. To do so, we need to get the introductions out of the way with the elephant in the room: specifically, let's all agree right up front that – as attractive as it sounds – the concept of actually "repealing the business cycle" is the economic equivalent of science fiction: recessions are a natural, if unpleasant, part of the cycle and one that will be revisiting us at some point, even if not now then at some point in the not-too-distant future.

One Step Closer to the Edge…but Not About to Break

Both the U.S. and global economies have been exhibiting a gradual slowdown in their pace of growth over the past 12-18 months, hardly a surprise, as persistently high levels of policy uncertainty – expressed primarily in the monetary and, particular, the trade policy arenas – have driven economic uncertainty higher as well, weighing on the level of activity. In spite of this, overall recession probability levels – while higher than they were back in 2017 – remain relatively low by historical standards (see Chart 2, left). In fact, other than the elevated recession risk implied by what has long been an extraordinarily flat yield curve, most segments of the economy we monitor for early signs of recession have largely continued to give an "all-clear" signal. Now that the slope of the curve has turned outright negative, we have taken an additional – and not entirely insignificant – step in the move from "recession watch" towards "recession warning," though we believe there is still meaningful ground to be covered before we make that pivotal shift.

Chart 2: Currently Few Red Flags on Recession Dashboard



Other than the yield curve – which, in isolation, has been flashing a >40% probability of recession for the past year or so – most areas of the economy show relatively little near-term risk of an economic contraction. Probabilities remain higher than a couple of years ago but have pulled back considerably from year-end 2018 levels and, overall, remain fairly low by historical standards. This is not to say that we won't go into recession at some point (we will) nor that the yield curve signal should be dismissed – even taking into account the potential distortion introduced by the term premium, it's historical record of predicting recession is just too reliable to overlook. Nonetheless, while we will remain on "recession watch", the preponderance of the evidence would seem to argue against escalating this to "recession warning" at this time, though we are mindful of the adverse impact continued uncertainty may eventually begin to have on current areas of strength like consumer and business confidence or the labor market.

Of course, even though there's no fixed "shelf life" on how long we can remain in this gray area of weakening but positive growth, we do know that we cannot skirt recession indefinitely. Based on what we see as the lateness of the cycle – highlighted perhaps most vividly by an extremely tight labor market – our Investment Committee's consensus continues to view early- to mid-2021 as a likely horizon for potential economic contraction to materialize, though – given high levels of uncertainty and volatility on the policy front – this outlook remains fluid and will be updated as changing conditions dictate.

