INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

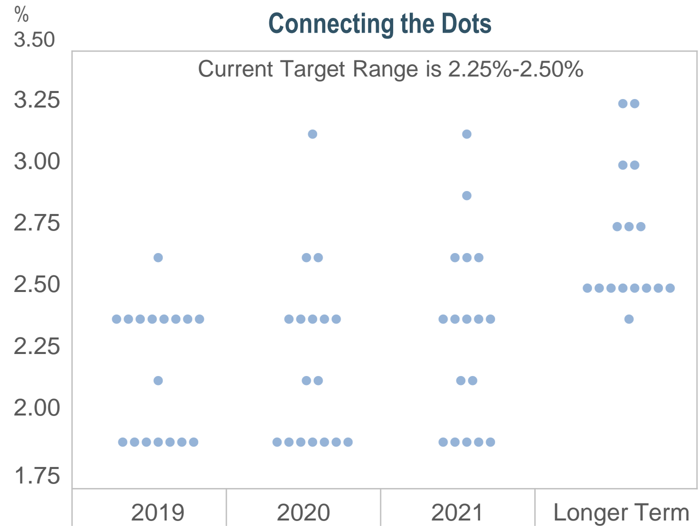
Curve Your Enthusiasm

July 24, 2019

In March 2019, the yield curve inverted for the first time since 2007, prompting many investors to question its meaning. Historically, the yield curve's ability to predict US economic recessions has been strong. The inversion in March, when the yield on the three-month Treasury bill exceeded that of the 10-year Treasury note, lasted just five days. Recession concerns quickly receded – until it happened again. In May, the three-month yield outpaced that of the 10-year for the second time this year. When this relationship surpasses 10 consecutive days, it often persists for weeks or months. While the signal's significance remains unclear, we believe that calmness should prevail.

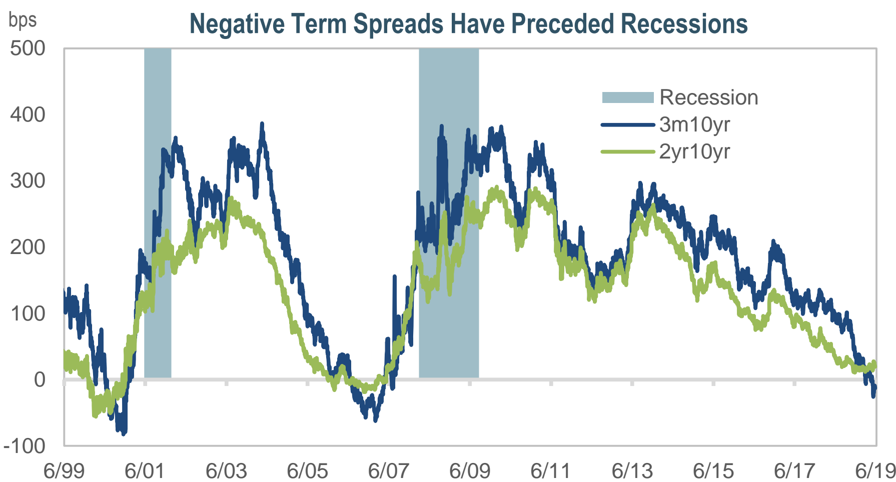
Which Way Do We Go?

- **The Fed has not lowered interest rates since the Financial Crisis.** With its tenth consecutive rate cut in December 2008, the Federal Reserve (Fed) entered a new era – a benchmark interest rate of effectively zero. That level remained unchanged until December 2015; the Fed has since raised rates nine times. It seemed poised to continue that trajectory until late 2018, when potential headwinds surfaced for the US economy.
- **What a difference (less than) a year makes.** The Fed had anticipated raising rates twice in 2019. Then, the correction happened in the fourth quarter of 2018. The Fed did a rapid about-face on rates, effectively hitting the brakes on future increases. In March, the Fed lowered its growth forecasts and signaled that it was done raising rates in 2019. It also unveiled its plan to end its balance-sheet runoff in September 2019.



- **The Fed has lost its patience.** In June, the Fed adopted a more dovish tone, removing the word "patient" from its view on future adjustments to the federal funds rate. The Fed believes that continued economic expansion and a strong labor market are likely; it also believes that uncertainties about this outlook have increased. The market's interpretation is more definitive, with fed fund futures implying a 100% probability of a rate cut in July – and lower rates of 75 bps by December.
- **The meaning behind the dots.** While the Fed publishes policymakers' short-term interest rate projections – the dot plot – four times a year, the predictive power of these estimates is debatable. The dot plot has become short-dated, as evidenced by its changes from March to June. In three months, policymakers went from forecasting one rate hike to one rate cut in 2020.

Who Can You Trust?



- **The prophetic power of the yield curve.** While the dot plot may not portend the future, the yield curve just might. Many believe that a yield curve inversion, when a short-term policy rate exceeds that of a 10-year Treasury, is a precursor to a recession. Historical evidence supports this view. Since 1956, a yield curve inversion has predicted every US recession, with just one false positive in the mid-1960s. Prior to the brief inversion in March 2019, the last yield curve inversion occurred in August 2006. The Great Financial Crisis began 16 months later, in December 2007.

Sources: Bloomberg Barclays as of 6/30/19 and the Federal Reserve Board as of 6/19/19. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable.

