A Curve Conversation

Steve Orr, Chief Investment Officer

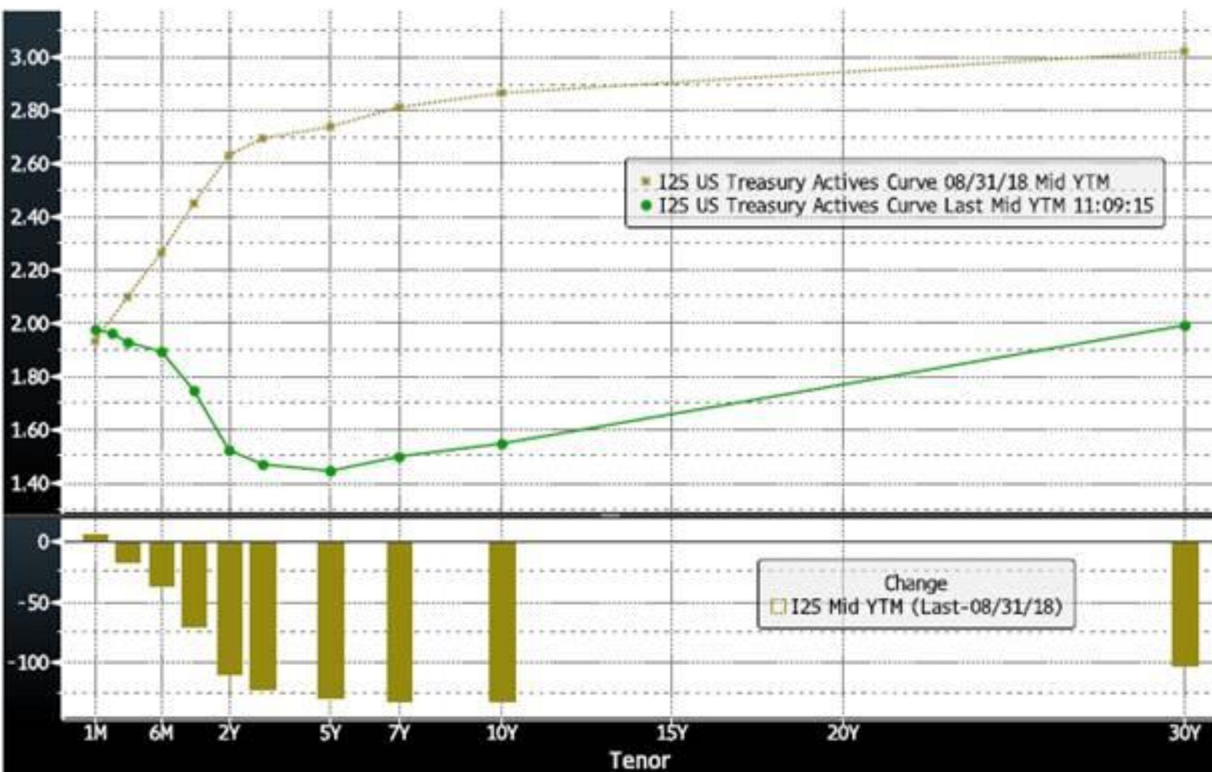
Lately all one hears from the financial press is “inversion” and “inverted yield curve” talk. What is an inverted yield curve and what does it mean for our portfolios?

The yield curve is a fancy term for the difference between short-term and long-term interest rates. An example of a short term rate would be the overnight rate one could earn in a money market account. Longer term interest rates range from ten to one hundred years. Ten- and thirty-year maturities are the most common length for government debt around the globe. Most home owners opt for a thirty year mortgage, paying the lender interest each year until the principal is repaid.

Plotting each year’s interest rate on a graph creates an upward sloping curve in “normal” times, like the below data points from a year ago:

The upward slope in the green curve shows that when an investor commits capital for a longer term, she is typically compensated with a higher interest rate. A year ago, the U.S. Treasury thirty-year bond had a yield just over 3%, and the two-year maturity yielded 2.62%.

In an inversion, the yield curve has just the opposite structure. Long term rates fall below short-term rates and the curve shape changes from concave to convex:



The green line in this graph is from this morning; note how the vertical bars show that the thirty-year Treasury yield fell one percent and the two-year maturity fell one-and-a-quarter percent over the last year.

What causes long-term interest rates to fall and how often does this happen? The school exam answer is that investors believe future growth and inflation will be much lower than it is today. Over the last twenty years, inflation has averaged 2.2% and has struggled lately to break 2%. The larger issue of the moment is future growth around the globe. Recent data from China and Germany show their economies are growing at their slowest rate in fifteen years. Longer-term interest rates peaked in the early 1980s, along with inflation in the U.S. and have been trending lower since.

Short-term rates also peaked back in the early 1980s and have been higher than long-term rates a number of times, usually for just a few days. What pushes short-term rates higher? The Fed – the Federal Open Market Committee meets regularly to assess the economy and determines whether to change the borrowing rate for its member banks and other credit measures for banks that affect the money supply. Every inversion has begun with the Federal Reserve raising short term rates. For pre-2008 hiking cycles, the Fed's justification for raising rates was an effort to cool down a red-hot economy. Raising short-term rates prior to the 2008 financial crisis often had the effect of choking off credit for investment in securities and companies. Hence the Wall Street maxims of "Bulls never die of old age; they die at the hands of the Fed" and "the Fed takes away the punchbowl."

Post 2008, many central banks around the world have kept interest rates artificially low with the hope of stimulating growth. In a number of countries, the central bank bought government debt, depressing the interest rate and raising bond prices. A number of these countries now sport negative interest rates, where the investor actually loses money –

the government pays the investor back less than he invested. Today over $16 trillion in global debt trades at negative yields, with Japan making up about 42% of that total.

The Fed has raised short-term rates nine times beginning in December 2015. Several central banks then followed with their own increases but the gap between our interest rates and the rest of the worlds' grew quite large from 2017 on. Our much higher (2% to 3%) interest rates drew capital from around the globe, slowing foreign economies. At the same time China's economy was slowing, fueling the thesis that the world experienced a "mini recession" in late 2015. We think the data supports that idea.

We believe much of the hand wringing and noise associated with the inverted yield curve story revolves around its use as a recession forecasting tool. Commentators point to the fact that a recession has occurred after a yield curve inversion. In fact, there have been a number of inversions that were not followed by a recession. Considerable debate surrounds how to even measure the inversion: is it three-month yields and ten-year notes, or two-year notes and thirty year bonds?

We acknowledge that some day there will be another recession. However, we believe current data does not point toward an imminent recession. Industrial production did slow earlier this year, after a rapid rise last year building up for China tariffs. Retail sales continue to grow at a very healthy 3+% per year, housing starts, and refinancing are enjoying lower interest rates, personal savings rates are back above 2008 levels and the number of jobs in the U.S. continues to hit new highs. Prior recessions often were led by deteriorating credit conditions and rising unemployment claims. Federal Reserve data shows credit availability for consumers and businesses remain very good and jobless claims are bouncing along at fifty-year lows.

A large portion of the anxiety surrounding the recent brief inversions we see as being driven by China and Europe's economic weakness. Their economies have meaningfully slowed over the last year. Europe is struggling with demographics, high debt levels and less trade with China. In turn, China is struggling with internal factions in the Communist Party that send confusing signals on trade talks and economic activity. Interest rates in the U.S. have plunged to near record lows based on fears of global recession. Our indicators show stocks are a better relative value after their recent drop, and we are staying the course.

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