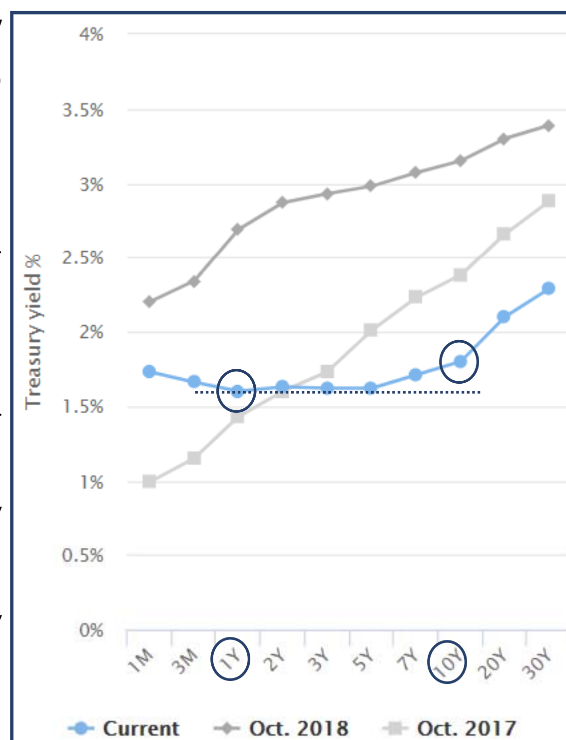
RECESSION RISK DOES NOT APPEAR TO BE UNUSUALLY HIGH

YIELD-CURVE INVERSIONS TEND TO PRECEDE RECESSION

In general, longer-term interest rates tend to exceed shorter-term ones because the risks associated with lending over longer periods of time tend to exceed the risks associated with lending over shorter ones. In short, as time accumulates, so do the risks associated with lending money. Therefore, interest-rate normalcy is violated whenever shorter-term interest rates associated with a given type of loan instrument or investment security exceed the rates on longer-term ones. In such cases the yield curve is said to have inverted.

Because the market for Treasury securities issued by the U.S. is comparatively large versus the markets for other types of debt instruments and because a yield-curve inversion could be symptomatic of some dark and destructive economic DNA lurking somewhere within an economic system, yield-curve inversions that develop within this particularly liquid market tend to command a great deal of investor attention regardless of how slightly or fleetingly the yield curve inverts.

