JS Replogle & Associates LLC

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RepReports

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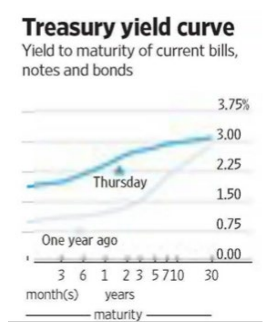
Perspectives

This quarter let's look at two terms in the spotlight of the financial news right now. They are the ***Yield Curve*** and ***Trade Wars (tariffs)***. The first is more of a finance calculation and the second more of a political expression. Both have elements of the other, finance and politics.

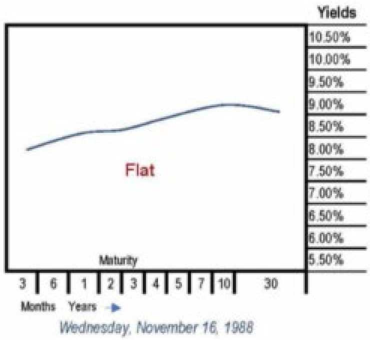
Yield Curves

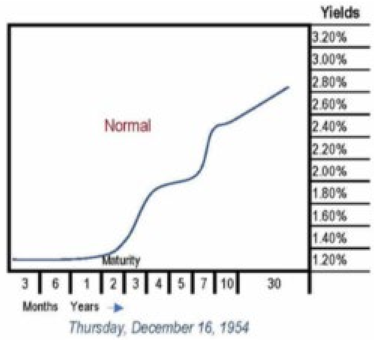
The yield curve, or the difference between shorter and longer Treasury yields, has gotten a lot of press coverage for the signal it supposedly sends about the economy. Lately, the curve, or yield-spread, illustrated below, has gotten awfully flat, for some not a good sign. To better understand the yield curve, we will need to dive into a fuller understanding of how it is constructed.

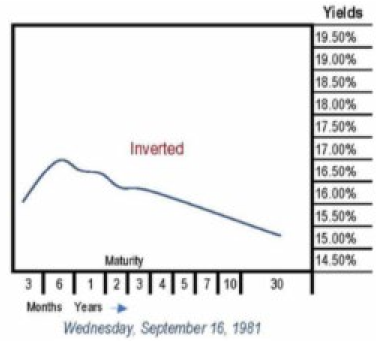


July 27, 2018
Source: Ryan ALM, Tullett Prebon; WSJ Market Data Group

The "yield curve or spread" is really a graph with key points or yields, plotted along the axis of their maturity. Short duration notes to the left and longer maturities moving to the right. The data usually comes from the Table of Treasury Bonds, Bills, and Notes. The exact points along the graph may vary, but the graph typically includes short, intermediate, and longer maturities. For example, interest rates for the three-month, six-month, one-year, two-year, five-year, ten-year, and 30-year Treasury maturities may be included. Often the yield curve from the previous year is illustrated along with the current spreads.For purposes of comparison, look at the three charts on the next page, which show three yield curves that differ significantly from each other. Pay attention both to the interest rate levels and to the shape of the curve. Please note that these charts illustrate notes from three months of duration to thirty years. Often yield spreads are illustrated by different time periods. For example, the spread between the two-year and ten-year notes —sometimes named the "2-10". Some economists look at the 2-year and the 30-year spread, others believe that the seven-year toten-year tells the tale. The tale is one of recession. More on that in a moment.







The first graph, dated November 16, 1988, shows three-month bill rates at about 8 1/4% and 30-year rates at 9%. The difference in yield between the three-month rate and the 30-year rate (the spread) is about 80 basis points (less than 1%). That is considered very narrow. As a result, this would be considered a relatively flat yield curve.

The December 1954 graph shows bill rates at about 1.2% and 30-year bonds at about 2.7%. The spread between the shortest three-month paper and the 30-year maturity is about 150 basis points (1 1/2%). That is considered a normal, that is, an upward sloping, yield curve, with long bonds yielding considerably more than short maturities. The 150-basis point spread is somewhat narrow for an upward sloping curve, due to the overall low interest rate level. At higher interest rate levels, the spread has been as high as 250 to 300 basis points.

