Market Commentary

1Q2019 Market Commentary

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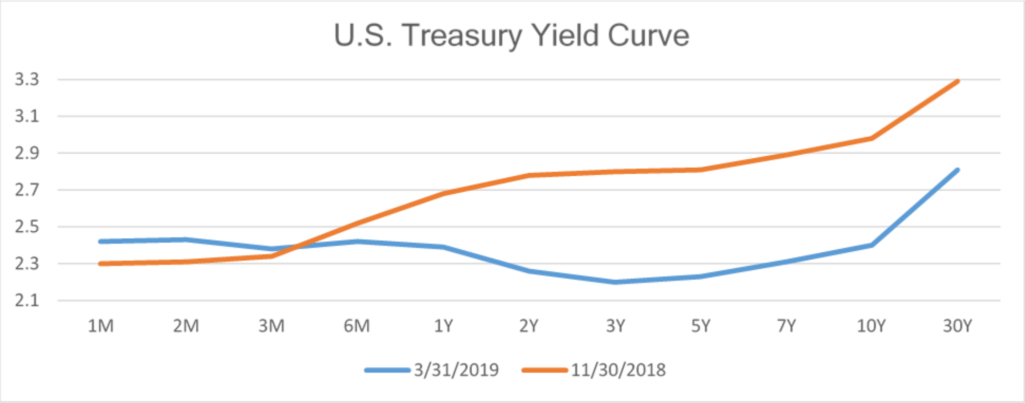
Is the U.S. Economy Inverting?

Through March 31, 2019 all major asset classes posted positive returns led by REITs (17.2%), U.S. Small Cap (14.6%), U.S. Large Cap (13.6%), and Developed International Equity (10.1%). Fixed Income returns were also positive, led by credit sectors like High Yield Bonds (7.3%) and Emerging Market Debt (7.0%), with the broad based Bloomberg Barclays U.S. Aggregate Bond Index bringing up the rear (2.9%) (Bloomberg L.P.). These returns may come as a bit of a surprise to those that have been paying regular attention to financial headlines that have mainly focused on slowing global growth, seemingly never-ending Brexit negotiations, and perhaps most concerning, the yield curve inverting.

An inverted yield curve refers to long term yields falling below short-term yields. Yield curve inversions have historically been a reliable indicators of a recession and often invert towards the end of a tightening cycle whereby the Federal Reserve raises the short-term Fed funds rate corresponding to a sharp rise on the front-end of the yield curve. Fed tightening cycles often occur near the end of the business cycle and are predominately used to combat inflation and prevent the economy from over-heating, thus signaling potential economic weakening.



Source: Bloomberg L.P.

So when the yield curve inverts, it quite literally means that investors believe rates will be lower in the future, either from declining economic activity or active rate cuts enacted by the Fed in their execution of monetary policy.

Why an inversion may not be signaling a recession

Yield curve inversions have been an early warning indicator but they do not automatically cause a recession nor are they consistent in the amount of time between inversion and a subsequent recession. The most accurate way to follow deteriorating economic conditions is in the aggregate data. Supporting signs of slowing economic activity are: declining consumer spending growth rates, which is the single largest driver of GDP growth; as well as declining housing starts and vehicle sales; and rising inventories (J.P. Morgan 2Q Guide to the Markets). Each of these areas point to potential slowdowns in GDP growth, which after all is the only definitive measure of a recession (two consecutive quarters of negative GDP growth).

What is driving positive first quarter asset class returns?

While there is certainly no shortage of pessimistic headlines, both the equity and fixed income markets showed us that current conditions were healthy enough to support positive first quarter growth. Unemployment levels remain at multi-year lows, inflation has been stable and in-line with the Fed's long-term target level of 2%, and wage inflation has remained subdued allowing corporates to continue to post positive–albeit slowing–year-over-year growth. All of these variables have deterred the Fed from sticking with their original 2019 path of one or two additional rate hikes and instead they are taking a more sit back and wait approach to current monetary policy.

The bottom line is nobody knows when the next recession will occur including the Federal Reserve; and to be honest, for individual investors it's not all that important. We should base our investment decisions on our willingness and capacity to take on risk. If the thought of a recession occurring within the next two years strikes fear that you will be unable to retire comfortably, the time to take action is not the day right before the markets drop, it's today. As they say, there is no better time than the present.

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