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ON OUR MINDS

Bad Moon Rising?

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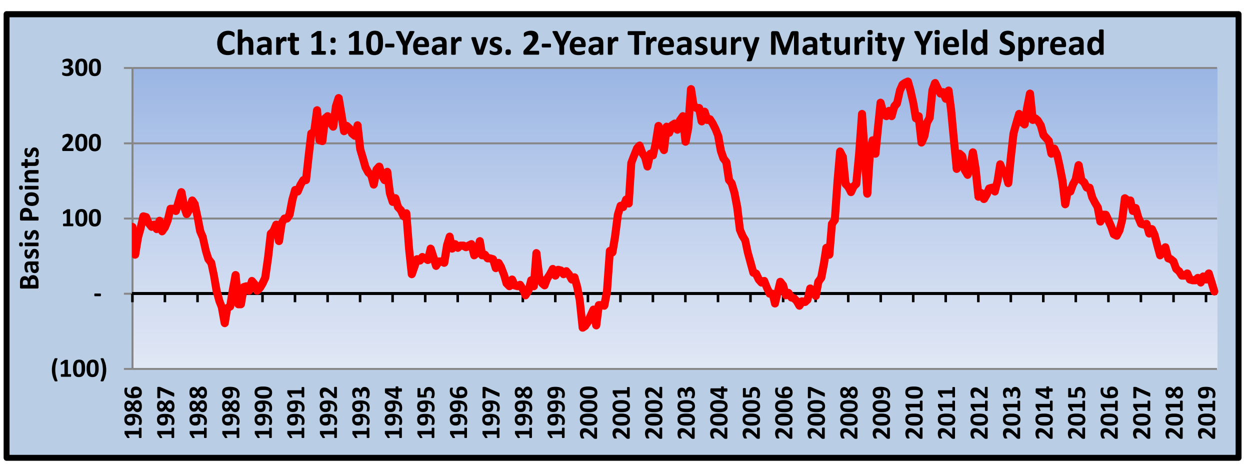
Did you see the full moon last Wednesday? It was absolutely gorgeous; but as full moons often do, it also brought out the wailing of the banshees, or at least of the cable TV pundits bemoaning the inverted yield curve and record-low 30-year Treasury yields and China's slowing growth and Germany's recession and Eurozone somnolence and whatever other factoids they could find to justify their gloom. But it was probably just the full moon.

I see a bad moon a-rising
I see trouble on the way
I see earthquakes and lightning
I see bad times today

John Fogerty was probably writing about Vietnam when he penned those lines fifty years ago,[1] but they also aptly describe the current investment climate. The U.S. economy is doing very well – as witness 2.1% GDP growth, 3.7% unemployment, 1.8% inflation, 3.1% wage growth, all excellent readings – but you'd never know it from the tone of most market watchers lately.

The immediate catalyst for last week's stock market nosedive was the brief inversion of 2-year and 10-year Treasury yields. Investors panicked because they have been warned incessantly that such an inversion (in which short-term yields are higher than long-term yields) inevitably leads to recession. Yet as Chart 1 shows, the inversion Wednesday was by just one basis point (0.01%), and it didn't even last a full trading day.

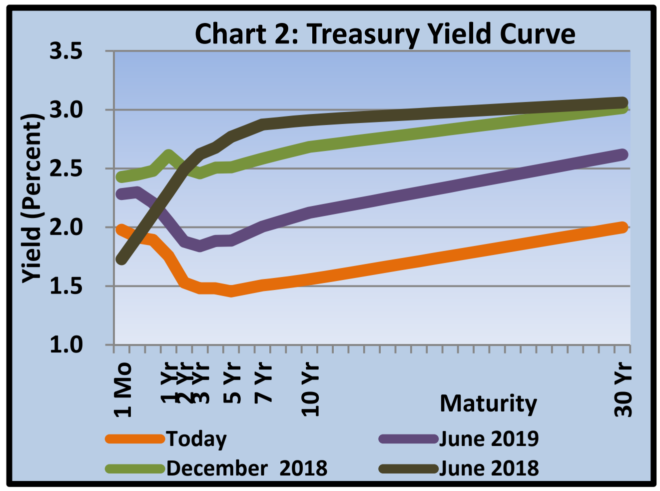


Source: FactSet

[1] Alternatively, he was prescient about climate change. Creedence Clearwater Revival hit the singles charts with "Bad Moon Rising" in the summer of 1969, about a decade before even the earliest reports of anthropogenic climate change were published, yet the lyrics eerily foretell altered weather patterns.

Such a small and short-lived inversion cannot possibly be considered dispositive. A similar inversion occurred in 1998, when Asian currencies crumbled and a large hedge fund's failure almost caused a financial crisis. Quick action by the Federal Reserve to inject liquidity and stability averted the crisis, and spreads reverted to normal for another two years.

