LEWIS
WEALTH MANAGEMENT

Newsletter

August 16, 2019

Executive Summary

The stock market swooned this week because the yield curve briefly inverted.

In the past, a sustained, inverted yield curve has been a fairly good predictor of future recessions.

But this time may be different as there are unpresented distortions in bond markets around the world that are contributing to this inversion.

That said, no one has abolished the business cycle and we are 10 years into the current expansion, the longest in modern history.

The newsletter discusses the causes of this yield curve inversion and what it means for investors.

Investors should prepare for continued volatility.

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Yield Curve Inversion Insanity

If you have been watching the news, you know the inverted yield curve is currently the subject of great interest and concern. Many investors have only a vague idea what this means. I think it is worth your time to take a deeper dive into this complex subject to see if this inversion should have an impact on your investment strategy going forward.

What is the yield curve anyway?

Normally, the yield is lower on short-term bonds than on long-term bonds. This makes sense, as the investor is committing his or her money to the issuer of the bond for a longer period of time. The longer the commitment, the more yield the investor normally expects. ***This is a normal yield curve (i.e., short-term yields are lower than long-term yields).***

What is a yield curve inversion and what causes it?

Every once in a while, the yield curve inverts. Short-term yields are higher than long-term yields. This can occur when investors flee to safety by buying long-term bonds. When this happens, the price of short-term bonds falls (because there is lower demand for them) and the price of long-term bonds rises (because there is higher demand).

Remember that bond prices and yields move opposite one another. The higher the bond price, the lower the yield, and vice versa. Because investors are fleeing to long-term bonds, the price of those bonds goes up and their yield moves down. Because investors are selling short-term bonds, the price of those bonds goes down and their yields move up. That's how the yield curve inverts.

Of particular interest is the difference in yield (or spread) between the 2-year U.S. Treasury note and the 10-year U.S. Treasury note. These are two bellwether bonds that are widely monitored by the markets every day. Normally, the yield on the 2-year Treasury is lower than the 10-year Treasury. Well, this week the yields on both those bonds hovered around 1.5%, and for a brief time, the yield on the 2-year was slightly higher than on the 10-year.

Why do the markets care so much whether the yield curve inverts?

In the past, when the yield curve between the 2-year Treasury and 10-year Treasury inverted for a lengthy period of time (like for several months), a recession has occurred within about 12 or 18 months of the initial inversion. ***Yield curve inversions have been a very good recession predictor.*** They have correctly predicted the past nine recessions. This is what panicked markets this week and caused investors to dump stocks and buy more long-term bonds.

Does this mean we are definitely heading into a recession?

Maybe, but not necessarily. I usually hate it when people say "This time is different," but current market conditions are unprecedented, and they ***may*** make this inversion a false indicator. Here's why.

First, ***interest rates are extremely low – some of the lowest rates in history***. Central banks around the world (except in the U.S.) have kept rates at rock-bottom levels to stimulate economic growth. In fact, yields on some bonds (like the German Bund) are actually negative. Low rates mean that the interest rate spreads between short-term and long-term bonds are very tight, which means it is easier for the yield curve to invert.

Second, ***the U.S. Treasury market is a magnet for cash right now***. Sovereign countries and large investors (and even small ones) have the need to park very large amounts of cash (billions) in safe investments in deep, efficient, and transparent financial markets. Since yields are near zero or even negative in Europe and Japan and the Chinese bond market is small and not transparent, the U.S. Treasury market is really the only game in town right now. And everyone, I mean everyone, is buying 10-year U.S. Treasury notes, which are currently yielding about 1.5%. As stated above, this is putting tremendous upward pressure on the price of the 10-year and driving down its yield at the same time. This is an important reason why the yield curve is inverting right now.

The bond market is currently being distorted by the difference in interest rates set by central banks around the world. This is also the reason the U.S. dollar is so strong right now – people and countries are exchanging foreign currency to buy U.S. dollars to buy U.S. Treasuries.

Third, ***the previous two factors are putting the Federal Reserve in a really awkward position***. In the past couple of years, the U.S. economy has outperformed most other economies. The Fed has been raising key short-term interest rates to unwind the monetary stimulus that was in place during the Great Recession. Most economists have viewed this as appropriate. The economies of other developed countries have experienced only tepid recoveries. Central banks in those countries are keeping rates low. Consequently, money is pouring into the U.S. to take advantage of our relatively higher rates. As discussed, this is raising bond prices and lowering yields on U.S. Treasury notes. So, the Fed is in a bind. The more they raise short-term rates, the more they are helping the yield curve invert. President Trump feels that the Fed should be lowering (not raising) rates to help correct this distortion and stimulate the economy. And the Fed recently did cut short-term rates by a quarter point, and another cut is probably coming in September.

All three of these factors are putting artificial pressure on the yield curve to invert. ***The Fed is pushing up yields on the 2-year Treasury while the market is pushing down yields on the 10-year Treasury. That is why some economists are stating the inverted yield curve may not be a true recession indicator this time around.***

To be sure, no one has abolished the business cycle. We are 10 years into this expansion, the longest in modern history. ***It would not be a shock to have a recession on the horizon.*** The trade war with China is pulling down global growth. Germany has recently hit a soft patch. U.S. manufacturing numbers are off. That said, labor markets and consumer confidence remain strong.

I would watch leading economic indicators in addition to this yield curve inversion. It is still possible for us to avoid a recession. Only time will tell.

What should an investor do right now?

A good portfolio should already contain conservative bonds. Therefore, you already own bonds that panicked equity investors want to own. They are bidding up the prices on those bonds. This will increase the rate of return on your bond portfolio and help offset the losses you may be suffering on the equity side. Panic is never a sound investment strategy, and panicked investors are selling stocks and buying conservative bonds right now. Stock markets are still up for the year, and other asset classes, like real estate, are still doing well.

If you have a long investment horizon (and you should), you can simply use this volatility to rebalance your portfolio. Let your bond positions help cushion the downside, and look for opportunities to buy stocks when markets are down. Make sure to add other asset classes, like real estate, to help diversify your portfolio.

Most importantly, make sure your asset allocation correctly fits your long-term goals and your risk tolerance. Prepare for volatility . . .

If you have questions or concerns about your situation, please give us a call at (855) 353-3800.

Thank you,
Austin Lewis