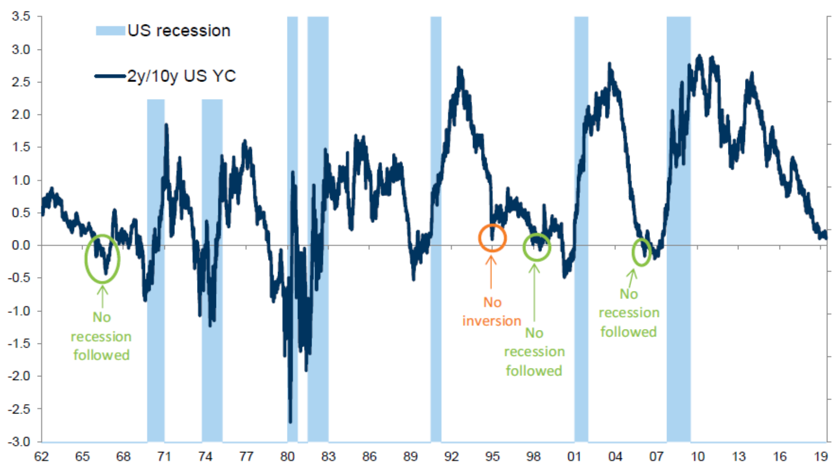
I see Yield, you see me

I am revealing my age here with the caption of this month's Navigator' "I see you (yield), you see me". Some of you will know this is the lyrics from a Daryl Hall and John Oates hit, Private Eyes. With the yield curve slipping into negative for the first time since Mar 2006, the cauldron of market commentators and general public are ringing the bells of an imminent recession. If the inversion in the yield curve is the be-all and end-all in predicting recessions, they will be no need for economists and quantitative econometric models. To make all your investment decision using just a single input, especially one that is so market-driven and is susceptible to herd mentality, is both hasty and amateurish.

Before we delve into what an inverted yield curve means, we like to remind readers which is the most important tenure of the yield curve to monitor and the accuracy of an inverted yield curve in predicting recession and bear markets. **The most important tenures of the yield curve as another input into recession modeling has empirically been the 2yrs vs 10 years.** It is less prone to market speculation on the long end while any tenure less than 2 years are greatly influenced by central bankers' policy rate and momentary liquidity conditions. Since 1960, **the 2-10 yield curve has inverted 9 times, however, there has been 3 times the inversion was not a harbinger of an impending recession**. Those were in the years of 1965, 1998 and 2005. In other words, the predictive value of an inverted yield curve to a possible recession is 67%. For those years it was accurate in predicting a recession, the average lag time from an inversion into a recession was 13 months and ranges from shortest of 6mths lag (1973) to longest 18mths (1989-90). The exigent question should be is an inverted yield curve a canary in the coal mine of an upcoming bear market? **The empirical data is even less convincing on the usefulness of an inverted yield curve to foretell bear markets.** Out of the 9 times it inverted, there were 4 occasions (56% accurate) it didn't presage a bear market (1978, 1989, 1998, 2006) in the next 21 months. Even when it did, there is an average lead time of 4 months to a bear market though there was once back in 2000 it was a coincidental indicator. We want to reiterate the inverted yield curve is merely one of the many indicators that we should use in predicting a recession and not the holy grail.

<u>Inverted Yield Curve is important but not all-encompassing in predicting recession or bear markets</u>