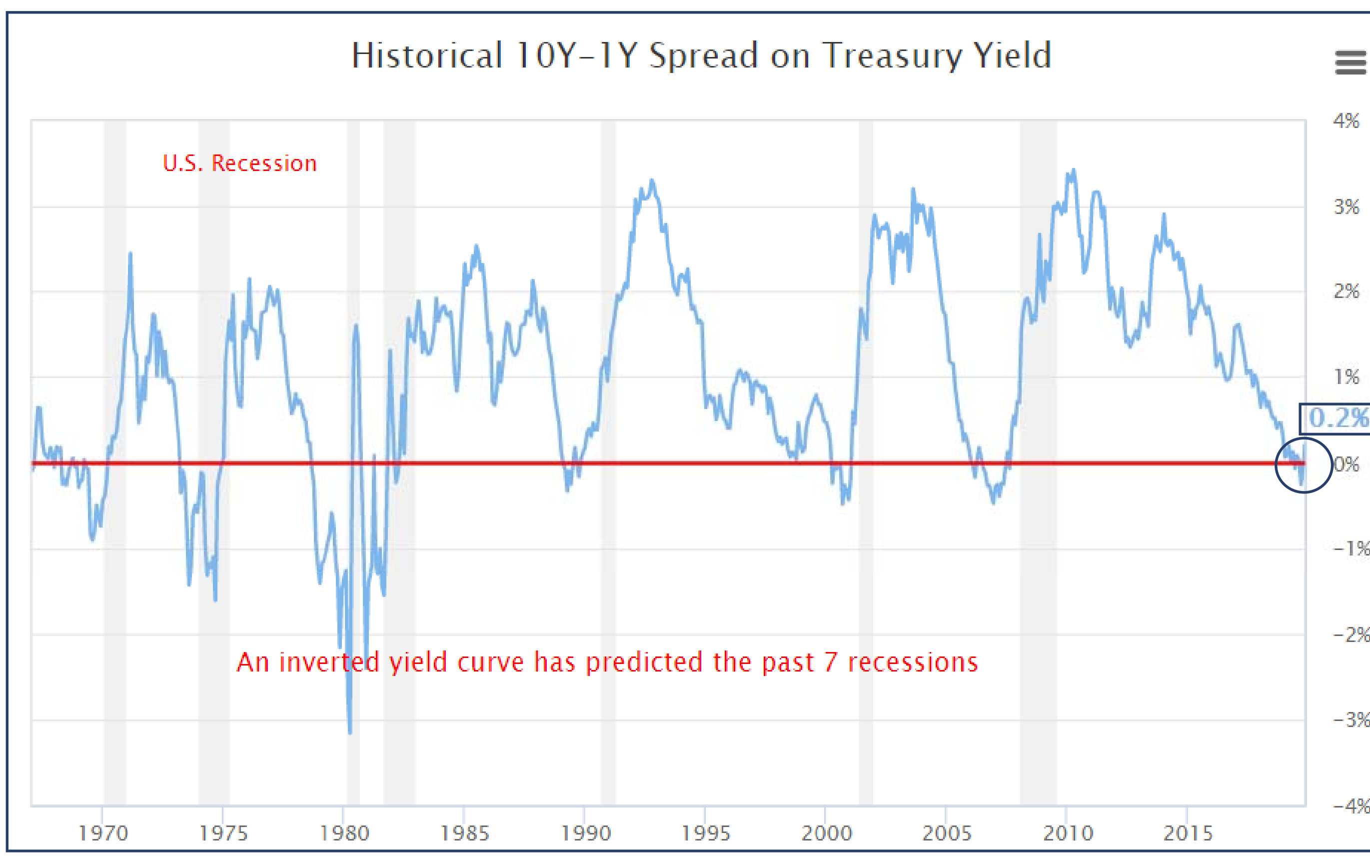
The poor quality image to the right shows how Treasury yields as of October 25, 2019 (in blue) compare to those of the previous couple of years. Since investors prefer to compare the yields on 1-year and 10-year Treasuries, I've plotted a horizontal line through the 1-year yield to ease that comparison. At this point, no inversion exists versus the 10-year yield, but it's obvious that a substantial portion of the yield curve remains inverted versus 1-month and 3-month Treasury yields. Although 10-year Treasury yields are currently not inverted versus the 1-year yield, they were and the media rang the alarm bells with vigor.



Even if that inversion does not directly signal an ensuing recession, there's no question that the alarm associated with an inversion can induce various behaviors that could bring the recession they so fear to fruition. To ready themselves for the recession they fear is already inevitable, consumers are apt to delay or even forego certain expenditures, business owners are apt to trim inventory levels and staffing, and investors are apt to sharpen their equity-trimming reflexes to help ensure they can beat other equity investors to the proverbial door. Again, these conditioned responses can actually trigger a recession that may not actually have been in the cards in the first place. In my view, yield-curve inversions have become so closely associated with recession that I wonder if some of their predictive value has been augmented by some causal value. Happily, the Fed knows everything I do and is well positioned to intervene.

RECESSION IMMINENT?

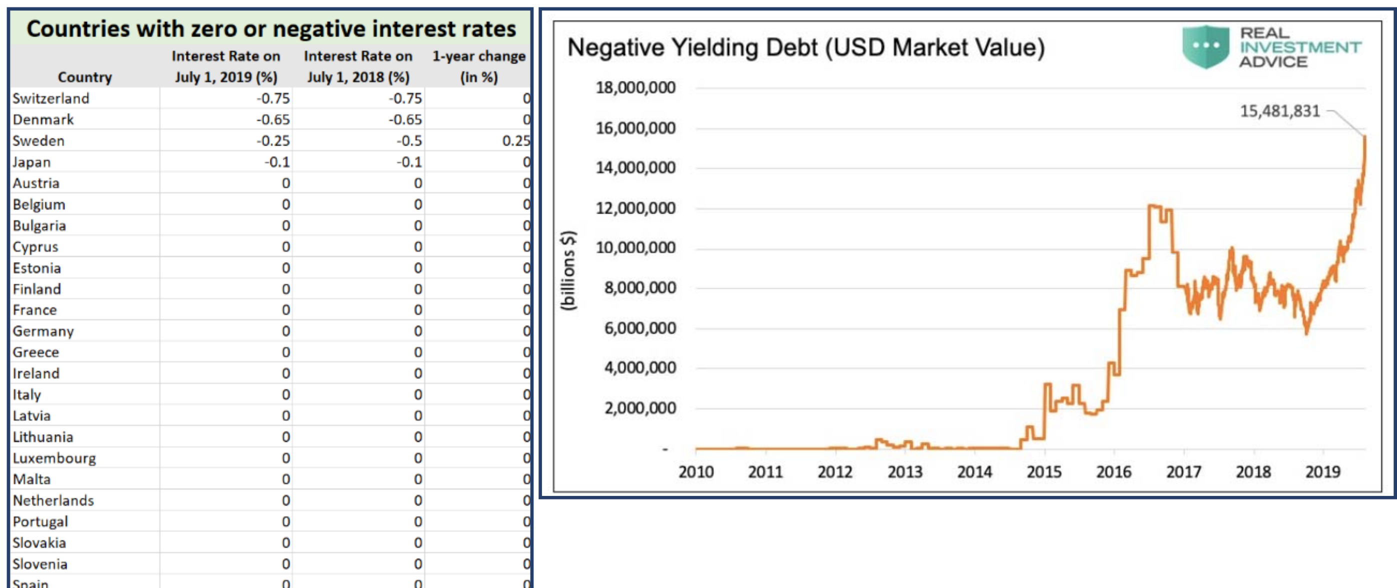
The following washed-out image plots the difference in yield between 1-year and 10-year Treasury securities by subtracting the 1-year yield from the 10-year yield over time. When the result (known as the "spread") is negative, the yield curve is inverted.