Last week's inversion was newsworthy only because the 2-year and 10-year Treasury yields are so widely watched as benchmark rates. But other parts of the yield curve have been inverted for months, as shown in Chart 2. This chart shows Treasury yields across the entire maturity spectrum from overnight to 30 years, at four different points in time. The top line, showing the curve at June 2018, displays a "normal" shape, with longer maturities carrying higher yields and a mostly convex shape to the arc. Six months later, at year-end 2018, a "kink" had developed, as the slope turned negative for a small portion (1- to 3-year maturities) of the curve. By June 2019, the kink had become a clear inversion through three years. Today, the curve is inverted through five years and is also sharply lower than it has been in years; the 30-year rate has never been lower.

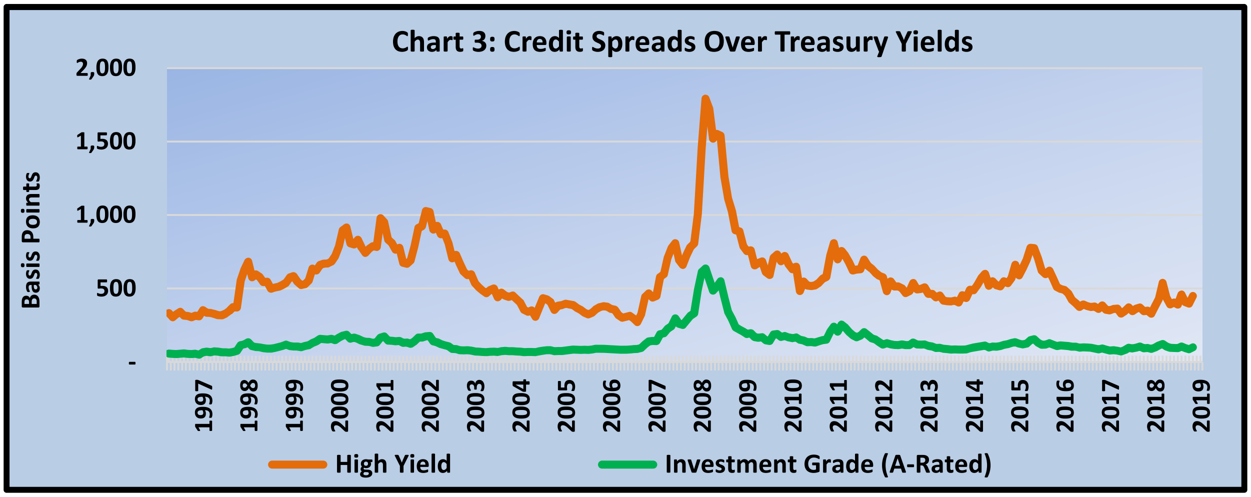


Source: FactSet

Is this a warning sign? Is a recession on the way? It's a pointless question: *Of course a recession is coming.* Recessions and expansions are simply artifacts of human nature and the play of our emotions on our economic behavior. The relevant questions are *when* and *how severe* the next recession will be; for this, alas, the yield curve offers little help. Typically, recession has arrived six to 24 months after a sustained inversion of the 2- and 10-year maturities; we haven't even gotten to the sustained inversion yet, let alone the expected time lag. So the best we can say from the yield curve is that we'll get a recession at some point in the future, possibly a year or two from now. Because the current expansion has been one of the slowest (albeit longest) on record, few excesses have developed and the next recession might therefore be shallow and short.

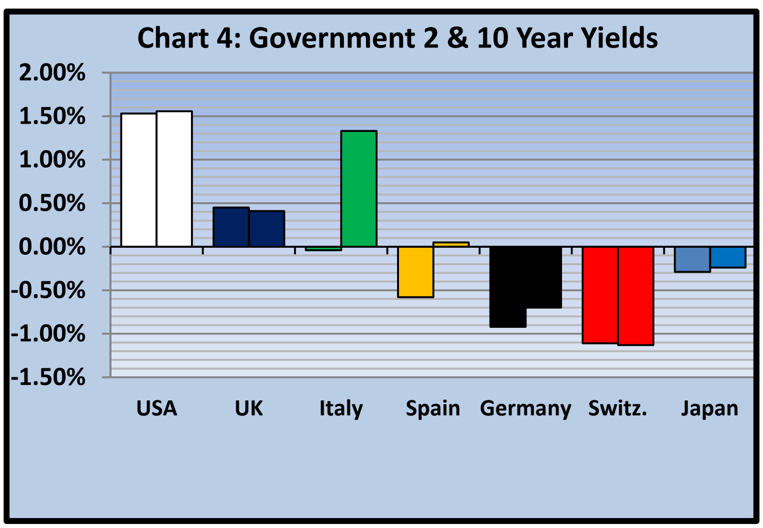
> *I hear hurricanes a-blowing*
> *I know the end is coming soon*
> *I fear rivers overflowing*
> *I hear the voice of rage and ruin*

While the cable TV "experts" are doing their best to stir up a frenzy, the bond markets were considerably more restrained. Chart 3 shows how investment grade and high-yield corporate debt yields have compared with Treasury yields of the same maturity, over the past 20-plus years. If a recession were imminent, bond investors would shun corporate debt, resulting in higher differentials ("spreads") between corporate and Treasury debt. This was plainly in evidence before and during the 2001 and 2008 recessions, but not today. While corporate spreads have widened slightly in the past six months, bond investors aren't panicking.