US recessions based on NBER definition



Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

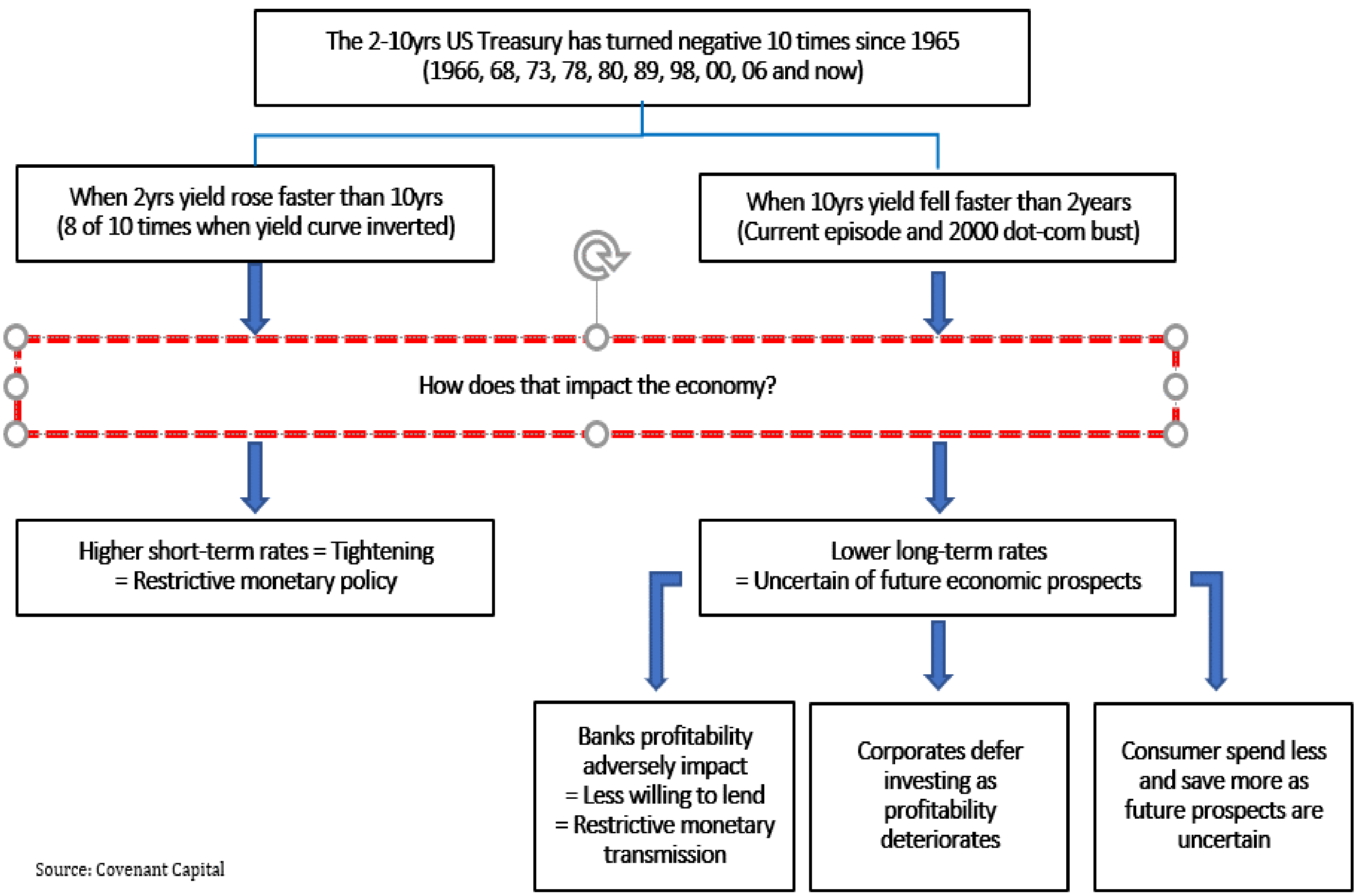
	Lead (-) and Lag (+) IYC Efficacy (months)		
Yield Curve Inversion Period	Recession	Bear markets	Bear market decline
11-Jan-66	No	1	-21%
19-Dec-68	12	5	-33%
1-Jun-73	6	5	-41%
18-Aug-78	17	No	NA
9-Sep-80	11	12	-21%
4-Jan-89	18	No	NA
9-Jun-98	No	No	NA
10-Feb-00	14	0	-49%
17-Jan-06	No *	No *	NA
14-Aug-19	?	?	-2.90%
Efficacy of IYC	67%	56%	
Average (mths)	13.0	4.6	-33%

Source: NDR, Bloomberg * though SPX peak in Oct 2007 , 21 mths later

The question one should be asking is how does an inverted yield curve impact the economy? Critically, an inverted yield curve restricted monetary flows into the economy. The restriction is transmitted via two channels. The first channel is via higher short-term rates which immediately translate to higher borrowing cost and the second channel is via lower long-term rates which influence future spending and investments decisions. It is critical to inform our readers of the last 10 times the yield curve inverted (including the current episode), 8 of them were caused by the 2 years rates rising faster than the 10 years. This reasons for short-term rates rising faster were because either the Fed was embarking on a tightening cycle due to rising inflation or other endogenous issues that lead to short-term liquidity tightening such as in 1998 was LTCM crisis erupted. But the current environment we have the Fed alongside many other central bankers cutting rates instead, with the Fed likely to make another cut in September. 17 of the 30 important central banks in the world has already cut rates in the last 3 months. Furthermore, the US 2-years short-term rates have actually fallen by -43bp since the start of Aug. Global monetary conditions have actually loosen further not tighten.

