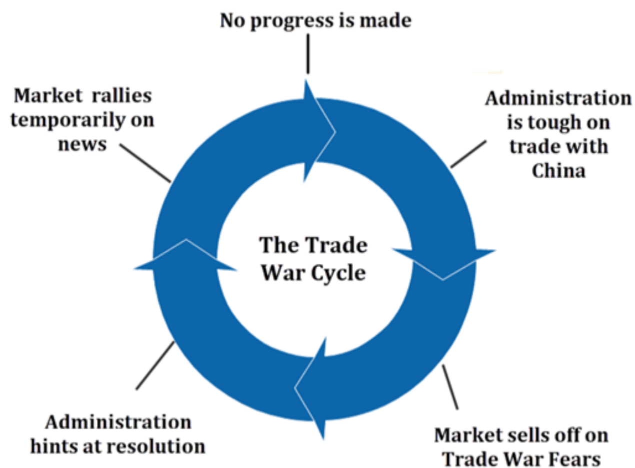
Graybill, Bartz & Associates, Ltd.

COMMENTARY

September 2019

The month of August was a roller coaster for investors, with volatility picking up in a month that traditionally has been marked by late summer calm. The Twitter account of President Donald Trump has ensured no such calm of late, as escalation in the trade dispute with China waged publicly via the social media platform has driven this increased volatility in markets. After 4 months of optimism to start the year, the last 4 have been marked by a common pattern in which trade war rhetoric heats up, markets panic, trade war talk cools down, and markets rally (rinse and repeat, see chart on right). As the tension and distrust on both sides of the Pacific has risen, economists at the venerable Wall Street investment bank Goldman Sachs recently declared that they no longer expect a trade deal before the 2020 U.S. Presidential election.



While this "Trade War Cycle" has resulted in gyrating, but generally rising, equity markets, it has resulted in a much more consistent pattern in the bond markets. Interest rates have had a clear trend for the entire year: down. The benchmark 10 year U.S. government bond yield has fallen from 2% to 1.5% in a month, continuing its slide from a high above 3% less than one year ago. Even more worrisome, the 30 year U.S. government yield has fallen below 2%, an all-time low. The reasons to explain the fall in rates have been numerous: declining inflation expectations, falling expectations of GDP growth, and lower rates in the rest of the world dragging down U.S. rates (with negative rates on government bonds in many parts of Europe and Japan). The fall in longer rates resulted in a long anticipated inversion of the yield curve in August (specifically the 2 year rate vs the 10 year rate).

As we have written in the past, a yield curve inversion results when short term interest rates are higher than long term rates. An inversion is abnormal because investors are generally compensated for the risk of lending for longer periods of time. Yield curve inversions are important because historically they have been the best signal of a coming recession of any economic indicator. While the precise reason for the explanatory power of inversions has been heavily debated, the results cannot be: over the last 50 years, the curve has inverted before each U.S. recession with only 1 false signal. This is the bad news. The good news is that the signal works with a significant lag, meaning that has not been a good idea to sell stocks immediately upon inversion. Since 1965, the average time lag between the yield curve inverting and the ensuing peak in the stock market has been 16 months, during which

Yield Curve vs. S&P 500 Peak vs. Recession

Inversion Date	S&P 500 Peak Date	S&P 500 % Change	# of Months	Recession Start	# of Months
12/17/1965	11/29/1968	18%	35	12/31/1969	48
3/30/1973	1/11/1973		-2	11/30/1973	8
8/17/1978	1/30/1980	10%	17	1/31/1980	17
9/11/1980	11/28/1980	12%	2	7/31/1981	10
12/14/1988	7/16/1990	34%	19	7/31/1990	19
5/26/1998	3/24/2000	40%	22	3/31/2001	34
12/27/2005	10/9/2007	25%	22	12/31/2007	24
	Average	**23%**	**16**	**Average**	**23**

Source: Bloomberg, Canaccord Genuity

time stocks rose 23% on average, with the economy entering a recession an average of 23 months from inversion. If history is any guide, the economy and stock market still have room to run over the next 1-2 years.

In the meantime, the current state of the U.S. economy can be summed in one word: divergence. On one side you have the consumer economy, with retail sales numbers continuing to be resilient in the face of negative trade war headlines. Target, a bellwether of the health of middle American consumers, reported strong sales growth in its latest earnings report, catapulting it to be the top performing stock in the S&P 500 during the month of August. Unemployment rates remain near all time lows, with little evidence thus far that this will turn dramatically. On the other side you have the industrial economy, which has been struggling as of late. The August ISM Manufacturing Index, a broad measure of manufacturing health in the U.S., signaled contraction for the first time in 3 years. Recent surveys of corporate leaders show increased hesitancy to invest in growth as the trade war vacillates.

Despite some recent negative headlines, there are positive signs heading into autumn. The dramatic fall in interest rates this year may help sustain the economic expansion, helping both Main Street and Wall Street alike. As you may have noticed yourself, mortgage rates have dipped considerably, with the benchmark 30 year fixed rate mortgage falling from an average of 4.7% last year to a current 3.8% according to Bankrate. This will help home affordability and allow many to refinance their mortgages at lower rates, putting additional dollars into the pockets of already healthy consumers. On the corporate side, a drop in rates will help companies support their debt burdens, which at this point look manageable. Despite the drop in bond yields, there has not been a widening of corporate credit spreads. Corporate credit spreads are the difference between what the government pays and what corporations pay on their debt. When investors are worried about the economy, corporate credit spreads widen, and when investors are optimistic, spreads tighten. Widening of credit spreads may also suggest that banks have cut back lending to corporate America, but there are few signs of that in August. Until banks slow or shut down lending, the economy should continue to grow, albeit at a slower rate.

Given the combination of the unpredictable nature of the trade war and the signal coming from the yield curve, markets may remain volatile in the short to medium term. In this environment, we continue to seek attractive opportunities to tilt portfolios in a more defensive fashion without meaningfully sacrificing upside, while maintaining a degree of cautious optimism from an easier Federal Reserve and continued U.S. consumer strength.

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