POLARIS
WEALTH ADVISORY GROUP

The Polaris Perspective

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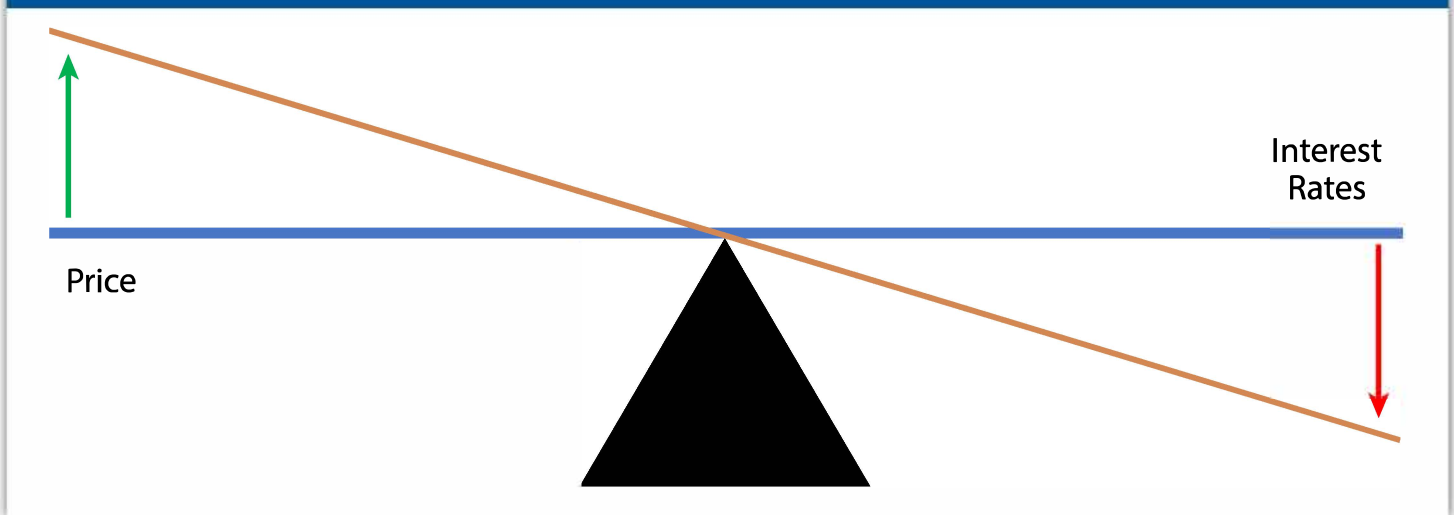
Dark Clouds Looming?

Yesterday was a rough day. The S&P 500 dropped 85 points, or 2.93%. The Dow Jones dropped over 800 points, or 3.05%, and the NASDAQ dropped 242 points (3.02%). All eleven sectors that make up the S&P 500 were down. There were only nine stocks listed on the S&P 500 that were not down yesterday. What sent the markets into a free fall? CNBC's headline was "Dow tanks 800 points in worst day of 2019 after bond market sends recession warning." What was the bond market warning? The 2-year treasury traded at a higher yield than the 10-year treasury. This is known as an inverted yield curve. The last time the 2-year treasury yielded more than the 10-year treasury was in December 2005.

Why is an inverted yield curve bad?

An inverted yield curve has historically been a pretty good signal of a future recession. Not all inverted yield curves have preceded a recession. But all recessions have had an inverted yield curve prior to the recession.

Former Federal Reserve Chair Janet Yellen doesn't believe that this inverted yield curve will turn into a recession. When asked if the United States is heading for a recession on Fox Business News she said, "I think the U.S. economy has enough strength to avoid that, but the odds have clearly risen..." She went on to say, "there are a number of factors other than market expectations about the future path of interest rates that are pushing down long-term yield." The factor she is discussing is the $15 trillion of negative interest rate sovereign debt worldwide. For example, the 10-year German Bund is yielding -0.65%. Imagine being a German investor. If you invested $100,000 into a 10-year German Bund you would get back $93,500 after your ten-year investment. This is driving more foreign investors to buy U.S. Treasuries. When more people want to buy any good, the price goes up. If you remember, there is an inverted relationship



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The U.S. treasury yield curve has flattened for one other reason, the Federal Reserve. The Federal Reserve cut rates 25-basis points in July. It seems like this is the first of many cuts to come. Currently, there is a 100% probability that the Fed will lower rates again at their next meeting on September 18th. The only question is "how much?" There is a 67% chance of a 25-basis point cut, and a 33% chance they cut 50-basis points. As you can see in the graph below, the highest probability is the Fed will cut 75-basis points by the end of the year.

