Dave Hutchison, CERTIFIED FINANCIAL PLANNER™

1720 E Calle Santa Cruz
Phoenix Arizona 85022

HUTCHISON INVESTMENT ADVISORS
Registered Investment Advisor
Founded on a CPA Firm Background
(602) 955-7500

E-mail: dave@HutchisonRIA.com
website: www.HutchisonRIA.com
Fax (602) 955-1458

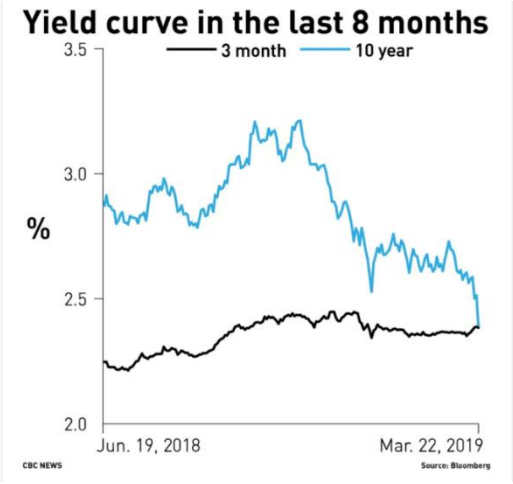
Inverted Yield Curve Panic? - Action Plan

The Dow fell 460 points on March 22, 2019 driven by poor European data, a slightly inverted U.S. yield curve, and automated machine momentum trading accelerating the loss into the closing.

While the inverted Treasury yield curve got a lot of attention since it has forecasted a recession in the past, the downturn was also driven by the contraction reading of 47.6 for the European manufacturing PMI (Purchasing Managers Index) - the worst in nearly six years, according to IHS Markit data. Data also showed a sharp downturn in German manufacturing to 44.7 - a 79-month low for Europe's largest economy. A reading below 50 indicates contraction. Most European economies are in or near recession and getting worse.

While declining, the U.S. data was much stronger. The U.S. manufacturing PMI only fell slightly to 52.5 from 53 - but a 21-month low, while the services PMI fell to 54.8 from 56. Any reading above 50 indicates improving conditions.

The European contraction pushed the 10-year German Government Bund yield negative. Combined with the strong U.S. dollar increased demand for U.S. Treasuries at about 2.4% vs. negative or very low yields in Europe. Japan's 10-year yield has been below zero for most of 2019 and sunk further on March 22nd after the Cabinet Office downgraded it assessment of the world's third-largest economy after a key indicator signaled Japan may already be in a recession.



Barely Inverted Yield Curve

The yield curved flipped for the first time since the Great Recession. Normally, short-term debt yields less than long-term debt that requires investors to tie up their money for a longer period. When short-term debt pays more than long-term debt, the yield curve has inverted.

There has been high demand for longer-term U.S. Treasury Bonds both due to the U.S. having comparatively high yields for the world's safest bonds and worries about global growth moving some investors out of equities into bonds.

Shorter-term rates, by contrast, are influenced less by investors and more by the Federal Reserve, which raised its benchmark short-term rate seven times over the past two years. This momentum will likely slow now that the Fed foresees no rate hikes in 2019. But if longer-term Treasury yields continue to weaken, the curve could remain inverted.

The financial sector - mostly banks - led the broader market down as the yield curve inverted. This makes lending less profitable for banks.

Historically an inverted yield curve that lasts a month or so has often been a predictor of a future recession. However, there are unusual factors today that may account for the inversion not leading to U.S. recession

Marketwatch 3/22/2019 points out: While an inverted yield curve is a recession indicator, investors may be pushing the panic button prematurely. Since so many Treasury bonds are held by central banks,

the yield can no longer be seen as market-driven, said economist Ryan Sweet of Moody's Analytics. Also, many analysts see the Fed eager to avoid inversion of the yield curve, which could prompt policymakers to move from standby mode toward easing mode.

An inverted curve can be a source of concern if short-term rates are high because an overly tight monetary policy is slowing the economy. Today, while the economy is slowing to around a 2% growth rate after the short-term stimulus of the massive tax cuts, the Fed just reversed course with its pause on rate increases. The U.S. 2% projected growth rate is better than most other global economies. As Barron's said, **"The U.S. economy still appears to be sailing on serenely, while the rest of the world economy sinks like a stone."**

Besides, there is significant fiscal stimulus by the $trillions of U.S. deficit spending, which helps economic growth at the cost of a potential future debt crisis, with potentially soaring interest rates to continue to fund the massive government debt. On 3/22/2019 the Treasury announced it ran a budget deficit of $234 billion in February – the biggest monthly shortfall on record. For now, the deficit helps support the economy.

Cetera Investment Management 3/22/2019 points out: It is widely expected that economic growth in the U.S. will continue to slow, the question is by how much. If it slows to expected levels, that would be in line with prior years before the tax legislation boosted markets and economic growth in 2018. The expansion's length is a product of its pace too. Growth has been slower compared to prior expansions, and the economy has not overheated.

Action Plan Recommendations which I can discuss individually with specific recommendations based on goals, objectives and risk tolerance.

Increase growth objective allocations to more U.S. equities. Reduce allocations in Europe and Japan. While growth is slowing, the U.S. has comparatively stronger economics than most global economies.

Consider more U.S. Small-Mid caps, which overall are less dependent on European sales. With revenues more from within the U.S., they do not have the currency risk of a stronger dollar that reduces foreign earnings. Smaller companies have the potential for faster growth, and with so many more smaller companies than large, good research can potentially find hidden gems. Smaller companies' stocks are often more volatile with less trading volume, but over the long term have rewarded investors.

Instead of "dumb" index funds with no stock selection based on individual company outlooks, or similar ETF's (only make sense for traders, not investors), I suggest managers with long-term track records of outperformance compared to the category they invest in and compared to the risk taken (Alpha vs. Beta in investment terms) – not just raw returns.

For those who want to build an ark for some of their funds for more protection I recommend a strategy that participates in part of equity gains without downside risk and not having to recover market losses to have future annual gains, backed by a strong insurance company[1]. Guaranteed[1] fixed annuities are also an option. However, we only recommend a few of these carefully selected options.

[1]Index annuities are insurance contracts that, depending on the contract, may offer a guaranteed annual interest rate and some participation growth, if any, of a stock market index. Such contracts have substantial variation in terms, costs of guarantees and features and may cap participation or returns in significant ways. Any guarantees offered are backed by the financial strength of the insurance company, not an outside entity. Investors are cautioned to carefully review an index annuity for its features, costs, risks, and how the variables are calculated.