SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Market Observations
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INVERSION?

Federal Reserve policy has resulted in an increase in short-term interest rates relative to long-term interest rates. As these rates move closer to parity, concern has risen over the onset of a recession if the relationship inverts, i.e., short rates become greater than long rates. The goal of monetary policy is to promote growth with stable inflation. But what if policymakers get it wrong and raise rates too much? An assessment of past inversions and outcomes can provide perspective.

Perspective

Interest rate inversion, the phenomenon of short-term rates rising above long-term rates has been viewed as a harbinger of economic recession for good reason. Chart I plots the yield advantage of 10-year U.S. Treasury notes over 3-month U.S. Treasury bills. The shaded areas reflect the seven U.S. recessions that have occurred since 1962. Prior to each recession, short-term rates exceeded long-term rates, i.e., the spread was negative. The connection is clear in that Federal Reserve policy directly affects the supply of credit, the price of which is interest rates. As credit supply falls short of demand from a growing economy, rates rise to the point where demand falls as credit has become too costly. Credit appears abundantly available today and long-term rates remain above short-term rates. If an interest rate inversion were to occur, will a recession be far behind?

The relationship of stock market returns to economic recessions is shown in Chart II. The reason for investor concern over the impact of recession on stock market return is clear. The twelve-month return of the Dow Jones Industrial Average has turned negative more times since 1962 than there have been recessions, but each recession (shaded areas) has included a stock market decline.

Real U.S. economic growth in fact has accelerated recently with each of the last two quarters above the long-term average of +3.2% as shown in Chart III. Consensus forecast for the current quarter and each quarter of 2019 is real growth slipping below +3% and trending steadily lower to a +2% rate in 4Q2019. Not a recession, but as noted above, stock market declines can occur when other factors exist. Looking into 2019, such factors include trade uncertainties, slower earnings growth and levels of and impact from interest rates.

Investment Implications

With the U.S. stock market already in a correction (-10.8%) and foreign stock indexes near bear market levels (-18.9% overall and -26.6% for emerging markets), the most important activity at this time is to ensure that levels of portfolio risk are properly aligned with individual goals, time horizons and tolerance for risk.

CHART I

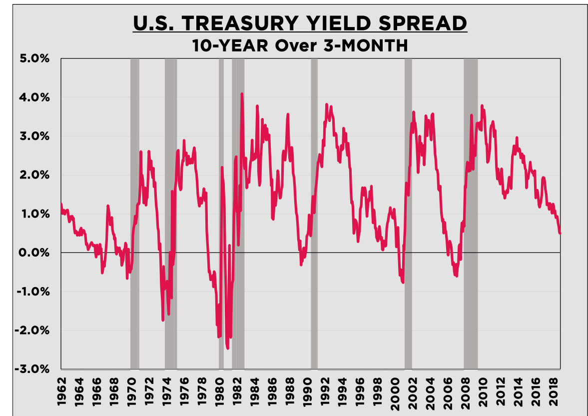


CHART II

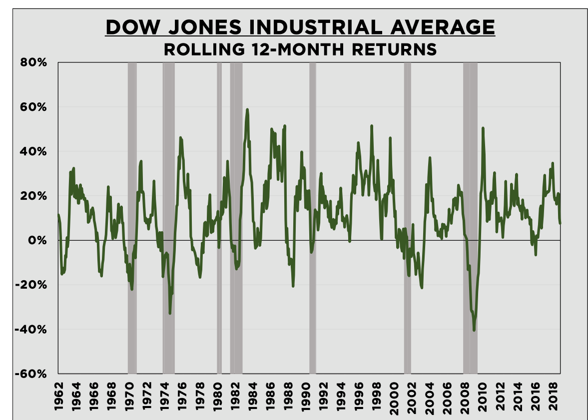
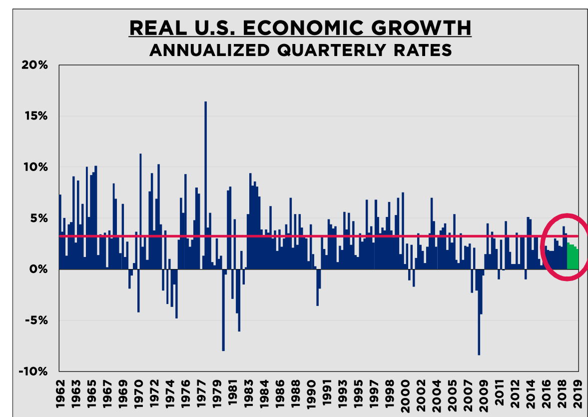


CHART III



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