The yield curve and the ferocious wolf

Monthly Strategy Report May 2018

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BancaMarch

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One of the primary fears for the economy and for markets is an inversion of the interest-rate or yield curve. History has shown us that when this happens, it is often a bad omen since every recession in the US since the 1960s has been preceded by a period of slope inversion. In the fable of The Boy Who Cried Wolf, it is as if the wolf descended the mountain and ate all the sheep.

In recent weeks, the slope of the US yield curve has flattened, hitting its lowest level since the last crisis. This flattening is cause for particular concern in the US economy, which has been growing for nine years and is facing the second longest economic cycle in history.

The reasoning behind the inversion of the curve holds that if short-term interest rates rise faster than long-term rates, there is a point at which companies stop borrowing money, and when the cost of capital exceeds the expected structural yield of profits, they prefer to repay debt, postpone investments, and eventually the recession—or the wolf—appears. Are we heading toward an impending recession? In our opinion, it is still too early to draw conclusions and sell-off risk assets.

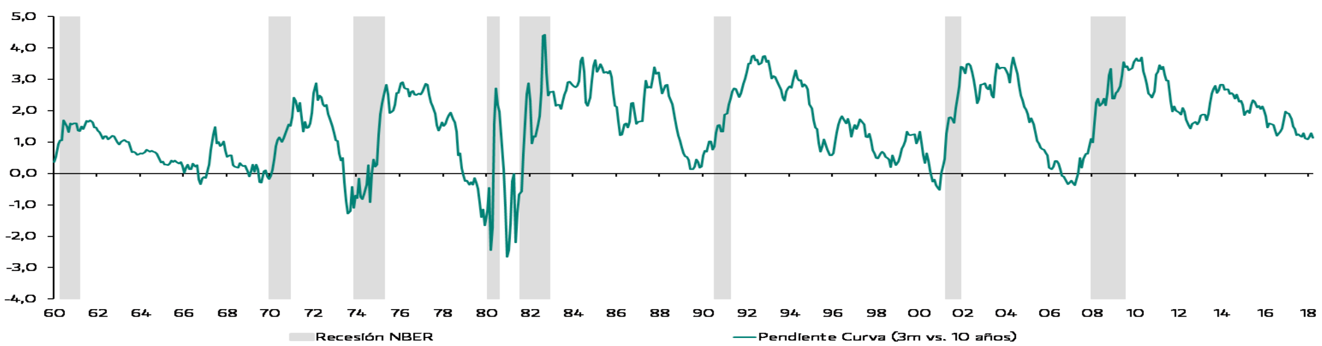
Doubtless, the slope of the curve is one of the most important factors to monitor. It is a good instrument with which to measure how the Federal Reserve's process of raising interest rates and increasing the cost of money (underway since 2015) affects the economy, inflation, and long-term growth prospects. The current waiting game, wherein investors try to monitor the effects of monetary normalisation, in conjunction with the impact of a reduced balance sheet, lower taxes, and the job market places us in a tense situation.

(1) The interest-rate or yield curve is an illustrated representation of the yields offered by the market based on different maturities. The curve typically has an upward slope because when investors buy short-term debt, they often obtain lower returns than on long-term equivalents where profitability is offset by the assumption of more risk for having to wait longer to recover the investment.

It is essential to examine several points before reaching a conclusion:

1. Like the fable of The Boy Who Cried Wolf, we must be wary of false alarms: the yield curve is not infallible! While the inverted slope of the US curve has been a necessary condition in determining previous recessions, it alone is not a sufficient determinant. Using as a reference the difference between the 10-year and the 3-month treasury rate, as the Federal Reserve does in its recession prediction model, we can see that there have been false alarms in the past. In 1966, the US economy continued to grow despite a slowdown in industrial production and an inversion of the curve. The graph below also shows the alarm sounded in 1998 after the LTCM crisis, which failed to trigger an immediate recession.

Graph 1: Slope of the US interest-rate curve (10-year – 3-month) and recessions.



Source: NBER, NY Fed, Bloomberg and Banca March.

2. In the last three recessions, the flattening of the curve coincided with an increase in the implicit likelihood of a recession from the Fed's Yield Curve Recession Model, which indicated recession probabilities of over 25%. This condition, therefore, is not met, since the current recession probability stands at 11%.

3. In the rest of the G7 countries, the relationship between the inversion of the curve and a recession is much lower than in the US. This is likely due more to the influence of the US curve on other economies than to their own growth expectations, but the data since 1960 are clear.

Recisiones y Curvas Invertidas desde 1960

Paises G7	Recesiones	Veces que la curva se ha invertido
EEUU	6	9
Reino Unido	6	10
Francia	3	4
Canada	5	10
Italia	9	5
Alemania	9	3
Japón	9	3

Source: Thomson Reuters, CE.

4. Even if the yield curve were to invert, an immediate recession would not necessarily follow. Historically, the US economy takes an average of 18 months after a curve inversion to enter into a recession, which would not necessarily be a bad thing for the stock market, as it typically continues to rise and, as illustrated by the table, begins to decline about six months prior to the onset of the recession. In fact, if those last six months are avoided, the final stretch of the cycle can be a very profitable period in terms of return.

Retornos Reales anualizados en los meses previos a la Recesión (%)

	13- 24 Meses	1- 24 Meses	7- 12 Meses	1- 12 Meses	1- 6 Meses	Meses Sin Recesión
Julio 1953 - Mayo 1954	21,9	12	17,8	2	-13,8	14,7
Agosto 1957 - Abrl 1958	15,8	7,1	-17	-1,6	13,9	19,3
Abril 1960 -Feb 1961	31,3	16,8	6,6	2,2	-2,2	15,8
Dic 1969 -Nov 1970	13,4	-1,3	-11	-15,9	-20,7	5,8
Nov 1973 - Mar 1975	16,9	4,9	-11,3	-7	-2,7	6,2
Enero 1980 - Jul 1980	0,5	2,2	6,8	5,4	4	3,1
Jul 1981 - Nov 1982 (*)			32,2	10,5	-11,2	4
Jul 1990 - Mar 1991	14,3	13,1	22,2	11,9	1,6	14
Mar 2001 - Nov 2001	8,9	-0,7	20	-10,3	-40,6	12,5
Dic 2007 - Jun 2009	11,6	7,6	13,6	3,6	-6,3	4
Retornos Medios desde 1950	**14,2**	**6,8**	**8**	**0,1**	**-7,8**	**10,1**

(*) Periodo coincidente con la recesión previa

The conclusion is that, clearly, after such a prolonged cycle we must be vigilant of the curve and how it develops, but we must also be careful not to withdraw before time. The last stretch of the cycle is usually very attractive for equities. The curve's slope has not inverted and the call to sell has not arrived. We believe, therefore, it is still too early to be alarmed.

In the current environment, the wolf we are facing has yet to become ferocious. It is much more docile, similar to the one Prokofiev describes in Peter and the Wolf. This symphony, composed in 1936, has a happy ending, in which no one dies. In fact, even the lives of the duck and wolf are saved after Peter convinces the hunters to take the wolf to the zoo and, in the last bars of the work, an oboe sounds as proof that the duck—which had initially been swallowed whole by the wolf—is still alive. The recession will come eventually, but we mustn't jump ship too early.