Weekly Market Commentary

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Grading on a Curve (the Yield Curve, That Is)

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Highlights

The yield curve has a perfect record in signaling recessions over the past 50 years.

One of our "Five Forecasters," the yield curve tells us that a recession and significant market downturn are likely a ways off.

The yield curve is one of the Five Forecasters featured in our *Mid-Year Outlook 2014: The Investor's Almanac Field Notes* that has consistently signaled increasing fragility of the economy and a transition to the late stage of the economic cycle, an oncoming recession, and ensuing market downturn.

Bull markets have ended and bear markets have begun when the Fed pushes short-term rates above long-term rates.

Kids are back in school and have started taking tests. Some of those tests are graded on a curve, meaning that students are graded based on their score relative to the rest of the class. In terms of stock market indicators, one that gets an A+ and ranks at the top of its class is another type of curve—the yield curve. In fact, this indicator receives a perfect score (seven for seven) in signaling recessions over the past 50 years.

The goal for all investors is to find indicators to help anticipate big down moves, and the yield curve has been about as good as it gets on that score. One of the Five Forecasters featured in our *Mid-Year Outlook 2014: The Investor's Almanac Field Notes*, the yield curve passes the test as an indicator that has consistently signaled increasing fragility of the U.S. economy and a transition to the late stage of the economic cycle, an oncoming recession, and ensuing market downturn.

Many market participants have become worried (if not obsessed) about when the Federal Reserve (Fed) may start hiking short-term interest rates. Most economists and Fed watchers currently expect the Fed to begin rate hikes sometime in mid- to late 2015. But history shows the start of rate hikes, which may initially spark modest, but brief, stock market weakness, does not really alter the longer-term upward trajectory of stocks during an economic expansion—as we discussed in our *Weekly Market Commentary*, "Ready, Set, HIKE!" on August 25, 2014. History tells us that the difference between short-term rates and long-term rates matters more, and the Fed has much more influence over short-term rates.

Bull markets have ended and bear markets have begun when the Fed pushes short-term rates above long-term rates. This is referred to as an inverted yield curve. For example, the S&P 500 Index peaked in 2000 and 2007 when the yield curve inverted, with the three-month T-bill yield about 0.5% above the yield on the 10-year Treasury note.

Why does an inverted yield curve signal a major peak for the stock market? Because every recession over the past 50 years was preceded by the Fed hiking rates to slow inflation and/or an overheated economy enough to invert the yield curve [Figure 1]. That is seven out of seven times—a perfect forecasting track record. The yield curve inversion usually takes place about 12 months before the start of the recession, but the lead time ranges from about five to 16 months [Figure 2]. The peak in the stock market comes around the time of the yield curve inversion, ahead of the recession and accompanying a downturn in corporate profits.

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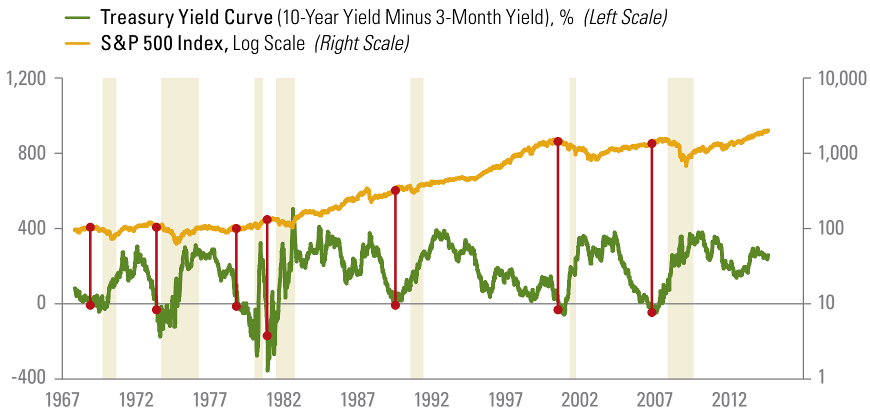
1 Yield Curve Inversions Mark Stock Market Peaks



Source: LPL Financial Research, Bloomberg data 09/29/14

Red bars indicate when yield curve began to invert. Shaded areas indicate recession.

Past performance is no guarantee of future results.

