WASMER SCHROEDER

The Implications of the Recent Yield Curve Inversion

March 2019

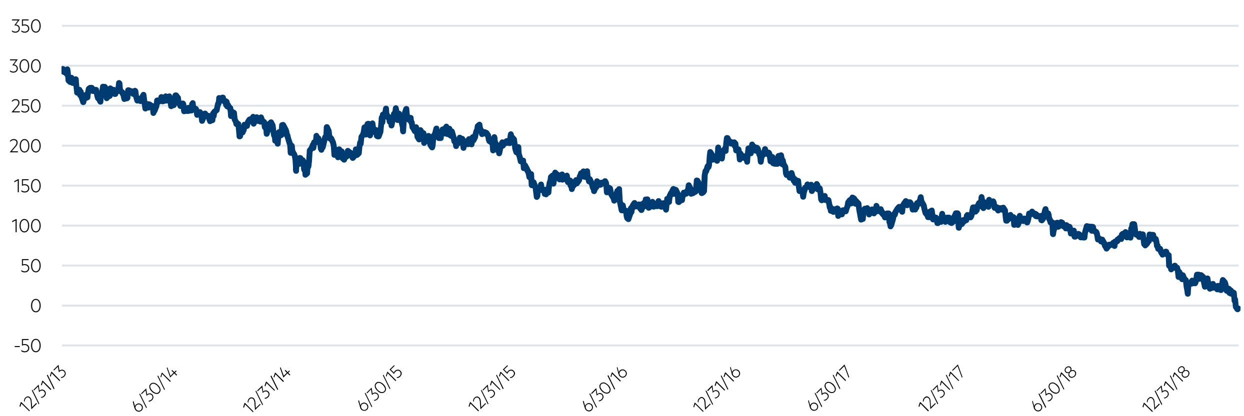
Five Years of Flattening Ends

The US Treasury yield curve reached a historically-significant point last week in the five-plus year flattening trend that began in late 2013. The yield differential between 3-month T-bills and 10-year Treasury notes *inverted* on March 22, meaning that yields on T-bills were offered higher than yields on 10-year notes. Why is this important? In a normally functioning economy, the yield curve is positively sloped—meaning that investors demand higher yields as they go further out the curve to compensate for inflation risks. When the curve is negatively sloped, or inverted, we can assume that there are economic factors in play that are skewing how investors typically price the risk of longer-term yield premiums.

An Important New Milestone

The inversion of the curve from 3-months to 10-years is a particularly important milestone in this current, long-lived economic cycle. This inversion metric has traditionally been the most reliable market-based predictor that an economic recession will arrive within 12 months, and it has preceded the last seven recessions dating back to 1970.[1] In fact, the spread between 3-month T-Bill yields and 10-year yields is the primary input used in the Federal Reserve Bank of New York's recession model. Importantly, while it took almost five years for the 3mo/10y spread to fall from +300 to +100 basis points, it took less than six months for that +100 basis point spread to turn negative. While there are many reasons why the curve has been flattening over the last five-plus years, the pace of flattening in recent months implies a significant change in market sentiment since September.

Yield Spread 3M T-Bills to 10Y Treasury Notes



12/31/2013 - 3/26/2019; Source: Bloomberg

Indeed, inflation expectations remain stubbornly low. Global economic growth indicators, particularly in the Eurozone and China, are showing signs of rapid deterioration. The amount of global debt with negative yields has risen by 75% since October to more than $10 trillion.[2] The Federal Open Market Committee (FOMC), having raised the federal funds rate nine times since 2015, messaged what many considered to be a "hard stop" to monetary policy tightening after their March meeting.

What Does It Mean From Here?

In Wasmer Schroeder's (WS) opinion, the inversion of the yield curve requires that three questions be considered: (1) Are the odds of a recession materially greater today than they were prior to the inversion? (2) If a recession does materialize, will it come in the form of a *hard* or *soft* landing for the US economy? and (3) What are the implications of an inverted curve for WS clients?

With regard to the first question, WSC believes a plausible case can be made for 1.00%-2.00% domestic GDP growth over the course of 2019, with the clear potential for additional softness further into 2020. To the FOMC's credit, it has been preparing for an eventual end to what is nearing a record economic expansion by aggressively rebuilding its monetary policy tool kit. The federal funds rate (currently at an upper boundary of 2.50%) is at a level where the FOMC has a measurable degree of dry powder in the event that stimulus is warranted. The announced termination of the Fed's balance sheet tapering program in late 2019 should also help ease monetary policy conditions as we enter 2020.

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We have a more difficult time forecasting a scenario in which we would see two consecutive quarters of negative GDP growth. However, if the U.S. economy were to enter into a recession, the sheer amount of liquidity in the financial system suggests that it should be a mild one and unlikely to approach anything near the calamity that we managed through during the Financial Crisis ten years ago. In the event that a recession does arrive within the next 12-24 months, the odds of a soft landing appear to be stronger than those of a hard one.

For WS's clients, it is important to remember the primary themes that underpin our philosophy on portfolio management, whether they take place during environments of economic growth or contraction. Our goal is to develop diversified portfolio structures that mitigate the impact of interest rate fluctuations, while achieving our clients' duration target with an optimal maturity and credit mix. How we achieve duration and where we deploy credit may shift, depending on where we see value, and those discussions take place continually.

While the thoughts above articulate our current base case scenario, we at WS realize that the course of both the US and global economies, and the policy communications and actions of Central Banks around the developed world are much more uncertain than has been the case for many years. As always, we stand ready to adjust our thoughts and positioning, based on incoming information and headlines. The markets are ever changing—but you, our clients, can be sure that we will continue to diligently monitor and navigate the dynamics that drive them.

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Mr. Diefenthaler earned his B.S. in Finance from Florida State University. He is a member of the Firm's Executive, Portfolio Management, Credit, Investment, Risk, and Compliance Committees.

[1] https://www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_Rec.pdf
[2] https://www.bloomberg.com/opinion/articles/2019-03-25/german-bond-yields-below-zero-spell-trouble-for-hedge-funds