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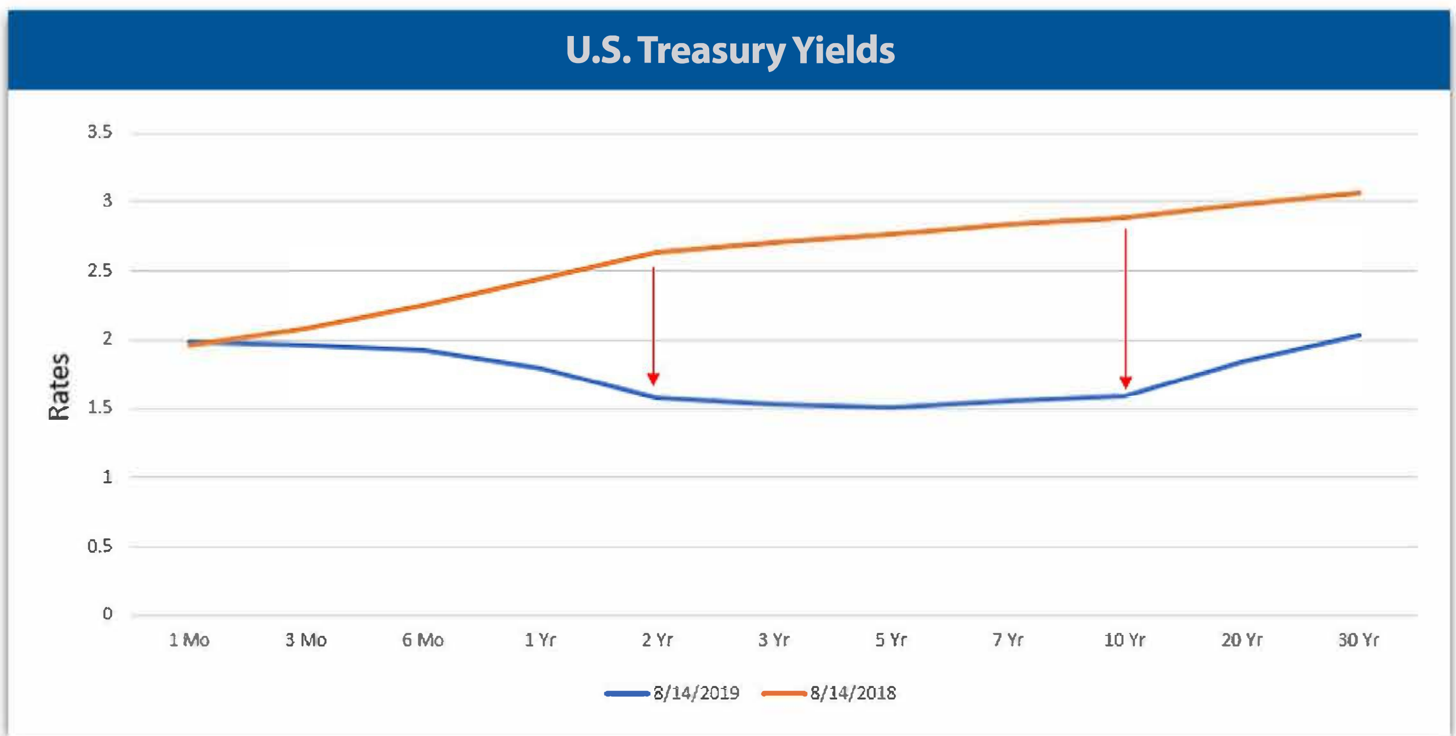
Fed futures point towards a continued cutting of rates well into next year. As a result, bond investors have been selling their short-term bonds and extending their maturity in an attempt to lock in higher rates. Remember our previous supply demand explanation. If you have more sellers than buyers, price should drop, and yield should rise. As you can see from the chart below, the one-month treasury is at the exact same level it was a year ago. But fed fund rates are 0.25% below where they were a year ago. The selling pressure pushed short-term rates up and essentially nullified the cut in rates on the yield curve. Intermediate and long-term bond yields have dropped over the past year, due to high demand we've already discussed. The most noteworthy take away is the 10-year treasury yielding slightly less than the two-year treasury, thus the inverted yield curve.



Historically, the Federal Reserve has combatted recessions by lowering interest rates, thus making it more attractive for people to borrow money. The idea is that "cheap" money will attract more borrowers. This can be in the form of individuals spending money on credit, people refinancing their homes to improve their cash flow, corporations borrowing money for R&D, equipment purchases, or hiring more employees. Lowering interest rates may be good for economic stimulus, but it is bad for short-term bond investors. It means that they will be getting less income from their investment. In order to combat lower income, bond investors will sell their short-term bonds and buy intermediate or long-term bonds. Selling pressure on the short end of the bond market pushes yields up. Buying pressure on intermediate and long-term bonds pushes prices up and yield down. This inverts the yield curve. If the Fed is not on their game, the U.S. economy slips into a recession. This is why people think that an inverted yield curve is a precursor to a recession.

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Is it time to run for the hills?

No! There is definitely more risk out there, but an inverted yield curve is not a good enough reason to get out of the market. But let's say Janet Yellen and I are both wrong and this inverted yield curve is a precursor to a recession. The last three inverted yield curves preceded the recession by almost 21 months. The S&P 500 averages a 31.7% return from the point the bond market inverted, and the United States went into a recession. I don't know very many investors that would want to miss that kind of return. We are continuously looking at leading and lagging economic indicators to understand our probability of going into a recession. While our economy has slowed, we have not triggered any signal that would give me alarm.

As hard as it is to keep a blind eye to the headlines, we encourage you to do your best to ignore them. We are already navigating these choppy waters with care and discipline.

As always, I welcome all questions and comments. Please feel to reach out to me.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer

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