Note how the curve has tended to invert (fall below the 0% divider) prior to recession (the shaded areas). In August, the slight, fleeting inversion I mentioned earlier (circled) suggests to many investors that the U.S. is due for a recession.

FORMER FED CHAIR DOESN'T THINK SO

Former Fed Chair, Janet Yellen, dismissed the yield-curve inversion by explaining that there were a number of factors other than market expectations causing the yield curve to invert. For example, slower growth rates around the globe and the pervasiveness of bond yields that are already near zero and, in some cases, below zero in other regions have resulted in strong demand for U.S. Treasury securities. In short, Janet Yellen believes that the yield-curve inversion we recently experienced has more to do with strong demand from other countries where yields are substantially lower there than they are in the U.S. and less to do with any nefarious economic conditions that might be brewing from within. The following images provide some context for Janet Yellen's comments.



Countries with zero or negative interest rates

Country	Interest Rate on July 1, 2019 (%)	Interest Rate on July 1, 2018 (%)	1-year change (in %)
Switzerland	-0.75	-0.75	0
Denmark	-0.65	-0.65	0
Sweden	-0.25	-0.5	0.25
Japan	-0.1	-0.1	0
Austria	0	0	0
Belgium	0	0	0
Bulgaria	0	0	0
Cyprus	0	0	0
Estonia	0	0	0
Finland	0	0	0
France	0	0	0
Germany	0	0	0
Greece	0	0	0
Ireland	0	0	0
Italy	0	0	0
Latvia	0	0	0
Lithuania	0	0	0
Luxembourg	0	0	0
Malta	0	0	0
Netherlands	0	0	0
Portugal	0	0	0
Slovakia	0	0	0
Slovenia	0	0	0
Spain	0	0	0

2 SHOTS OF MONETARY STIMULUS ALREADY IN THE BAG ...

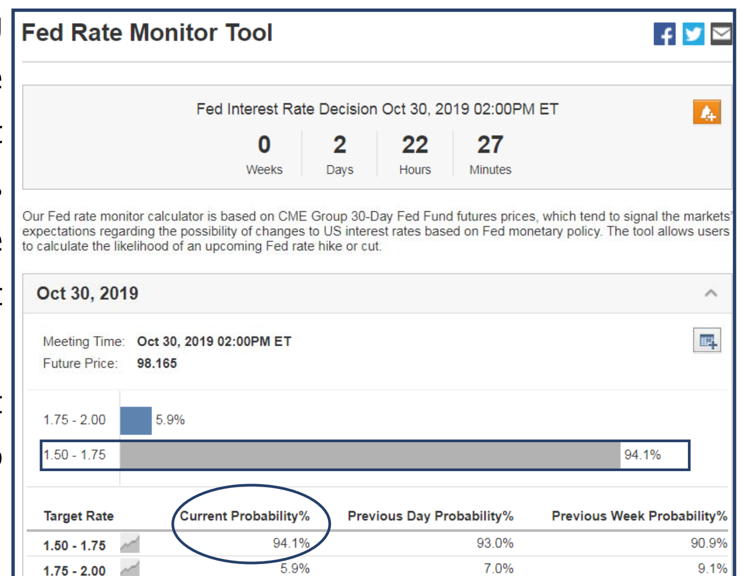
The Federal Reserve reduced the benchmark Federal Funds rate by .25% in August and again in September to a range of 1.75% - 2% which reduced the comparative yield advantage short-term, U.S. Treasury securities held over similar offerings in other countries. The yield-curve inversion that had gripped investors with fear then quickly

disappeared as shown (circled) on page two. According to the Federal Reserve's September 18th press release, seven members voted to reduce the Fed Funds rate to the targeted range I just mentioned whereas one voting member voted for a larger, .50% rate cut and another member voted to leave the Fed Funds rate at its previous level.