This current episode of yield curve inversion is driven by the sharper dive in long-term rates instead. The only time the yield curve inverted because long-rate declined faster than the short-end was in the depths of dot-com busts on 2000. What is the relevance of the longer-end rates rising faster than the short-end to the monetary transmission channel and to corporate investment and consumer spending? The sharp decline on the long-end rates adversely impact banks profitability and hence curtail their willingness to lend thereafter limiting monetary flow into the economy. This is especially impactful for economies such as Europe, Japan and China where the banking system is still the primary conduit of monetary transmission. However, it is less pernicious to the US economy where banks account for 30% of the corporate debt financing source, while the bond markets contribute 70%. If we consider the rest of the other capital markets like equity, VC funding and private placements, US economy reliance on the banks to grease the economy would fall significantly lower than 30%. In China, despite easing liquidity conditions through cuts in reserve capital requirements and lowering interest rates, the banks have been reluctant to lend money to the sectors that need it the most, the private sector, preferring to hide in safety perceived creditworthiness of its SOEs. While we expect PBOC to increase liquidity in the coming months more forcibly, the flow of credit will still be stymied into counter-productive sectors given banks' reticence to lend to the private sector. In Europe, we expect ECB to launch QE2 and alter the conditions of tier-interest rates scheme to induce more of its banks to lend to the real economy in Sep. Whereas in China and Europe, the negative yield curve has the unintended consequence of disenfranchising the banks to lend, we do not have such a problem in Japan. Japan banks are willing to lend given they have lived in a negative yield environment for so many years, its problem is there are little credit-worthy opportunities to lend to in Japan.

What is the impact on the economy when the 2-10yrs yield curve inverts?

