Appleton Partners, Inc.

Sympathy for the Yield Curve

"The US economy is showing vulnerability to geopolitical risk, but – as Mick Jagger once sang in 'Sympathy for the Devil' – "as heads is tails," a bear reading and a bull reading of the economy may explain the seeming contradiction of the first quarter. The two readings are at the end of the day still two sides of the same coin."

The contradiction between the stock and bond markets in the first quarter couldn't have been more striking. Equities were off to the races, with the S&P 500 posting its best quarterly return since Q3 2009. Meanwhile, the bond market was flashing warning signs of recession, with the 3-month to 10Yr curve inverting after the 10Yr fell like a rolling stone by nearly 30bps, coupled with Fed Funds futures abruptly pricing in about a two-in-three likelihood of rate cuts before year-end.

A sensible market observer would not expect to see these things happening simultaneously, yet here we are. While this scenario was beneficial to investors, with nearly all risk assets putting up unusually high returns, it's also one that should give pause. Is the stock market right about the economy, or the bond market? Our answer is "neither."

Moments of Doubt and Pain

There's an old economist's joke that an inverted yield curve has correctly predicted eight of the last six recessions. There's a grain of truth behind that quip. The Treasury yield curve is normally upwards-sloping, meaning the longer an investor is willing to lock up capital, the higher yields they will earn. This compensates longer-term investors for the possibility that shorter, risk-free rates are higher at some point than they are today. When the curve inverts and becomes downward-sloping, it suggests investors either expect risk-free rates to fall, or are so eager to safely tie up money for longer periods of time that they're willing to give up yield to do so. Both cases suggest uneasiness about the economy.

And there are plenty of reasons to feel that way. What seemed like a shutdown-related blip in retail sales in December has instead extended through February, and inventory levels have risen. Most measures of inflation have also ticked downwards, implying weak demand. Capital goods orders are stagnant, GDP growth weakened in Q4 and is expected to come in weaker still in Q1, and corporate earnings appear on track to decline for the first time since 2016. Fed Funds futures on 3/31 projected a 64% chance of a rate cut before year-end, reversing expectations from a mere six months ago. Complicating matters, President Trump has escalated his war on the Fed's independence. From this perspective, it's hard to discount reversion to the mean as an explanation for the S&P 500's stellar first quarter.

All the Sinners, Saints

However, there's a highly credible bull case here, too. Corporate earnings may be expected to drop in Q1, but investors typically focus on the second half when earnings growth is projected to resume. GDP may be decelerating, but this was expected after the stimulus effects of the Tax Cuts and Jobs Act wore off, and we appear to be settling back towards a post-Financial Crisis 2% real GDP growth trendline. Business confidence indices may have weakened, but only to roughly five-year average levels, hardly cause for concern. Forward price-to-earnings ratios may be a little stretched, but they are not significantly above recent averages. Even if feared yield curve inversions have been reasonably good - if imperfect – past recession indicators, 12-18 months of solid equity performance usually follows. And while the Fed notes the Fed Funds rate is below their long-term neutral rate estimate, they've also emphasized that it is at a short-term neutral level and that a pause is appropriate.

The Fed's pragmatism is an encouraging sign – most past inversions occurred when the Fed pushed short rates too far, choking growth. In 2006, the curve inverted shortly after a rate hike and remained there for most of the year. The current inversion followed nearly three months of relative stability, lasted mere days, and occurred not because the short end increased, but after the long end fell on a contraction in German manufacturing. The cause of the yield curve's inversion appears very different this time around, an overlooked factor that we believe has meaning.

Please Allow Me to Introduce Myself

Our view is that this inversion primarily reflects uncertainty due to geopolitical risk factors having little to do with the current health of the US economy. The US is engaged in extended trade negotiations with China, and while we continue to believe a modest deal is reasonably likely, there is still little clarity as to what that might look like. Further, the Trump Administration is also threatening tariffs on auto imports, which if imposed, would have negative economic ramifications at home and abroad. And finally, the clock is ticking on a wildly unpredictable Brexit saga with the end game yet to present itself. How these issues ultimately play out will have major implications for trade and overall global economic conditions.

Last month's inversion in the curve looks more to us like a rational response to event risk than market conviction a recession is imminent. That's not to say one is impossible. Investor risk appetites matter, "this time it's different" stories are routine before recessions, and an external shock in a skittish market could lead to recession. Nonetheless, we believe that successful resolution of these largely geopolitical concerns would cause the stock and bond markets to re-focus on fundamentals and be valued in accordance with an economy experiencing 2% annual growth, low unemployment, and low inflation.