Source: Federal Reserve Bank of St. Louis; Bank of America Merrill Lynch

So why have Treasury yields fallen so much? Why did the entire yield curve (Chart 2) drop from year-end 2018 to today? The answer lies mostly overseas, not here at home. Chart 4 shows government bond yields across several major economies. Struggling to jump-start stalled economic growth, central banks in Japan and across Europe have maintained zero or negative short-term interest rates, and they have bought long-term bonds in the hope that lowering the price of money would create demand for loans and better industrial production numbers.



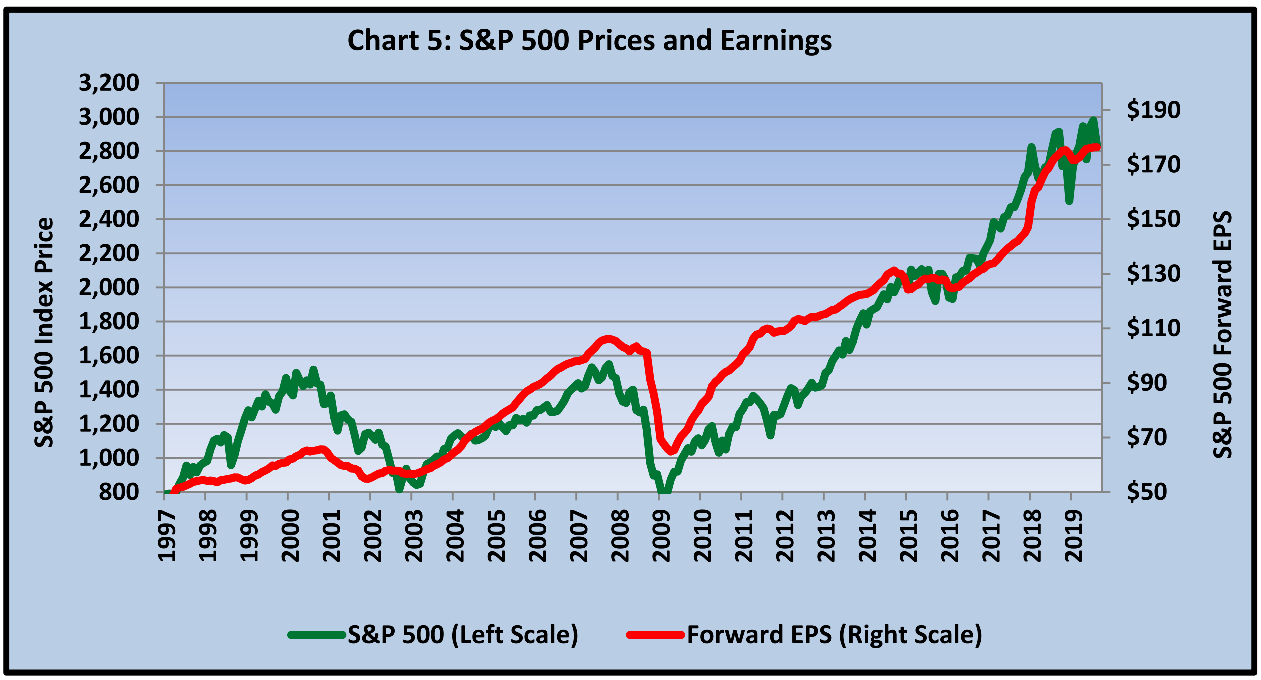
Source: FactSet

It's no surprise, then, that bond yields have plunged across most developed foreign markets; indeed, over $16 trillion in debt now carries negative yields. By contrast, a 1.5% Treasury note looks like a great bargain: No other major economy comes close to the same combination of cheap price and high quality. That dynamic, more than any economic data, is keeping a ceiling on U.S. interest rates, especially at the longer end of the maturity spectrum.

Yet the European Central Bank policies have starved the Continent's banks of capital and given investors palpable reasons for concern. Across the globe, Japanese bond investors also have much to fear, starting with the pronounced slowdown in China's industrial production and that nation's ballooning debt. These factors have been exacerbated by the potential for U.S. tariffs on Chinese imports to depress demand worldwide – and this, too, has held down U.S. bond yields. It's also fair to note that some important sectors of the U.S. economy – most notably housing and business investment – have sagged lately, adding to bond investors' worries and thereby putting downward pressure on U.S. interest rates.