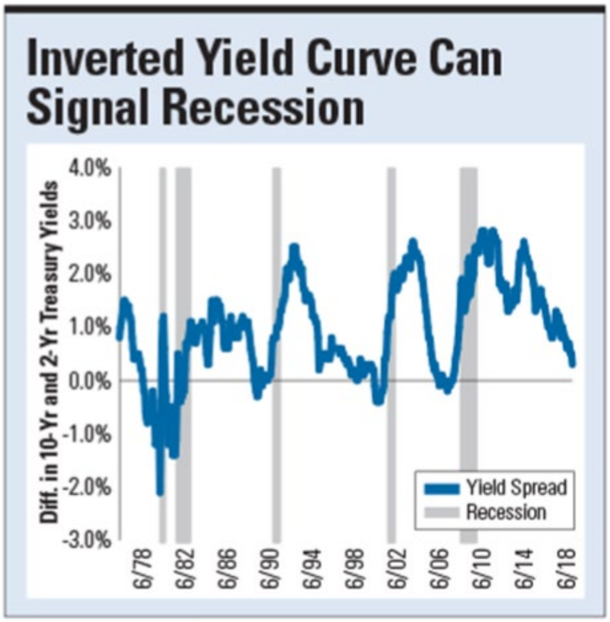
Finally, look at the last graph, dated September 1981. Three-month rates are close to 16%; six-month rates are 17%; 30-year rates are below six-month rates, at 15%. That is called an inverted yield curve, with long rates lower than short rates. That suggests that the market is predicting lower rates at some future date, and therefore slower economic growth. For that reason, inverted yield curves are believed to predict recessions. Unfortunately for some would-be forecasters, it is also said that postwar, inverted yield curves have predicted nine out of five recessions.

Currently, the 10-year Treasury yield, at 2.89%, is just 0.3 percentage point higher than the yield on the two-year Treasury. With the Fed on course to keep raising short-term rates, it is easy to imagine the two-year yield rising above the 10-year yield. That is worrisome, since such yield-curve inversions have been for many forecasters, a reliable indicator of coming recessions.

An inverted curve is a signal investors believe that the Fed's current rate-raising efforts are going beyond what the economy can handle and overnight rates will eventually fall. Fed policy makers don't seem to think that is the risk now.

Rather, they think longer-term yields are lower than they should be because of all the bonds purchased by the Fed and other central banks to prop up their economies. They believe that has driven term premia—the extra yield investors demand for the risk of lending over a long period— negative.

According to Federal Reserve Bank of New York estimates, if the average term premia that prevailed over the past 25 years were in effect today, the 10-year Treasury yield would be about 1.4 percentage points higher than the two-year yield.



In 2006, the Fed's view of the inverted yield curve was that a global savings glut had pushed down long-term interest rates. Meeting transcripts show policy makers believed this had driven down term premia, just as they see the glut of central bank holdings driving down term premia now. As a result, they weren't all that worried about the inverted yield curve. By the end of 2007, the economy had entered a recession and they were frantically cutting rates.

In the Fed's defense, it probably was right in 2006 about the cause of low long-term rates. What it missed was that those low rates drove investors to take on more risk to boost yields—in many cases risks they didn't understand.

Today, evidence abounds —from super tight spreads to negative yields to high stock valuations to the popularity of structured products—that investors are willing to take risks to capture yield. Since the financial crisis, the Fed has paid more attention to such dangers. But it appears to have a blind spot when it comes to the cause of the flattening yield curve.

Two things are worth noting. The first is that on average, these five recessions didn't begin until more than 16 months after the yield curve inverted. Even the 1981 recession didn't begin until 11 months after short-term interest rates rose above long-term rates. Second, because there have been very few recessions, we haven't got a whole lot of data to go on. So, maybe the inverting of yields signals a recession, and maybe not. It looks good, but as you can see, the yield curve often reverts to normal before a recession begins.

Now, let's just consider why the current yield curve is causing such panic. At the short end of the maturity spectrum, the Federal Reserve has been lifting interest rates, and this has had an immediate impact on short-term bond yields. But while the "short" end has been rising, bond yields at the longer-maturity end of the yield curve typically respond to changes in inflation, rather than Fed policy. And so far, inflation has been quiescent. Despite all the concern, though, at the end of June the 2–10 yield spread was still 33 basis points, or 0.33%. While there's no question that another recession is in our future, predicting when it will occur is a tough game. I'll stick with "slow growth, not no growth" over "impending doom."

Note: Much of the factual information was obtained from The Bond Book by Annette Thaw, and from a July 23, 2018 Wall Street Journal article entitled "Fed Shouldn't Ignore Yield Curve", and from a recent article in The Independent Advisor.

Tariffs and Trade Wars

In the formation years of the democracy known as the United States of America, the institution of government was primarily financed by bonds sold to the general public and by tariffs placed on the importation of goods into the country. Throughout these earlier times the size of the tariffs and the products to which they were applied ebbed and flowed as economic times shifted and different political philosophies gained political strength.

