Smith Graham
INVESTMENT ADVISORS

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The U.S. 10-year treasury closed on August 15th below 1.5% for the first time since August 2016. Rates down one day, up the next, and down again once more seem to be the latest sequence of events in the financial markets. Accelerating recession fears, brought on by an inverted yield curve has sent treasury yields and equity markets lower. Investment grade and high yield bond spreads have weakened during the previous month. Bonds spreads have continued to widen a fair amount month to date.

In this latest downturn, it was increasing fears of uncertainty that lead to an inverted yield curve. An inverted yield curve is one in which shorter-dated Treasury issues, in this case the 2-year note, yield more than longer-dated notes, suggesting a rush to buy longer-term notes as a safe-haven asset. An inverted yield curve is less of a signal to correctly predict a recession than it was in the past. The flatter yield curve is reflected in lower expectations of growth, not a recession. The latest downturn in the market also was a consequence of weak economic data out of China and Germany, with GDP in this latter instance shrinking in the second quarter.

We can see below that data are increasingly sparse as the yield curve inverts, since there are fewer recessionary periods as categorized by the National Bureau of Economic Research (NBER), than there are non-recessionary periods. Going back further would not provide a significantly accurate representation because of the changes to the U.S. and global economies.

Cycle Peak	Cycle Trough	Peak to Trough
July 1981	November 1982	16
July 1990	March 1991	8
March 2001	November 2001	8
December 2007	June 2009	18

Source: National Bureau of Economic Research

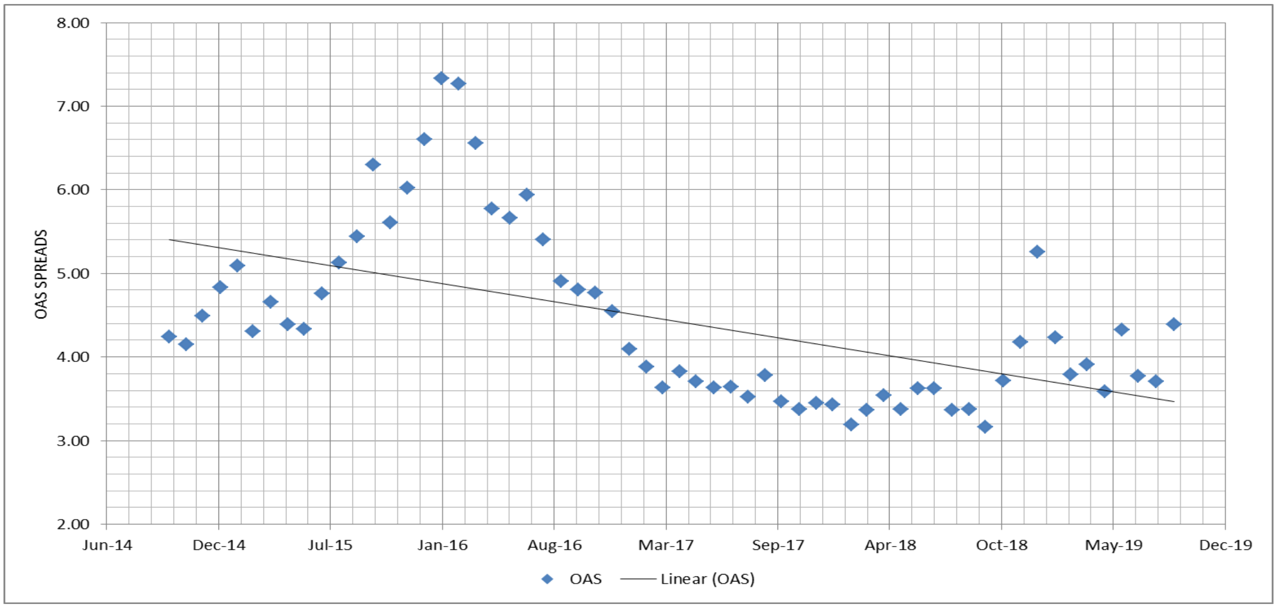
People often say a recession is when the GDP growth rate is negative for two consecutive quarters or more. A recession can quietly begin before the quarterly gross domestic product reports are out. The NBER measures four other factors, in addition to GDP. Those four economic indicators are: income, employment, manufacturing, and retail sales. These four data series come out monthly. When these economic indicators decline, so will GDP. The strongest and best predictor for recession is the current GDP growth rate, which currently is about 1.5%.

Gross Domestic Product	→
Income	→
Employment	→
Manufacturing	↓
Retail Sales	↑

With the latest data from China and the euro-zone pointing to continued weakness and trade policy uncertainty intensifying, the manufacturing downturn probably still has further to fade. Some of these market drivers are perception and psychology. The economic pundits and the ivory-tower folks are talking their way into a self-fulfilling prophecy. Perception is more directed towards negative events than positive events.

High yield bonds are considered an equity surrogate. High yield bonds are less interest rate sensitive than investment grade bonds. High yield bond spreads have widened recently and are near their five year average of 4.41%. Yes, the economy is slowing, but a recession is not on the horizon. Keep a close watch on high yield spreads to get a leading indicator of the economic health of the country.

High Yield Bond OAS Spreads



Source: Bloomberg Barclays Indices and SGIA

The focus is now squarely on the rift between the U.S. and China trade, followed by the increasing probability of a start of a Fed easing to fight off decelerating growth. The big picture stuff has now moved to the forefront for the moment. The combination of lower treasury yields and wider credit spreads has put the market in a risk-off environment.

The visible absence of real inflation, other than mostly in financial assets, seemingly guarantees the race downwards with regards to interest rates. The inversion of a new part of the yield curve does not add anything new to the economic picture. Remember, an inverted yield curve is less of a signal to correctly predict a recession than it was in the past.