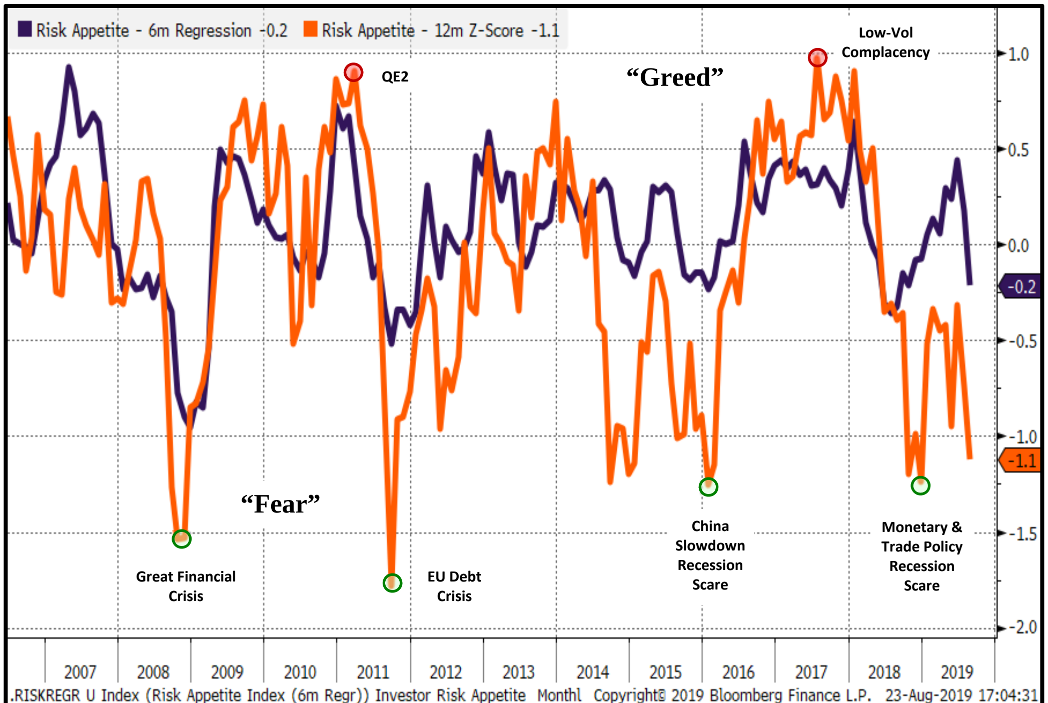
Even once it is upon us, however, we do not currently expect the next recession to be anything like the last one – the same excesses simply are not there this time around! While we currently remain in the longest expansion in U.S. history, it has been far from the strongest and, given the fairly sluggish pace at which we have been moving forward, we would not expect to see a precipitous drop in economic activity once the cycle turns. Meanwhile, the consumer – which accounts for the lion's share of U.S. economic activity – appears to remain in remarkably good shape: the personal savings rate is running north of 8%, one standard deviation ahead of its 20-year average of 6% and lightyears ahead of the 2%-3% that prevailed prior to the '08-'09 crisis. At the same time, consumer wealth is just off its all-time high, while the household debt service ratio (the percentage of income households must use to pay off their debt) – at sub-10% – is sitting at its lowest level in 40 years. As a result, we expect the consumer to remain resilient and to continue to provide a backstop to the economy to prevent it from slipping into a recession for the time being.

Opportunity Often Means Going Against the Grain

On its face, the sharp reaction to the recent yield curve inversion conveys a deep sense of investor fear regarding where we are headed economically and what the implications of this might be for the market; as is typically the case, however, such conditions would seem to present an opportunity for the long-term, disciplined investor. If our outlook is correct and recession is anything but right around the corner, then a diversified portfolio of return-seeking assets is priced to do well going forward, while safe haven assets – even if we assume further interest rate cuts by the Federal Reserve – appear pretty much priced to perfection. In fact, as we look at investor risk appetite in the wake of the recent collapse in interest rates and heightening in trade war rhetoric, we can see that – while not quite at the extreme level of wash-out we have seen associated with major market bottoms – there has nonetheless been a very abrupt and steep decrease in risk appetite as investors have sought to rapidly shed risky assets and rotate into safe havens (see Chart 3, right). An easing in trade tensions – which we believe will materialize, albeit only gradually – should help rekindle investors' appetite for risk, reasserting the stock market's recently-interrupted upward momentum. Developments on the trade front will continue to bear monitoring throughout all of this, however, as these represent – via their potential effects on such factors as confidence, capital spending, hiring decisions, etc. – the most likely trigger capable of ultimately tipping the scales against the current expansion.

-Jim Ayres, CIO

Chart 3: Investors' "Risk-Off" Reflex Runs Deep



The yield curve's recent inversion has dogpiled onto a market increasingly worried about escalating trade tensions between the U.S. and China, sending investors scrambling for safety. This has driven a sharp decrease in investors' risk appetite and a correspondingly sharp sell-off in risky assets. While not yet quite as washed out as has been the case during the major market bottoms of the past decade, risk appetite appears relatively depressed given an outlook for slowing but still positive economic growth, appearing to offer a potentially favorable backdrop for a diversified exposure to return-seeking assets. Developments on the policy front pose the greatest risk here and will remain critical in shaping outcomes in this area, with further market volatility and near-term drawdowns possible given what remains a highly uncertain and often volatile policy backdrop.