But What's Puzzling You

So, we think neither the stock nor bond market has it right. The economy is unquestionably slowing. Equity markets are too sanguine about trade outcomes and future earnings growth, and we would welcome a period of consolidation to allow P/E ratios to tighten a little. Despite what today's Fed futures are saying, we don't see current economic conditions leading the Fed to start cutting rates and do not believe a recession is imminent. Rather, the US economy is showing vulnerability to geopolitical risk, but – as Mick Jagger once sang in 'Sympathy for the Devil' – "as heads is tails," a bear reading and a bull reading of the economy may explain the seeming contradiction of the first quarter. The two readings are at the end of the day still two sides of the same coin.

Market Observations & Implications

Tax-Exempt Investment Grade Municipals	• Strong momentum from Q4 '18 was sustained in QI '19 as yields fell across the curve by roughly 30-40 bps led by the longer end. The strong move was a function of low inflation expectations, weakening global economic conditions, and much more dovish Fed policy expectations. • Municipals out-performed USTs with 10Yr muni/UST ratio dropping from 84.76% to 77.18%. 2Yr, 5Yr and 30Yr maturities told a similar story. • The municipal curve continues to flatten as 2-10Yr AAA spreads dropped from 50 to 37 bps, the tightest level since 2007. • Front-end flatness (5 bps yield pick up between 1 and 4 years) coupled with SIFMA at 1.50% creates a conundrum as cash equivalents are out yielding 1-3Yr paper. With inflation remaining low and muted economic growth, the front-end could trade lower in yield. • Strong mutual fund flows have driven yields lower and credit spreads tighter. Over $22B flowed into funds in QI '19 over 12 consecutive positive weeks. • YTD issuance of $75B is up 14% from QI '18. Even if 2019 issuance hits a projected $370B level, JP Morgan expects net negative issuance of $63B. • Strong market technicals have led to recent duration and credit outperformance. The Long Bond segment (22 years +) of the Bloomberg Barclays Index posted a +3.85% Q1 return. Credit also performed well led by the lower grade sectors. Revenue bonds (+3.07%) outperformed the GO index (+2.78%) in QI. • Preliminary Q4 '18 state tax collections show that personal income tax (PIT) revenues declined vs. Q4 '17 in 23 of 41 states reporting. High tax states such as NY, CT, CA and NJ saw the largest declines, as PIT collections in 4Q '17 were unusually high ahead of the SALT deduction cap. However, over a full year (2018 vs. 2017), PIT growth averaged 5.7% and only three states recorded declines. • In a first for the US, the NY State legislature approved a "congestion pricing" plan to begin in late 2020 charging vehicles on most access routes into lower Manhattan. The tax is projected to raise up to $1B annually for mass transit and commuter rail projects and would also be leveraged to support up to $15 billion in new bond issues. This is a credit positive for the MTA, State and City as it provides a recurring source of funding for deferred maintenance and service improvements and resolves fiscal uncertainty.
Investment Grade Corporates & Treasuries	• A rapid change in Fed Funds expectations (0 increases in 2019 and 1 in 2020) has further compressed UST yields and already tight corporate spreads. Given this backdrop, recent fixed income returns have been strong. • Despite a recent 3 month to 10-year inversion of the UST yield curve, we do not see imminent recession. Corporate credit, job and wage growth, and consumer confidence remain strong and financial conditions have loosened. This is all supportive of credit and other risk assets. • However, the market is signaling that December's 0.25% rate hike may have been premature. The probability of a rate cut went from nearly zero to > 60% during March. • Fed Funds futures are also now pricing in a 40-50% of a rate cut by year-end.
Equities	• The S&P 500 finished Q1 2019 with a gain of 13.6%, the best quarter since Q3 2009. The rally was driven by US-China trade optimism, a dovish Fed pivot, and better-than-feared Q4 earnings. • Performance was broad-based (REITs: ~+15%, US small caps ~+14%, foreign stocks ~+10%, commodities ~+6%, and US fixed income ~+2-3%). • Equities can continue to perform well provided earnings come through. While Q1 earnings growth is expected to decline by 4.2%, full year 2019 is projected to see a 3.6% growth. • Growth is slowing, but still positive. We see potential upside to those estimates and will be closely monitoring forward guidance during the April earnings season.

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