… AND ANOTHER RATE CUT SEEMS LIKELY

At the conclusion of the Fed's two-day policy meeting in Jackson Hole, Wyoming this past August, current Fed Chair Jerome Powell characterized the U.S. economy as being in a "favorable place," concluding that it continues to "perform well, overall." At that time, he reiterated the Fed's commitment to "act as appropriate to sustain the expansion." He delivered those comments on the heels of an initial rate cut and, as already mentioned, the Fed has reduced the Fed Funds rate a second time since then.

The Federal Reserve's next policy-making meeting is set for October 29th/30th. While no one knows what the outcome of that meeting will be, hedgers and speculators expressing their views through the Chicago Mercantile Exchange suggest that there is a 94% probability the Fed will implement an additional .25% rate cut at that time. The Fed is doing its part to keep the expansion humming along.



CHINA STIMULATES IT'S ECONOMY, TOO

We've been hearing about a synchronized global slowdown for a while now, but as is the case here in the U.S., China began pumping additional stimulus into its economy in September. According to Zacks Research, China has now reduced the reserve ratio in its banking system to the lowest level since 2007. In general, reducing a banking system's reserve ratio tends to increase the availability of loans while also reducing their cost. This stimulation method is generally considered to be a less refined method than, say, trimming the targeted Federal Funds rate as is customarily done in this country.

Whereas shaving the Fed Funds rate might be likened to precisely measuring the sugar before blending it with the butter, reducing the reserve ratio would be more akin to pouring a mound of sugar directly from the bag on the notion that it would be better to have too much of a good thing rather than less.

According to Zacks, China's reduction to it's reserve ratio may create as much as $126 billion of additional liquidity within its economy. That move will not directly affect the U.S., but because China's economy is the second in size only to the U.S., this move ought to provide an indirect boost to the global economy.

LACK OF A TRADE DEAL REMAINS AN OVERHANG

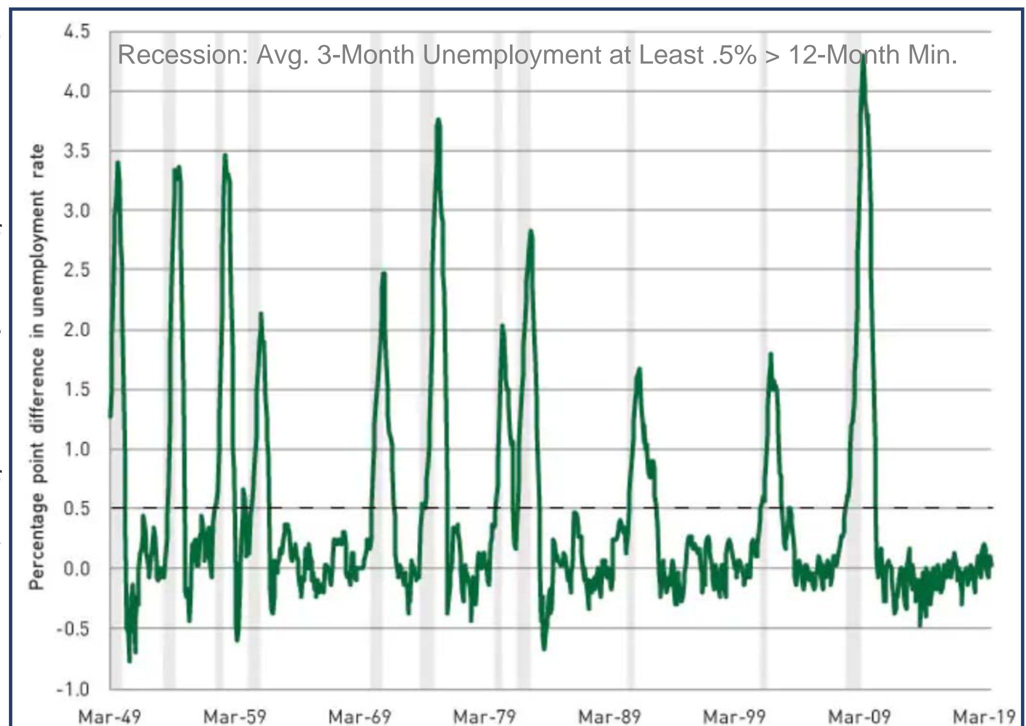
Despite any unfairness that may (and, I think, probably did and/or does) exist in the trade relations between China and the U.S., economists have long understood that trade wars are neither good for any of the combatants, nor are they easy to win. Even to the extent a given trade dispute develops into something less than a full-blown trade war, investor angst typically increases, causing asset valuations to fall or to at least rise less than they otherwise might.

