April 15, 2019

Dear Client,

When I was a little kid, my dad was the smartest guy on the planet. He wasn't around much, because he worked six days a week and two nights, but when he was, I dared not try to pull anything over on him because he would cut through my shenanigans like a laser. Well intelligence must be transient, because no sooner did I turn about thirteen, did my dad ever get stupid! He remained this way, in this transitory period of low I.Q. for most of my teenage years, and then amazingly, one day, he started getting smart again!! By the time I was in my twenties and working with my dad every day, he had made a full recovery!

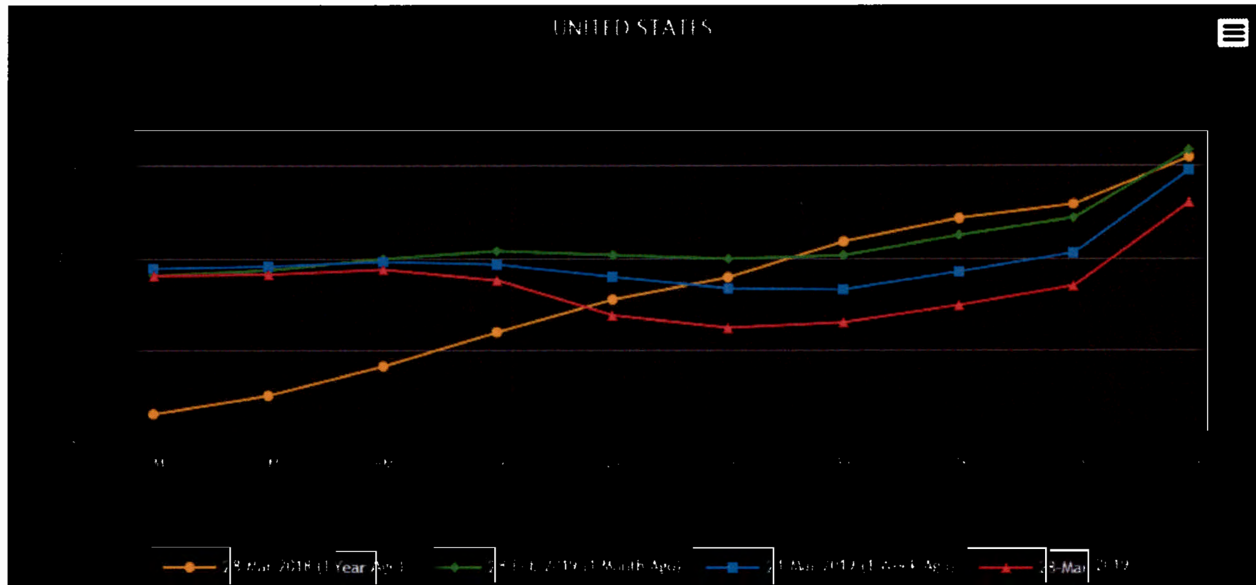
I mention this anecdote, because I had a remarkably similar experience over the past six months. At the end of last September, I was feeling pretty smart. The S&P 500 was sitting on a nice double-digit gain for the year, and all we needed to do was coast for a few more months through the fourth quarter. Well the stock market didn't get the memo, and proceeded to have the worst December since the 1930s. I looked back at those September account values, and frankly I felt pretty stupid to have let those gains slip away. Fortunately, unlike my hapless dad who had to endure a low IQ for most of my teenage years, I recovered really fast. Here we are, about three months after the Christmas Eve low in the S&P 500, and the stock market has recovered about 80% of what it lost from the September peak. I am smart again.

The S&P 500 returned 13.65% for the first quarter of this year. Most people would call this a good return—for the whole year. Obviously it is not going to continue linearly at this rate, or it will be up 54.6% by Christmas; possible, but very unlikely. Only fools predict the stock market. Well, here I go: More than likely, we are entering a period of time when the market digests the gains made so far, and moves sideways to lower over the next several months.

Lately we hear a lot of talk about something called an "inverted yield curve". What is this dreaded thing? What does it portend for the economy and the stock market?

The Yield Curve is just a graph with interest rates on the y axis and time on the x axis. It is kind of like the price of money shown across a range of time frames. Generally, people want to be compensated more for loaning money for a long period as opposed to a short period. A "normal" interest rate curve slopes up and to the right. Loan money overnight? Earn a small return. Loan money for ten years? Earn a bigger return. The Federal Reserve Bank, through monetary policy, sets the price of money loaned for the very short term. If Chairman Powell says the overnight rate is 2.25-2.50% that is the rate, period. The rate for long-term loans is set differently. No one person or entity sets the yield on the ten year Treasury bond. It is set every second of every day by the bond market. If more people want to buy bonds today than yesterday, the price of the bonds go up and the yield goes down, and vice-versa.

Here is what the yield curve looks like right now:



The purple line is where interest rates are as of 3/28/19. The blue line shows where they were one week prior, and so on. Two items stand out: 1. Long term rates have dropped over the past month and 2. Short term rates have risen over the past year. The ten year rate is now slightly higher than the three month rate, which is not normal. Hence, the Inverted Yield Curve.

This begs two questions. How did it get inverted, and what does this mean for the economy and the markets?