James Polk, running for president in 1844, crafted a new concept designed to assuage Southern planters as well as Northern industrialists. Polk proposed legislation based on two principles: first, tariff rates should not exceed levels needed to run the government on an economically sound basis; second, within that range the government could acceptably impose targeted duties to benefit specific industries in need of protection. Polk's bill, typically viewed as a "free trade" measure, passed Congress in 1846 and served as the country's fiscal bedrock through the 1850s, with average tariff rates running generally between 20 and 28 percent.

The argument between "protectionist" and "free-traders" continued for decades until the financial costs of the Civil War, moved the tariff rates to well over 40 percent. Over time this created government coffers that were over-flowing, and the Democrats sought to bring a better balance by cutting tariffs led by their primarily "free-trader" Grover Cleveland. This in turn, created negative budgets just as the advent of the industrial revolution of the late 19th and early 20th century was getting started.

Throughout history we see the pendulum of a specific issue, swing widely back-and-forth. In 1896 William McKinley was elected president substantially based on his "McKinley bill" introduced while he was on the powerful House Ways and Means committee. Speaking on the floor of Congress McKinley had dismissed opposition warnings that high tariffs would curtail U.S. exports as other countries put up retaliatory barriers. "We place no tax or burden or restraint upon American products going out of the country," insisted McKinley, citing statistics showing that U.S. exports increased under protectionist policies and declined during free-trade periods. "This bill is an American bill. It is made for the American people and American interest." (congressional applause.)

Does any of this sound familiar? American economy is based on democratic capitalism. The thought is that the producer of a sought-after product that delivers the highest quality at a desired price-point will succeed when others fail. In a sense this is a form of "free-trade" thinking, and it works pretty well within the boundaries of the United States where we all have the same form of currency and the government takes a "hands-off" position, only inserting itself when safety or unfair practices seem to warrant intervention.

However, problems arise when foreign governments, using foreign currencies, choose to subsidize the price of a product to increase labor opportunities or to gain market share on a unique product. This is a form of price-support.

Our current administration is using an old strategy to both better balance the government budget, level the trade imbalance, and punish those nationalities that seem to be taking advantage of various pricing strategies designed to negatively impact the United States. Setting aside the language, tactics, and vulgarity of the strategy, it seems we have been here before.

Therefore… 3 Narratives

As we conclude the two discussions on the Yield Curve and Tariffs, the natural next question may be, "so what does this all mean for the market (or client's portfolios)?"

The 1st and most obvious way the future may unfold is based on economics and politics. This is a short-term, but unsustainable boost to growth from the recent tax-cuts and China's stock piling of selected commodities like soybeans ahead of potential tariff initiatives. Additionally, higher oil prices are driving renewed investment in drilling operations; there is a rebound from weak household consumption in the first quarter, and second quarter growth of 4.1%. The more cynical individual might even note that with mid-term elections approaching, the growth figures were the strongest since before the last midterms, when the former President wanted people to feel good before voting.

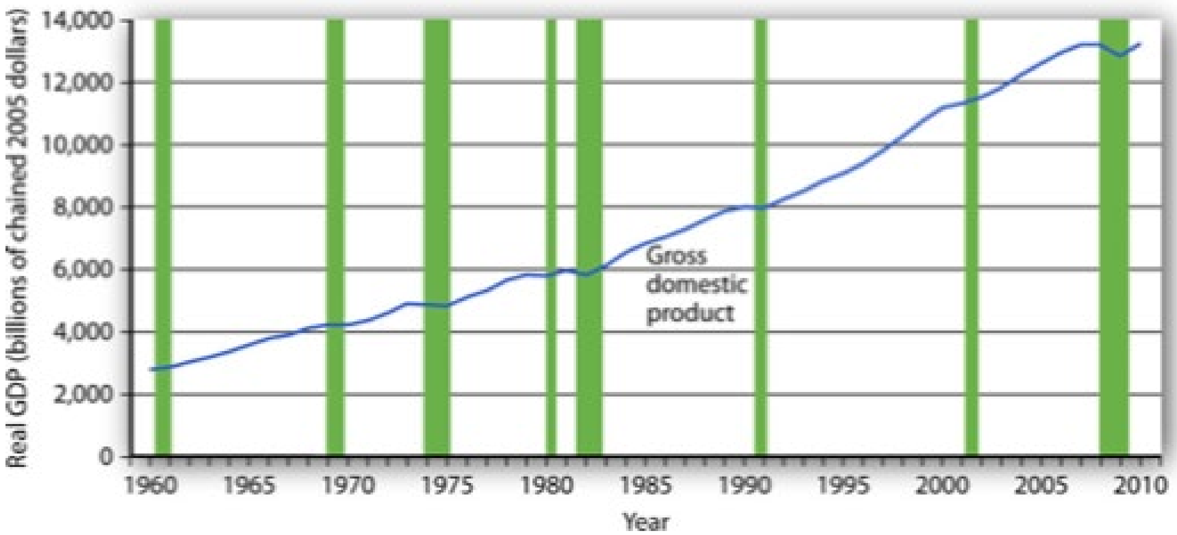
A 2nd and broader perspective could be that the American economy is approaching full capacity, the Federal Reserve raising rates and an economic cycle well into its final phase after nine years of growth. Investors should be loading up on cash and commodities as they prepare for inflation, and be more cautious of economically sensitive, or cyclical, stocks. The peak in long-dated bond yields is worth watching for as the cycle approaches recession. This doesn't mean recession is imminent, but it does mean a change from the pattern of the past few years. The reader may wish to refer to the previous article on the *Yield-Curve*.