IR+M

INCOME RESEARCH + MANAGEMENT

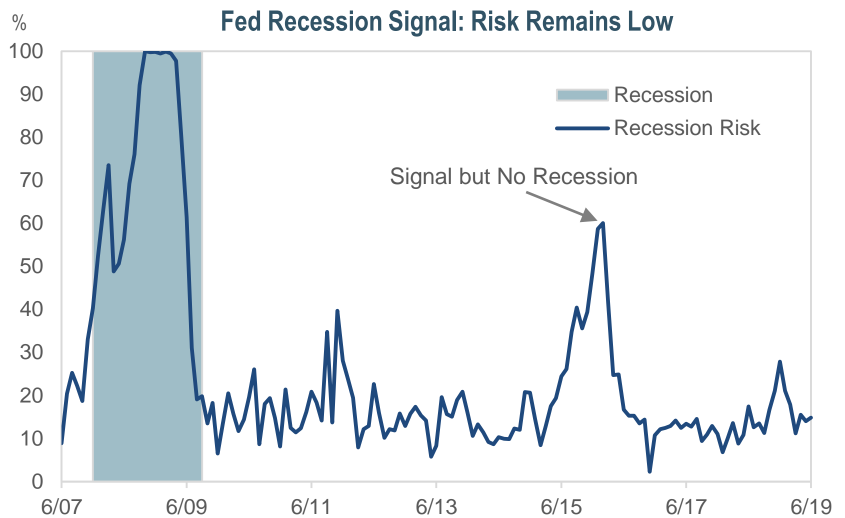
IR+M UPDATE

Curve Your Enthusiasm

July 24, 2019

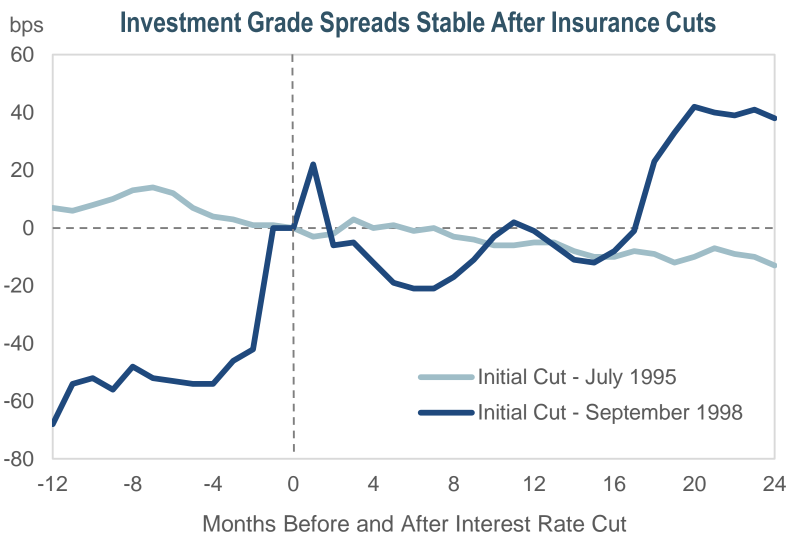
Who Can You Trust? (continued)

- **That was then and this is now.** The number of recessions over the last 60 years have been few, so this predictive measure has been based on a relatively small sample size. The next recession may be unlike those that have preceded it. Past recessions may have been caused by overheated economies and tight monetary policy: the loss of consumer confidence and the oil price shock in 1990; the internet bubble bursting and restrictive monetary policy in 2000; the housing market crash in 2007; and, a Fed-induced abnormally low rate period, concerns over slowing growth, and tariffs against China in 2019.



- **The data agrees.** Data corroborates the argument both for and against a looming recession. That there are contradictory views suggests that a recession is far from certain. Economic conditions are seemingly more robust this time. The labor market remains strong, unemployment is at a 50-year low, and the record-setting economic expansion continues.
- **Not so fast.** The Fed uses the excess bond premium in the credit market to predict the probability of a recession in the next 12 months. In 2019, this model has had an average recession risk of 16%. In the 12 months leading up to December 2008, it averaged 68%.

Is an Insurance Cut a Sure Thing?



- **It is what it is.** Typically, the Fed lowers rates when the economy begins to teeter or enter a recession. An insurance cut – an attempt to forestall potential economic weakness – may shield the US from a slowdown fueled by trade wars and tariffs with China. Inflation remains below the Fed's 2% target.
- **History repeating itself.** In 1995 and 1998, the Fed implemented insurance cuts despite economic stability. They were used as a safeguard against Mexican and Russian defaults, as well as the failure of Long-Term Capital Management. They seemed to prolong the economic expansion of the 1990s. With the current period of economic growth eclipsing the 10-year mark, and the benchmark rate at a historical low, the Fed may believe that an insurance cut is the best tool in the toolbox.

At IR+M, we believe that long-term views should drive portfolio construction. The recent yield curve inversion may be foreshadowing an economic recession, but our focus is on providing alpha while remaining duration and curve neutral. We believe that during this bout of uncertainty, it is prudent to be cautious and composed. While the changing shape of the yield curve and economic outlook may inform our decisions, they are but two of the many components of our investment mosaic.

Sources: Bloomberg Barclays and the Federal Reserve Board as of 6/30/19. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.