I believe there are two main reasons. One, the Federal Reserve has raised interest rates too far and too fast. The Fed last raised rates in December, and at that time they told us to expect several more hikes in 2019. Instead of letting the market's expectations of future inflation and growth guide them, they were focused on current economic data, which showed a strong economy. Though not always right, markets are very good at sniffing out future events. The second reason is related to the world economy, especially non-US developed countries. Europe and Japan are not growing at all and may be shrinking. This is despite the fact that interest rates in those counties are close to zero or even negative. So while a US treasury bond yielding 2.41% may sound puny, to a German investor, whose own country's ten year bond yields 0.385%, they look like a deal. Trillions of dollars flow between global bond markets every day, and money chases the highest return. So foreign investors sell Euros and buy dollar-denominated bonds, driving up the dollar in the process. All this foreign demand is pushing down our long term bond yields.

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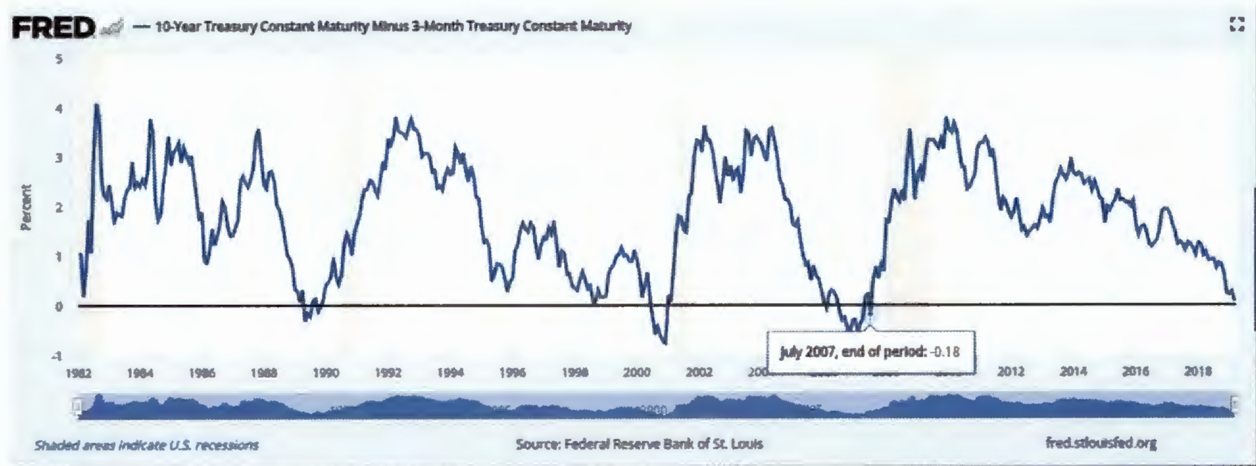
What does this mean for our economy and markets? Here is another graph of the ten year yield minus the two year yield*:



When the blue line goes negative, like it is right now by a tiny amount, the curve is inverted. Unfortunately, those grey vertical bars indicate past recessions. According to Bianco Research, the past six times the curve has inverted and stayed that way for at least ten days, a recession has followed within two years**:

Today is day 1.

How Long Until The Recession?

When the 3M/10Yr Curve Inverts For 10 Straight Days

Date of Inversion	Date of Next Recession	Days to Next Recession
1/10/1969	Dec-69	325
6/14/1973	Nov-73	140
12/8/1978	Jan-80	389
11/7/1980	Jul-81	236
6/6/1989	Jul-90	390
7/31/2000	Mar-01	213
8/1/2006	Dec-07	487
Average		**311**

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So this means a recession could start on average, about ten months from now. Not very helpful. As for the stock market, Bianco also notes that not every inversion is followed by a recession, and the S&P 500 did surprisingly well over the next year***:

Stocks Can Thrive After An Inverted Yield Curve

(S&P 500 Performance After Inversions Started)

- 1 month later: +1.74% on average
- 6 months later: +6.75% on average
- 1 year later: +9% minimum since 1978

Source: Bespoke Investment Group, per Barron's

At the end of the day, I believe this tiny interest rate anomaly is just another data point among a million different factors. In my opinion, the most likely outcome is that the Fed will start to lower rates, driving down the short term yield back below the long term yield. Recessions and bear markets are usually caused by policy errors or some exogenous event. I think the Fed has realized it was too aggressive, and they are correcting the situation now.

We often say what matters most is not timing the market, but time in the market. The economy and the market have their ups and downs. There will be another recession at some point. Stocks have provided a positive real return over the long term, and if we get sub 2% interest rates again any time soon, those dividends are going to start to look good again. Time has a way of making us look smart.

Regards,

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Joseph Brady
Sr. Vice President, Investments

Tonya Rasmussen
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*https://www.barrons.com/articles/the-yield-curve-just-inverted-that-doesnt-mean-sell-stocks-
**51553267161https://twitter.com/biancoresearch/status/1109094867790151682?mod=article_inline
***https://www.investopedia.com/why-s-and-p-500-may-surge-over-next-year-despite-yield-curve-angst-4589903

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. Opinions expressed in the attached article are those of the author and are not necessarily those of Raymond James. All opinions are as of this date and are subject to change without notice. Individual investor's results will vary. Past performance does not guarantee future results. Future investment performance cannot be guaranteed, investment yields will fluctuate with market conditions. Keep in mind that there is no assurance that any strategy will ultimately be successful or profitable nor protect against a loss. Investing involves risk and you may incur a profit or loss regardless of strategy selected, including diversification and asset allocation. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Prior to making an investment decision, please consult with your financial advisor about your individual situation. The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. International investing involves special risks, including currency fluctuations, differing financial accounting standards, and possible political and economic volatility. Dividends are not guaranteed and must be authorized by the company's board of directors. There is an inverse relationship between interest rate movements and bond prices. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices generally rise.