I'm certainly no expert with respect to China—U.S. trade relations, but I know that when a material trade dispute devolves to the use of initial and retaliatory tariffs, the investment climate tends to deteriorate, as well. Since trade tensions influence investor sentiment, Goldman Sachs has developed an algorithm that attempts to gauge the likelihood that the current trade dispute will be resolved within the next six months. With respect to the following image, I suspect that since China and the U.S. each have an incentive to resolve the existing trade dispute, it eventually will be. When that happens, a component of risk will have been eliminated and markets are likely to react favorably.

CHANGES IN 3-MONTH UNEMPLOYMENT RATE KEY TO GAUGING RECESSION RISK

Claudia Sahm, an economist and Fulbright Scholar who previously worked at the Brookings Institution and who now works for the Fed, has studied recessions and how best to detect their onset. Since the onset of a given recession is often not confirmed until well after the fact and since the public would be better served if policymakers could detect and respond to the onset of recession sooner, Dr. Sahm has studied the issue at length. In short, she has found that **when the average, three-month unemployment rate rises by at least .5% versus its previous 12-month low, the economy is likely to *already* be in recession.**

Compared to other predictive metrics, this indicator has an excellent track record of sensing the onset of recession (shaded areas). This indicator has correctly signaled recession 4-5 months following the onset of each event and has a virtually perfect record of detecting recessions since 1970.



WHERE ARE WE NOW?

I provided the image above because it depicts seven decades' worth of accurately confirming recession, but I recognize it spans only through March of the current year.

Whereas a rise in the average, three-month unemployment rate of at least .5% versus its previous 12-month low signals the onset of recession, data for the Sahm Recession Indicator has also been analyzed for readings that fall into a series of ranges that fall beneath that .5% threshold as you can see in the next image.

THE SAHM RECESSION INDICATOR FLASHES ZERO!

As of October 7th, the reading of the Sahm Recession Indicator was zero. As you can see in the grid below, an indicator of zero (boxed) does not equate to a recession risk of zero. Instead, a reading of zero suggests:

- A 2% probability that the U.S. is already in recession,
- A 5% probability that the U.S. will experience recession in the next three months,
- … and so on as the boxed data shows.

Notice that when this recession indicator is at or near zero, as it was in early October, historical data suggests there *still* remains a 20% probability of recession developing within the next year and a 39% probability of one developing within the next two years.

Probability of a Recession by Sahm Recession Indicator, 1970–2019

Excluding Months Between NBER Announcements of Business Cycle Peaks and Troughs

Sahm recession indicator (percentage point increase in unemployment rate)	Recession now	Recession in 3 months	Recession in 6 months	Recession in 12 months	Recession in 24 months	Number of months
Less than 0	1%	2%	5%	10%	25%	203
0 to 0.09	2%	5%	8%	20%	39%	122
0.10 to 0.19	2%	13%	23%	33%	37%	52
0.20 to 0.29	11%	33%	33%	39%	39%	18
0.30 to 0.39	40%	40%	40%	40%	40%	10
0.40 to 0.49	76%	76%	76%	76%	76%	17
Greater than or equal to 0.50	**97%**	**97%**	**97%**	**97%**	**97%**	**30**
Probability of a recession at any unemployment rate	12%	15%	19%	25%	38%	452

Although this is conjecture on my part, this data suggests to me that recessions can develop as a result of external shocks that arrive more or less unforeseen to the business community. If this were not the case, businesses would certainly trim their respective workforces in advance. Whether that's true or not, it seems as though the current risk of recession is not abnormally high.