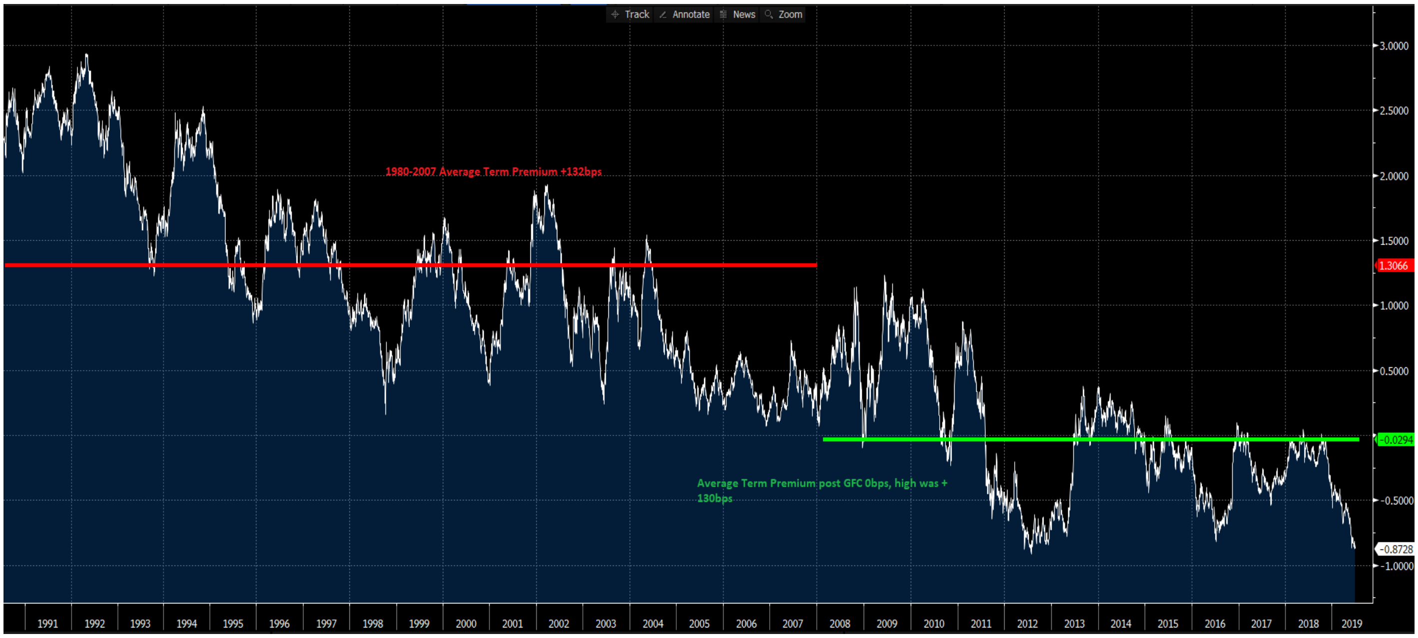


Source: Covenant Capital

This leads us to the risk of some form of Ricardian Equivalence that lower long-end rates can wreak on the economy, which we wrote back in 2016, Let's get fiscal, fiscal (oh no, another reference to 1980s). A lower long-term rates curb banks' propensity to lend, curtail corporates form investing as it impacts their future profitability and can sometimes lead to consumer retrenching from spending and saving more as they perceived long-term economic prospects are poor. Let's not be confused from the cause and effect between inversion of a yield curve and a recession. A recession does not cause the yield curve to invert. It is the impact of a negative yield curve that either impedes either monetary flow into the system and/or both corporates and consumer spending less therefore leading to a recession.

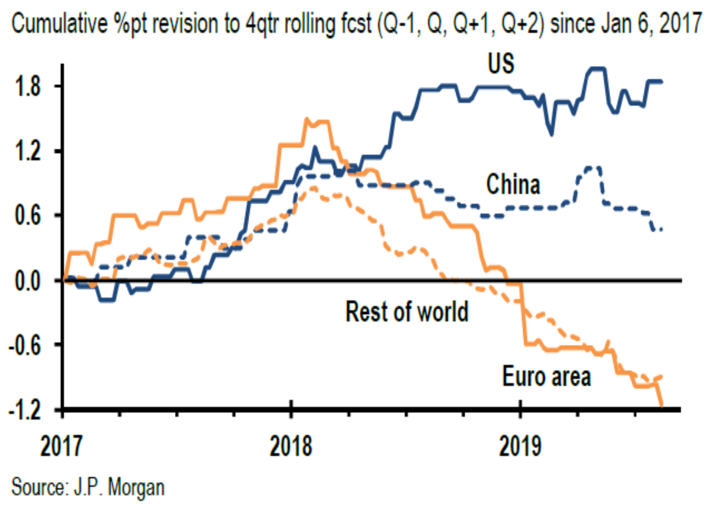
Another important distinction must also be pointed out: The flattening of the US Treasuries' term premium pre-GFC and post GFC. Since 2008, global QE has reduced the term premium significantly and structurally as well as central bankers' purchases of assets crowd out the investable universe. Even before QE, the term premium has been on the long-term decline since 1980s driven by demographics, technology advances that have kept inflation at bay and the globalization of capital and manufacturing flows. Prior to 2008, the average term premium from 1980-2007 was 130bps. Several studies have suggested that QE has reduced term premium by 100-130bps. In other words, **the continuation of QE via another QE program or slower asset purchase unwind should have lowered than the signaling level of yield curve inversion to -100bps or more but it currently stands at 0.08bps at the point of writing.**

QE could have also lowered IYC signaling threshold to -100bp not zero

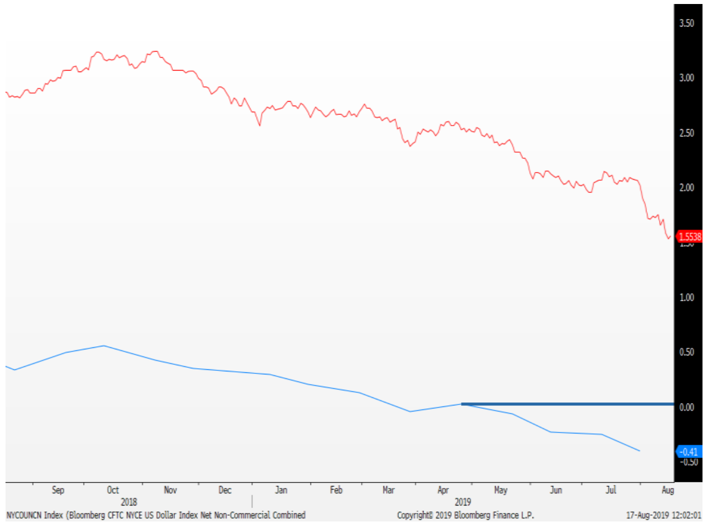


The major growth disappointments have come mainly from Europe and Japan rather than the US. As indicated by JPM GDP forecast revision, US forecast has been relatively stable while the revision in China growth has stabilized after the initial decline in 2Q as policymakers step-up both fiscal and monetary levers to attend to its ongoing jostling for trade and geopolitical supremacy with the US. However, the pronounced downgrading of economic forecast was most evident in Europe particularly in Germany and Brexit is not helping as well. It's no surprise that German ten-year bund slipped into negative territory in late April and extended its decline further to -41bps; the first time in history that its' bonds have joined the $12trn club of negative-yielding fixed income assets! We postulate the sharp drop in US ten-year yield in recent months coincided with the German bunds entering negative yield as investors are forced to park in anything that is of equivalent credit worthiness. There is none better substitute than the US government bonds. Reinforcing our view that taking US yield curve inversion as an indicator of US weakness is misleading.. **Next month ECB meeting and the change of guard will take on inordinate importance for the global risk appetite.**

