DCM Perspective on the Inverted Yield Curve
8-16-19

This week's business news has contained headlines warning that the Yield Curve has inverted. Indeed, on Wednesday, the 2-year US Treasury yield moved above the 10-year US treasury yield for the first time since 2007.

This phenomenon is called an Inverted Yield Curve and is widely considered by traders and investors to be a sign that a recession is approaching. In today's world of computerized trading, programmed algorithms sell stocks automatically when such events occur and create irrational and extreme short-term price fluctuations. In times like this, we prefer to take a step back and put events in the context of their long-term effect on our clients.

True, inverted yield curves have preceded the last seven recessions. Inversions do not always, however, lead to a recession nor are they immediately negative for stocks. In May of 1998, the yield curve briefly inverted. Twelve months later, the economy had not fallen into a recession and the S&P 500 had returned over 20%. In fact, the average performance in the twelve months following the last five inverted yield curves was 17%. Historically, an inverted curve alone has not spelled disaster for the stock market. The depth and duration of the inversion have historically indicated what's ahead. The chart below highlights the past performance of the S&P 500 following an inversion of the 2/10 yield curve. Note that in all instances but one, the market was positive 12 months later. In the lone exception that the market was negative, 2000, stocks only declined 5%.

Source: Strategas Research Partners

The recent inversion is nothing to ignore and we don't want to go down the path of 'this time is different', but our sense is that extremely low global yields outside the US are more likely to blame for US rates falling than what is happening in our domestic economy.

At the same time, economic conditions are weakening around the globe and the US trade dispute with China is putting pressure on the US economy. The probability of a recession occurring in the next 12 months is on the rise, but is still not our base case. Current estimates from the Federal Reserve have the US economy growing between 1.8% and 2.2% through 2020. This is certainly slower than the 2.9% rate posted in 2018, but far from recessionary.

The Fed has also acknowledged this slowdown and the uncertainty resulting from the trade dispute by cutting the Federal Funds Rate in July for the first time since 2007. We expect that they will continue to cut rates and could potentially cut another two to three more times in 2019. While trade remains an issue and it is difficult to say exactly how or when it gets resolved, the Fed is doing their part to create a cushion for the economy. This stands in stark contrast to late 2018 when the trade dispute was escalating and the Fed was raising rates.

To contend with the softening economic conditions and building uncertainty, we've been making a few changes in our portfolios and we will continue to do so as warranted.

- The US consumer is a bright spot in the global economy. Unemployment sits near historic lows; wages are rising at a solid pace; and consumer spending has been robust. We've shifted our portfolios toward companies that derive less of their sales from outside the US and more of their sales from inside the US.
- The trade dispute with China impacts goods producing companies to a greater extent than service providers. Tariffs are increasing material costs, disrupting supply chains, and delaying expansion projects. Service providers are more insulated from these effects, and we've tilted our portfolio towards these types of companies, as well.
- We also continue to focus on companies consistently paying and growing their dividends. Should the economy soften more than we anticipate, we have confidence that the high quality companies in our portfolios have the capacity to continue paying out and growing the income that our clients expect.

Right now, we don't anticipate a recession in the next 12 months, but we believe these changes will insulate the portfolios regardless. Not all recessions are created equal, and we have no reason to believe another recession like 2008-2009 is in the cards. We have confidence that your portfolio will provide the security, income, and growth that our strategies seek to deliver.

Blessings,

Preston May, CBE®, Research Analyst
DCM Investment Policy Committee