The yield curve is the Camellia sinensis of the investment world: As assiduously as some people read tea leaves, investors scrutinize the yield curve in search of insights into the future of the economy. The curve is simply a plot of Treasury interest rates over time, ranging from overnight to 30 years. Typically, the curve is upward sloping, because investors demand higher rates to take longer-term risks. The level, slope, and shape of the curve all convey information to investors.

The yield curve is particularly significant now, as a barometer of market sentiment about the Trump administration’s legislative outlook and the trajectory of the Fed’s current tightening cycle. Intuitively one would expect that as the Fed raises interest rates, yields would rise for all maturities; in other words, the spread between 2-year and 10-year Treasury yields would remain unchanged, as the entire curve lifts with each rate hike. However, since the beginning of 2017, this spread has actually narrowed. Investors have been buying longer maturities while selling short-term bonds, thus flattening the slope of the yield curve. What terrifies investors is that a flat yield curve is just a small step away from an inversion, in which long-term yields are lower than short-term yields. Every time the curve has inverted since World War II, a recession has followed within a year. (The Fed knows this, too; see adjacent article.)

Despite the optimism surrounding President Trump’s economic agenda, soaring stock prices, and strong economic data, bond investors are still worried. The spread between the 2-year and 10-year T-Notes is notably thinner than its 5-year average of 159 basis points. In our view, the likely causes of this phenomenon are fears that an aggressive Fed may hamper GDP growth, persistently low inflation, concerns about prospective tax cuts; and a steady flow of foreign buyers as European yields remain in negative territory.

Despite the modest flattening of the yield curve, we maintain our positive outlook for the U.S. economy. We expect earnings will continue to improve, global growth will regain strength, and President Trump will push through some tax and infrastructure plans, which will help the U.S. economy once again expand just over 2% this year.
Stock markets worldwide rise on earnings growth

By Rose Grant-Brooks
Equity Strategist, Eastern Bank Wealth Management

The S&P 500 index has tripled since its 2009 bottom, generating 19.5% annualized returns with dividends (including 6.1% in the first quarter of 2017). Can the current bull market keep moving upward? Solid economic growth provides a favorable framework for equity performance for the remainder of the year. Economies are growing not just in the U.S., but also internationally, which is favorable for U.S. corporations operating abroad. In addition, corporate profits have improved after suffering through six straight quarters of flat or negative growth due to the energy sector woes and a strong U.S. dollar; further profits growth, combined with stable energy prices and currencies, should help U.S. equity markets move higher.

Stock prices are rising this year worldwide; not just in the U.S. After many years of underperforming the U.S., Europe has seen an improvement in earnings leading to higher equity prices. Emerging markets — written off by some pundits late last year as likely victims of President Trump’s agenda — also have seen a lift in equity prices, as economies worldwide have improved.

So what could go wrong? Potential downside risks for the equity markets include weaker than expected earnings, sharply higher interest rates, and failure to implement key parts of President Trump’s political agenda. Although any of these events could lead to a sell-off, we would view such an event as a correction and not an end to the bull market.

American markets may be especially sensitive to political issues. To some degree, equity investors still expect tax cuts, infrastructure investment, and curtailment of certain business regulations. The disappointment of failing to pass a health care act in a Republican-led Congress is perceived as a negative and raises the question of whether other market-friendly Trump policies can be enacted. Some are appealing to both Democrats and Republicans; these include a partial tax holiday on earnings repatriated from abroad, lower corporate tax rates, and infrastructure investment incentives. Most of these are considered stimulative to the economy, and a failure to pass any legislation on these topics could be a negative to the equity markets. Yet with economic fundamentals and corporate profits improving, we expect the market to continue higher.

Another first quarter GDP stumble masks strong domestic growth

By Christina Lakich
Assistant Vice President, Eastern Bank Wealth Management

Optimism has skyrocketed since the presidential election, with consumer and business confidence surveys hitting multi-year highs. The data for manufacturing and services has also been solid. Yet the U.S. once again posted a weak first quarter GDP reading. How do we account for this disconnect between actual output and surveys? Should we be concerned about the health of the U.S. economy?

In our view, the domestic economy is tracking well. We believe that improvement in sentiment tends to lead to stronger growth. Federal Reserve Chair Janet Yellen recently noted that “GDP is a pretty noisy indicator,” and that she prefers to look at broader trends for growth rates over several quarters. In this respect, recent data support a positive outlook.

Retail sales have been up for nine of the past ten months, while corporate capital expenditure orders are showing their first annual gains since late 2014. Housing starts are on pace for a big gain this year. The unemployment rate has fallen to decade lows, even as millions of people are returning to the work force.

Most likely, seasonal aberrations, such as the timing of data collection and unusual weather patterns are partially to blame for the first quarter GDP weakness. We anticipate that history will repeat itself, and the first quarter’s tepid pace will be followed by a strong rebound in subsequent quarters, with GDP averaging 2.2%-2.5% this year.