Growth weakness concentrated in Euro and Japan



US 10 yield fell rapidly when German went zero



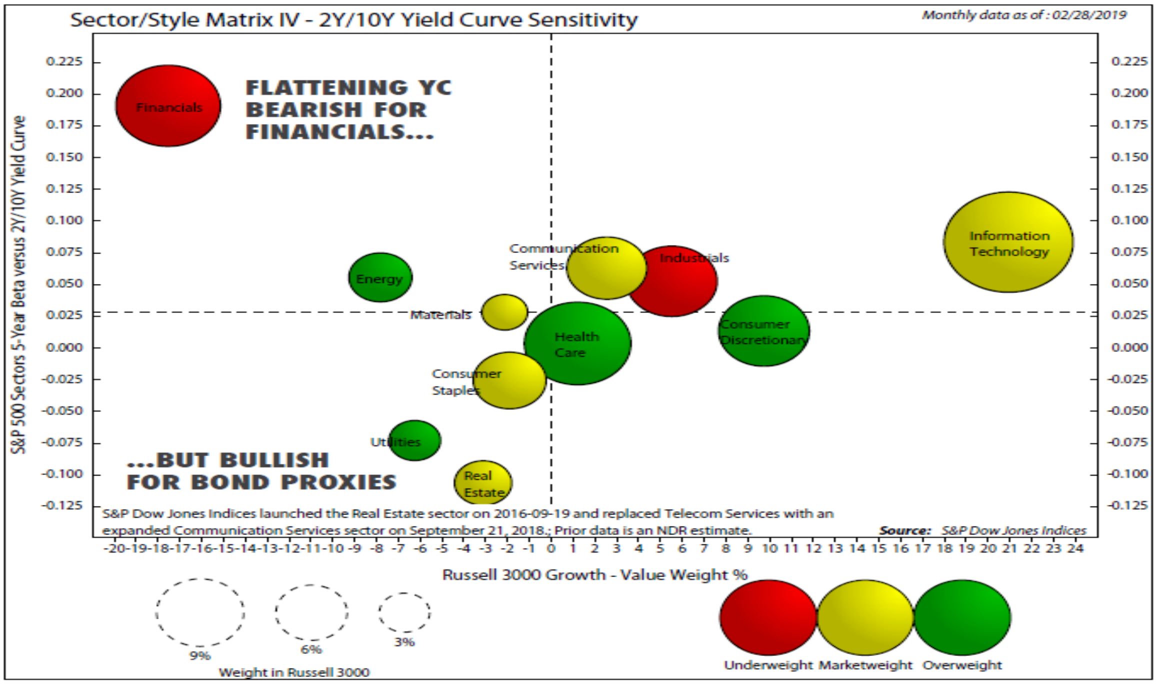
Asset Allocation Strategy

We have not changed our cautious views on markets despite our musings that the current inverted yield curve is a false signal. It is and will remain an important myriad of indicators to watch for growth inflection points, just not the only one. We remained concern with growth slipping, earnings downgrade risk and the overhang of US-China rhetoric that has now spread beyond trade. Valuations are still not cheap and in Fixed Income it has become even more expensive.

Equities: Underweight. In June's Navigator, [Conflated, confused, hopefully not concussed] and our 2H19 investment outlook, [It's getting late], we advocate a switch to defensive and income-oriented strategies as the economic and market cycle matures. We have analyzed the impact of various sectors and equities strategies that work best in the next 6-12 months after a first Fed cut and concluded Consumer Staples, Consumer Discretionary and suggested positioning in Healthcare and Dividend strategy as the appropriate strategies. While we are still slightly overweight Technology our focus is on two key sleeves. Bombed out semiconductors stocks especially those provided some decent yield and champions in long-term structural trends. We are Neutral in the US, slight overweight in Europe as there are handsome dividend from that region, underweight both Japan and Emerging markets, though we are seeing great value emerging in some Hong Kong stocks after 11 weeks of protests.