There is a major caveat to which even bearish investors need to pay attention. Cycles often end in wild excesses. The last cycle ended with an oil-price bubble and financial boom, while the previous cycle ended with the dot-com bubble. Manias are hard to predict, but now is a good time to be looking for them. It should not go un-noticed that our current President had the good fortune to take over an economic cycle that began in 2009 and was beginning to take-off after the Japanese/European recession of 2012 which the U.S. escaped. This suggests we may be towards the middle of the current cycle.

The 3rd narrative relegates the economic data to their proper place as an unreliable and heavily revised set of guesstimates. Instead, focus on the market. Stocks and bonds are telling a tale of a cycle that began only in 2016, a few months before our current president was elected.

The performance of bond yields and cyclical stocks from July 2016 was akin to the euphoria that follows the realization that recession is over. Benchmark 10-year Treasury yields have more than doubled from 1.36% to 2.98%, and the MSCI Cyclical Sectors Index beat its defensive counterpart by 44% from the low two years ago. That was slower but almost exactly the same size as the 46-point outperformance by cyclicals in the 2009 recovery, up to the 2010 realization that growth wouldn't quickly return to normal.

There may have been no recession this time, but the belief in deflation that set in two years ago wasn't much different. The good news is if the markets are right, there may be many more years before we need to worry about recession.

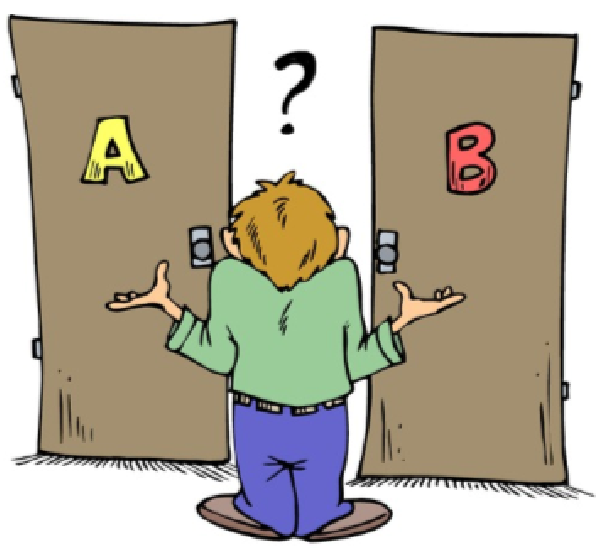


However, the markets already are suggesting a pause. Cyclicals and bond yields both have taken a breather over the past two months; one interpretation is that they anticipated a lot of growth and it has begun to arrive, but it is already priced in.

Another is that a switch to midcycle investing, more balanced between cyclicals and defensives, at least outside the energy sector, is under way.

Market prices, of course are no more "the gospel truth" than are the extrapolations of economists. Worse, the performance of cyclicals might have been distorted by the rise of disruptive technology companies (Amazon, Google, Facebook, etc.), which are counted in cyclical sectors but are being bought by investors for their ability to grow and profit whatever the economy does.

It is hard to avoid choosing one of these narratives, even though all three are plausible. I'm inclined toward the first story line, one of a short-term boost, in the middle of a longer slower period of growth. But, anyone who is certain what is going on is almost certainly fooling themselves. However, if the U.S. is still in the middle of its economic cycle, there is more growth ahead.



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