CREATIVE PLANNING

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Warning Sign?

Peter Mallouk
JD, MBA, CFP®
President

The Inverted Yield Curve and Recessions

So far, there are no indications we may see the often discussed year-end Santa Claus rally, with the market taking on a Grinch-like posture. There is more than one narrative around what is driving the latest market downturn. In reality, it appears confusing because more than one major factor is in play. Let's break down the major issues.

First, there is much talk about the "inverted yield curve" and a subsequent, pending recession. Unless you are interested in finance, economics or, like me, a nerd, you probably do not know what an inverted yield curve is.[1] To understand that, we first need to understand how bonds work.

Bonds are simply loans. There are two main factors that impact bond returns: credit risk and duration. If you loan money to McDonald's, you expect to be paid back. It has very strong credit, has been around a long time, and is likely not going anywhere. It's credit quality is strong. If you loan money to a cryptocurrency company or to a cannabis company, you may or may not get paid back. These industries are speculative, and the winners and losers have yet to be sorted out. The losers will go bankrupt. Because of this, their credit quality is weak, and they would need to pay you a higher interest rate. If they did not pay you a higher interest rate, then you would never loan them money, instead loaning money to a higher credit-quality company like McDonald's. The other factor that impacts bond returns is how long you are loaning the money. If you go to a bank and purchase a CD, you expect to be paid more if it is a 5 year CD than you do for a 1 year CD. This is because you are tying up your money longer and you should be rewarded for that. The same principle applies to bonds. If you loan money to McDonald's for 10 years, you expect to be paid more than if you loan them money for 1 year.

The safest bonds in the world are US Treasury Bonds.[2] These are loans to the federal government. These pay a generally low return because they are so safe. The federal government can always print money or tax everyone to pay you back. That is why these bonds nearly always pay less than other bonds. If you loan the money to the federal government for 10 years, you expect to be paid more than you would if you loan them money for 2 years. We all intuitively get this concept when it comes to mortgage rates. If you go to a bank and ask for a 30 year mortgage, they will charge you a higher rate than if you ask for a 10 year mortgage.

With these basic guidelines in mind, the market tends to freak out when things go off the norm. On occasion,

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cpi@creativeplanning.com

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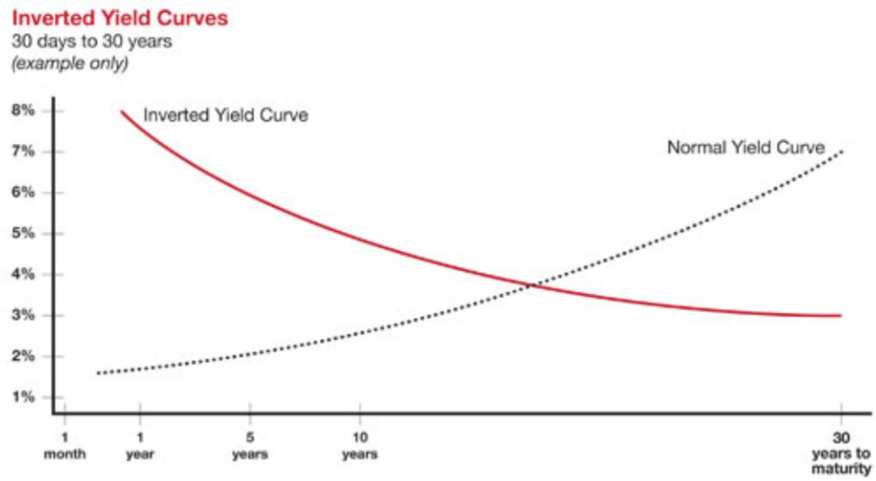
1. My oldest son had expressed an interest in finance until he read the first draft of this letter. After two paragraphs, he told me he's considering a new course of study. There's just no way to make inverted yield curves interesting.
2. Insert chuckle here. Many would argue that the US government is like a drunken spender. Some day all those credit card bills are going to have to be paid.

the market will sometimes pay a lender more for a short-term bond than for a long-term bond. This is called an inverted yield curve and is illustrated in the following graph:



For example, if you can loan money to the federal government for 2 years and get more interest than if you loan it money for 10 years, that tells market observers that something is wrong. There is only one reason why a short-term treasury bond would pay more than a long-term treasury bond, and that would be if investors expected long-term rates to decline. If you expect long-term rates to go down, you will loan money to the federal government for 10 years right now at an even lower rate than you would loan them money for 1 year. The same principle applies with mortgages. If you expect long-term interest rates to decline, you will wait to get a long-term mortgage. But, if you are a lender and expect long-term interest rates to decline, you will lock in a long-term loan now.

So what does this have to do with recessions?[3] The Federal Reserve sets interest rates. When they want to get an economy going, they lower interest rates so that people will borrow money and buy things like houses and cars, which gets people working and pulls the economy out of a recession. When markets are strong, unemployment is low and prices are rising, the Federal Reserve will raise interest rates so they can avoid high inflation which can lead to a bubble that will ultimately burst. We watched this exact cycle happen over the last 10 years. To help get us out of the worst recession in 80 years, the Federal Reserve drastically lowered rates, and sure enough, people started buying things, building homes, and hiring employees. This led to a recovery and economic expansion. Because the economy is generally very strong and unemployment is very low, the Federal Reserve began raising interest rates to keep the growth from becoming inflationary (no one needs another housing bubble).

Right now, the markets are concerned about the tariff spat and it's impact on consumers and corporations. The costs of tariffs are reflected in a hidden tax on consumers who pay for the higher cost of goods, decreased corporate profits if a corporation absorbs the increased costs without increasing prices to the consumer, or as is the case most of the time, both. The market is growing concerned that this trade war could escalate and eventually weaken the economy to the point where we go into a recession. At that point, the Federal Reserves would lower interest rates to help reinvigorate the economy and pull it out of recession.

3. I am so glad you asked.

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So, if investors see that coming, they buy longer-term treasuries on the assumption the rates will be lower in the future. When longer-term treasuries pay less than short-term ones, the yield curve is inverted. ***But, here's the thing: the yield curve, despite what the media is telling us, is not actually inverted.*** When economists compare short and long-term rates to predict a recession, they usually compare very short-term treasuries, say 2 years or less, to long-term treasuries of 10 years or more. At present, the 10 year treasury is paying 0.517 more than the 3 month treasury and 0.27 less than a 30 year treasury. In other words, the longer an investor loans money to the federal government, the more she gets paid, which is how it's supposed to work ***but, the yield curve is flattening.*** Getting 0.27 more to loan money to the federal government for 30 years instead of 10 years is not a big difference and suggests that the market thinks that long term rates won't rise anytime soon.

If the yield curve does eventually invert, and it may not, just how good a predictor of a recession is it? First, it is important to note that nearly every time the yield curve inverts, it corrects itself and the world doesn't end. Second, when it doesn't correct itself, and long-term rates stay lower than short-term rates, a recession usually follows several years (yes years) later.

The bottom line is this: the main issue the markets are facing now is the tariff dispute. Nearly everyone agrees the U.S. and China will ultimately reach a resolution here. The only question is when. If this trade dispute lasts so long that it greatly weakens both economies, the markets will predict a recession, the yield curve actually will invert, and if a resolution is not reached, we may have a recession in a few years. This path can happen, but is not the most likely outcome. The most likely outcome is that the tariff issues are worked out and the markets normalize. It is anyone's guess how long that can take. Predicting recessions and market returns is a fool's game, particularly because the economy is dynamic. Various factors impact the economy, from sentiment, to terrorism and war to the things that matter most like earnings and unemployment, both of which remain historically strong. Warren Buffett famously said that economists exist to make fortune tellers look good. Going into 2018, Barron's asked ten stock market forecasters their thoughts on 2018. All 10 of them predicted positive stock market performance. To date, every major stock index is negative. The best plan of action is to take advantage of opportunities should they present themselves, and to avoid trying to time the short term gyrations of the markets.

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