President Trump still seems committed to his economically damaging tariff policies. Likewise, the ECB and Bank of Japan remain stubbornly committed to their “cheap money is the solution” strategies, even though it seems unrealistic to expect that those policies will suddenly work after years of failure. If the ECB and the BOJ were instead to focus on recapitalizing private-sector banks, and if the U.S. were to repeal its tariff regime, we could see yields rise worldwide.

The stock market, meanwhile, is behaving well – even taking into account two 800-point drops this month. Equity investors do not appear to be concerned about a coming recession. Chart 5 shows the S&P 500 price in comparison to the projected earnings per share over the next year. The two lines on this chart overlap when the P/E ratio is 16, close to the average valuation over the past century. When the green price line is higher than the red earnings line, prices are high relative to earnings; the market is expensive, or at least anticipating a pickup in growth.



Source: FactSet

The chart indicates that the stock market today – on average – is fairly priced compared to its historical behavior. The recent dip from 3,000 to about 2,800 represents nothing more than the normal squiggles of volatile investor sentiment.[2] Over the long term, stock market prices are driven by earnings – as is clearly evident in the close relationship between the earnings and price lines of Chart 5. Markets are forward-looking by nature, so we typically look at year-ahead earnings forecasts in developing our investment strategies. Chart 6 shows investors’ expectations for year-ahead earnings growth rates for the S&P 500, and it tells a sobering story:

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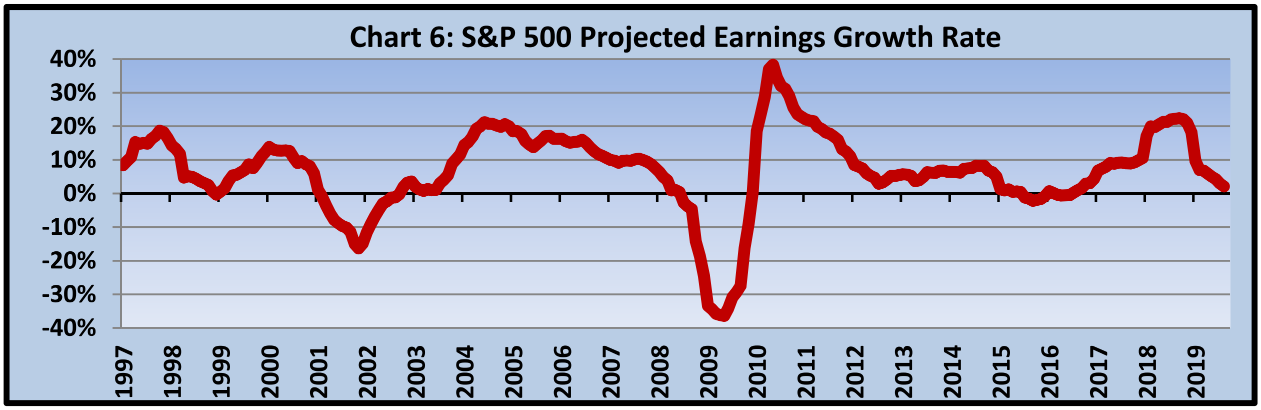
[2] You could make an argument that today’s ultra-low interest rates should correlate with higher P/E ratios. The Capital Asset Pricing Model asserts that prices of any risk asset (like shares of a company or a stock market index) can be derived from a risk-free rate. As the risk-free (Treasury) rate falls, prices should rise. I would dispute the validity of this argument at current levels of interest rates, but let’s leave that discussion for another day.



Source: FactSet

After a torrid pace last year (driven mainly by hyperstimulative corporate tax cuts), earnings growth has stalled this year. Reported EPS in the first two quarters of 2019 were actually below the same periods from last year, but investors still expect slightly positive earnings growth through the balance of this year. That would be quite an accomplishment, considering the deceleration in foreign demand, the potential adverse effects of new tariffs, and higher expenses associated with 3% wage growth.

I hope you have got your things together
Looks like we're in for nasty weather
There's a bad moon on the rise

We're not ready to throw in the towel on the U.S. stock market, at least not yet. Even if earnings growth remains negative, the combination of a (possibly) inverting yield curve and a generally accommodative Federal Reserve means that valuations can rise; historically, rising P/E ratios have more than offset falling earnings in the first year of a Fed easing cycle. In other words, stock markets typically rise in the first year after the yield curve inverts, as investors grab for yield before actual signs of recession appear.

Even so, some caution is merited. Twice already this year, we have reduced our equity allocations in client portfolios. We have also shifted both equity and fixed income holdings to reflect higher quality and more defensive attributes. For all its beauty, last week's celestial spectacle may still be a bad moon rising.