This week we overlay these equities strategies with what works better when the yield curve inverts. According to NDR research, our preferred sectors of Consumer Staples and Healthcare are less sensitive to the negative impact of an inverted yield curve. Real Estate and Utilities are the other two sectors that have inverse correlation to a negative yield curve. However, we have opted for REITs instead of broad real estate (except a few bottom-fishing ideas in HK real estate) and utilities (historically has performed poorly when Fed cuts) because our over-arching overlay of deriving more income at this juncture.

Staples, Healthcare, Utilities and Real Estate have an inverse correlation to negative yield curve.



Fixed Income: Remains Neutral especially with spreads on corporate debt so thin while our growth concerns build. We have added more government bonds as a hedge and are watching carefully the USD to decide if we should be trimming our EM exposures. For the time being, the prospect of another 25bps cut by the Fed should allow EM central bankers to cut another 50bps or more in the coming months.

FX: Ambivalent at best but we expect USD to strengthen moderately due to its relatively exceptional better growth stability when compared to the rest of the world.

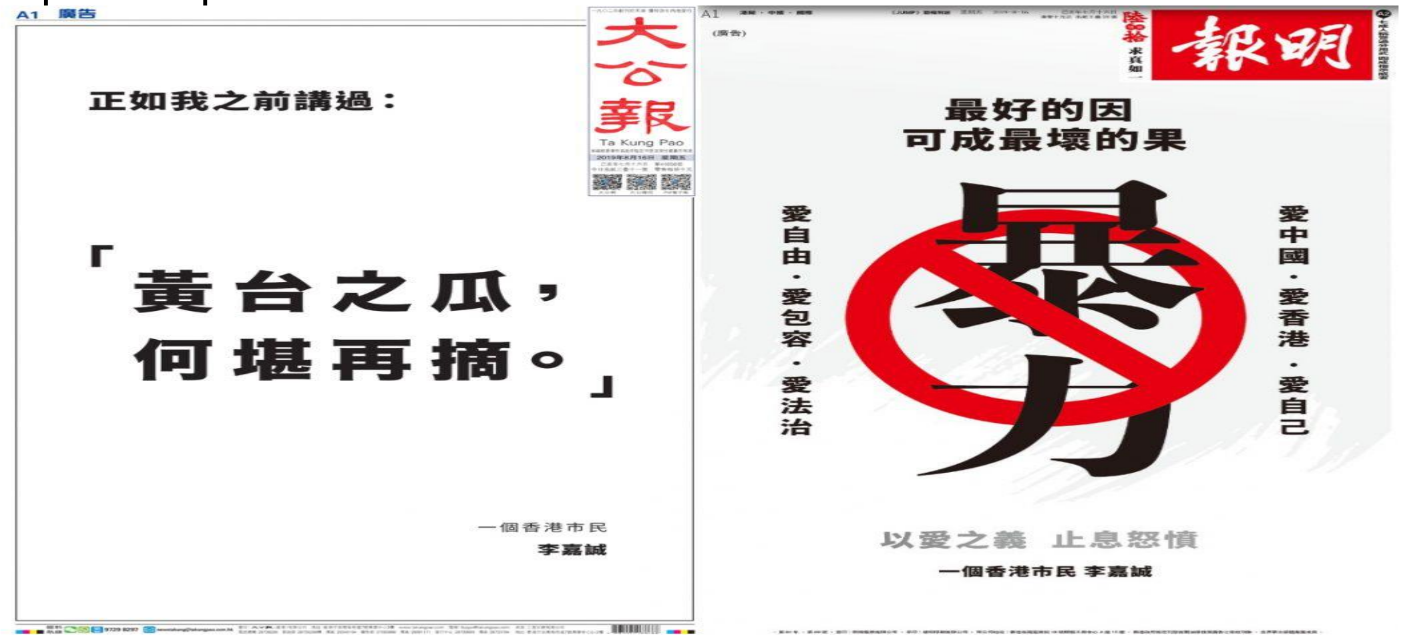
Commodities: Neutral with Gold as a safe-haven hedge.

Alternative Investments: No change

Cash: Cash will be within 10-12% as deposit rates have fallen in tandem with declining global rates. We are parking some of our cash in short-term investment grade corporate debt to pick up better yield and perhaps enjoy some capital gain from declining rates.

Featured Picture/Quote:

Superman speaks.



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Risk Disclosure