2 Yield Curve Has a Strong Track Record of Signaling Recessions

Date Yield Curve Inverted	Recession Start Date	Number of Months Lead Time
June 1969	December 1969	6
June 1973	November 1973	5
December 1978	January 1980	13
October 1980	July 1981	9
July 1989	July 1990	12
August 2000	March 2001	7
August 2006	December 2007	16

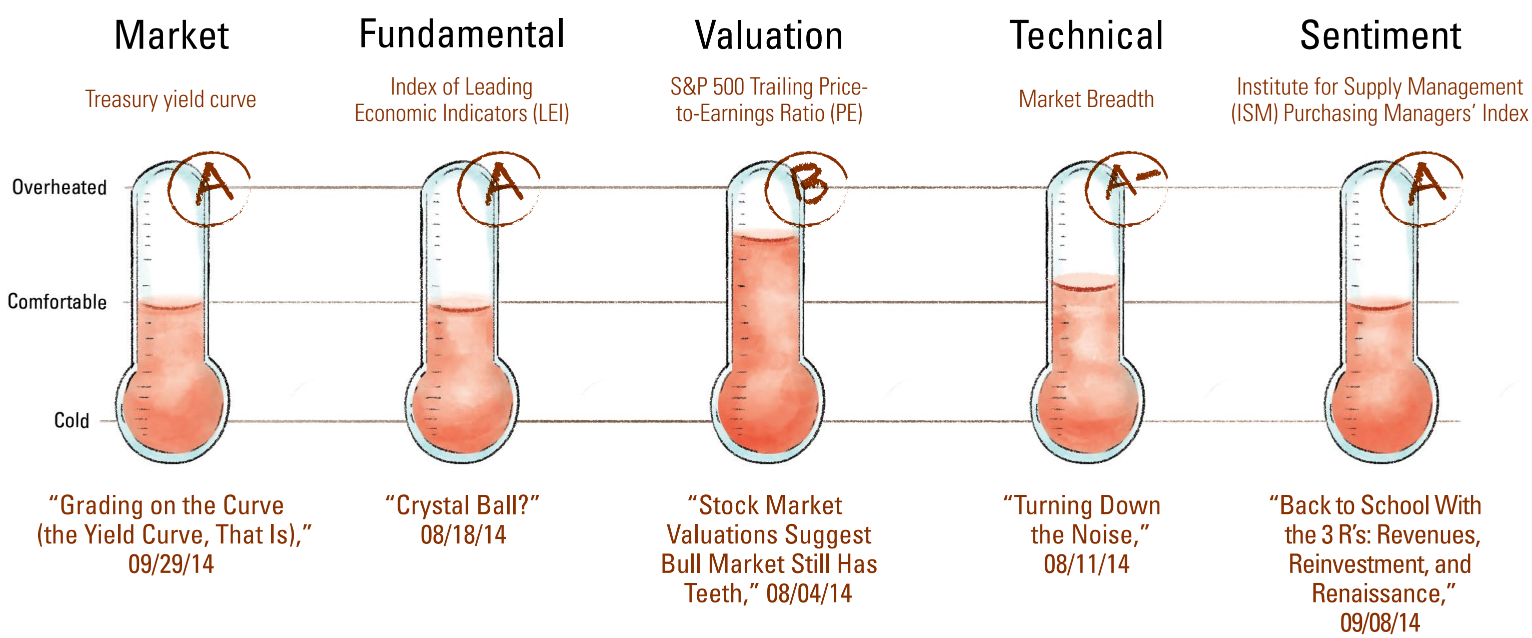
Source: LPL Financial Research, National Bureau of Economic Research (NBER) 09/26/14

How far the Fed must push up short-term rates before the yield curve inverts by 0.5%, the level that has marked prior market peaks, depends on where long-term rates are. Even if long-term rates stay at the very low yield of 2.5% (as of September 26, 2014), to invert the yield curve by 0.5% the Fed would need to hike short-term rates from their current level (at around zero) to more than 3.0%. Based on the latest survey of current Fed members that vote on rate hikes, most do not expect to raise rates above 3.0% until sometime in 2017. Even if the economy continues to grow at 4.0%—as it did during the second quarter and has done so far during the third—and the Fed raises rates as soon as next spring, it is still a long way off from reaching 3.0%. As a result, the yield curve indicator may be a long way away from signaling the start of a bear market. There are more good grades to come for this indicator.

Our Other Favorite Indicators Sending Similar Signals

The message that the yield curve is sending—that a recession and significant market downturn are likely a ways off—is the same message coming from the other Five Forecasters. Here are the grades we give these five indicators at this point, with the dates of our last *Weekly Market Commentary* on each topic:

3 The Five Forecasters Are Not Sending Worrisome Market Signals



Source: LPL Financial Research 09/26/14

Conclusion

We continue to believe we are just entering the latter half of the current business cycle, and a recession and bear market are unlikely based upon the yield curve indicator. Although there are reasons the U.S. economy could experience a recession without first experiencing an inversion in the yield curve, the flawless track record earned over 50 years of varying economic, legislative, regulatory, geopolitical, and social conditions is a testament to the robust nature of the yield curve as an indicator. So while we expect stock market volatility to increase this fall, and the geopolitical landscape investors are facing does seem precarious, we do not expect a bear market. We maintain our positive outlook for stocks over the balance of 2014 but will continue to test and grade the Five Forecasters as the school year continues, in order to gauge the sustainability of the current economic expansion and ongoing bull market.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

Price-to-earnings ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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