TREASURY BOND YIELDS TYPICALLY EXCEEDS DIVIDEND YIELDS ON STOCKS …

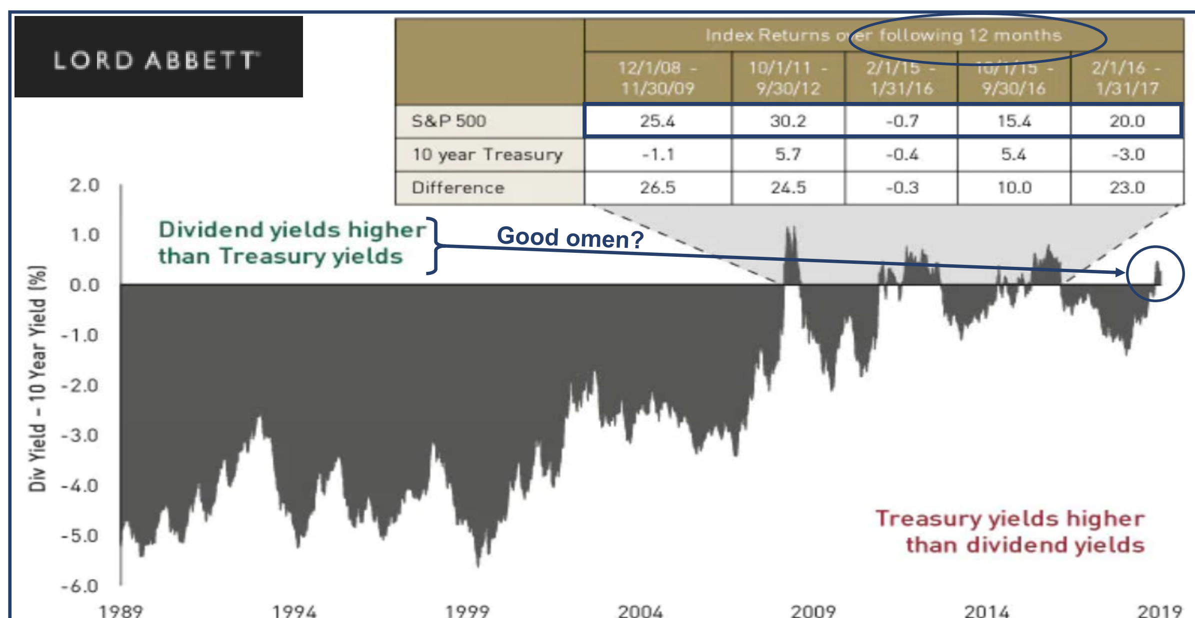
Bonds generate interest, but with limited exceptions they don't typically offer investors much in terms of capital appreciation. In contrast, equities (stocks) often offer dividends that not only rise from year to year, but do so at a pace that can easily dwarf the rate of inflation and these rising cash flow streams typically translate into rising share prices.

Companies that pay dividends typically retain a material portion of their cash flows and earnings to further grow their respective enterprises which may then further drive those rising dividends and future appreciation. Because of these self-reinforcing attributes, stockholders typically enjoy returns significantly higher than do bondholders.

... BUT NOT NOW. IF HISTORY IS A GUIDE, THIS COULD BE A GOOD TIME TO OWN EQUITIES

However, that relationship occasionally reverses itself such that the dividend yields on stocks exceed the interest yields offered certain Treasury bonds. Recent rate cuts by the Fed have caused Treasury bond yields to fall and a further Fed rate cut, which appears to be widely anticipated, is likely to have already driven Treasury bond yields lower still. Relatively low bond yields coupled with the earnings and cash flow advances reported by the typical publicly-held company have resulted in an atypical situation where the yields offered by equities exceeds those offered by 10-year Treasury bonds.

The circled area, below, shows this atypical relationship. Again, this situation is atypical and it's often fleeting, but when it does occur, equity investors have tended to benefit as other, yield-hungry investors abandon their relatively low-yielding bonds in favor of higher-yielding equities. Equity valuations have tended to rise generously as a result.



	Index Returns over following 12 months				
	12/1/08 - 11/30/09	10/1/11 - 9/30/12	2/1/15 - 1/31/16	10/1/15 - 9/30/16	2/1/16 - 1/31/17
S&P 500	25.4	30.2	-0.7	15.4	20.0
10 year Treasury	-1.1	5.7	-0.4	5.4	-3.0
Difference	26.5	24.5	-0.3	10.0	23.0

Main takeaways: The recent yield-curve inversion is out of step with Janet Yellen's view and with The Sahm Recession Indicator which senses no elevated risk of recession, comparatively rich dividend yields may be signaling opportunity for equity investors, and it's always a good idea to eat plenty of ruffage. — Glenn Wessel