What's Around the (Yield) Curve?

After falling 10% from peak to trough earlier this year, the stock market recovered from correction territory during the second quarter, led by continued momentum in the technology sector. While the S&P 500 was up by 1.67% through June, the Dow Jones Industrial Average was down by -1.81%. Meanwhile, the NASDAQ Composite gained 8.79% for the first half of the year. The composite of all equities under management at Osher Van de Voorde rose by 0.10% through June.

The performance disparity between the Dow Jones Industrial Average, a proxy for value investing, and the NASDAQ, a technology-heavy proxy for growth and momentum, is reaching proportions not seen since the dot-com bubble of early 2000. In fact, the Russell 1000 Value Index is in the midst of a fifth consecutive year (and tenth year of the past eleven) underperforming the Russell 1000 Growth Index. The technology sector now represents 26% of the S&P 500, almost twice as much as the next highest sector, health care at 14.1%. Further, the technology sector tops the 25.7% market cap of industrials, consumer staples, energy and utilities combined.

In fact, the combined market capitalization of technology bellwethers Apple, Amazon, Google, Microsoft and Facebook now top over $4 trillion and represent 17% of the $24 trillion S&P 500. Conversely, according to the Leuthold Group, the percentage of the S&P 500's market capitalization comprised of "defensive" sectors has fallen nearly 60% since 1991. While narrow market leadership has been fueled by price-insensitive ETF investors over the most recent years, there is evidence that this trend may be changing as the baton may finally pass from momentum to value investors. Blackrock, the world's largest asset manager and purveyor of ETFs, reported outflows of $22.4 billion from stock products in the second quarter, while investors bought $26.4 billion in fixed income. Morningstar reports that the amount of money invested in all U.S. passive mutual funds and ETFs for the first half of 2018 was down 44% from the same period a year ago. Meanwhile, Bloomberg reports that fixed income ETFs enjoyed the largest one-month inflows since October 2014 and have surpassed monthly inflows for equity ETFs for the third consecutive month. These trends seem to be consistent with increased stock market volatility, concern about the implications of the flattened yield curve and fears of a trade war with China that threatens to destabilize the global economy.

With few false warnings, every U.S. recession since 1957 has been preceded by an inverted yield curve. An inversion of the yield curve occurs when ten-year Treasury yield drops below the yield of short-term Treasuries. With two-year Treasuries yielding 2.62% and ten-year Treasuries yielding 2.86%, this 0.24% gap is the lowest spread between two-year and ten-year Treasury yields since 2007, just before the financial crisis and Great Recession of 2008-09. And perhaps

coincidentally, the yield on a three-month Treasury bill rose above 2% for the first time since Jun 2008. It is striking that an investor presently earns only 0.86% more on a ten-year Treasury than on a three-month bill! As we wrote in a recent private letter to clients, the good news is that investors are finally obtaining a more competitive return on money market funds and other cash equivalents.

Since the Federal Reserve remains on course to raise interest rates by another 0.50% this year, should ten-year Treasury yields remain stubbornly below 3%, it won't be long before the currently flattened yield curve inverts. With U.S. GDP accelerating in the second quarter, GDP expected to top 3% for all of 2018 and unemployment at 4%, the potential recessionary warning of an inverted yield curve seems to be at odds with present economic data. However, according to the San Francisco Fed, the yield curve has inverted between six months and two years ahead of recession, so it remains a distinct possibility that the market may be sniffing out an imminent peak in the economic cycle.

There are other factors to consider that make it more difficult to precisely predict the message of a potential yield curve inversion. For starters, the Fed's unprecedented quantitative easing program may continue to distort price discovery, even as the Fed proceeds with the unwinding of its multi-trillion-dollar balance sheet. Next, and perhaps more important, significantly lower yields for comparable sovereign bonds throughout Europe and Japan imply that yield-hungry investors, particularly pension and other long-term institutional investors, will continue to soak up higher yielding U.S. Treasury bonds. Head of London-based G+ Economics Lena Komileva recently summarized that "a surplus of investment funds looking for returns in low-yield global markets results in a cap on longer-term yield and a flat yield curve". Komileva goes on to conclude that "ultra-easy financial conditions, coupled with unprecedented fiscal easing in the U.S. at this late stage of the economic cycle, have the potential to overextend investor demand for risk and debt creation too far relative to weak productivity in real economies".

Borrowers with loans tied to short-term rates, including small businesses and homeowners are undoubtedly feeling the pinch of rising interest rates. And since banks are in the business of borrowing money at short-term rates and lending it at long-term rates, the flattened yield curve makes banking a less profitable business, potentially foretelling a curtailed flow of bank lending. The burst of economic benefits from President Trump's tax reform may prove to be but a temporary sugar high and the bond market may be signaling the growing propensity for Federal Reserve policy error.

Recent commentary by Fed Presidents John Williams, James Bullard and Raphael Bostic, as well as more dovish recent comments from Fed Chair Jerome Powell, all strongly indicate that the potential recessionary warnings of the yield curve are not

lost on the Federal Reserve. Indeed, massive inflows into bond funds and the flattened curve may suggest that the Federal Reserve is closer to the end of its rate hike campaign than previously anticipated.

Also not lost on the Fed is the potential for tariff-induced trade wars to disrupt the global economy. While it remains uncertain whether President Trump's threat to impose tariffs on $200 billion of imports brings China any closer to compromise, especially with regard to U.S. intellectual property rights, retaliatory tariffs on steel and aluminum imposed by the European Union, China, Canada and Mexico are already having negative consequences. Harley Davidson offers a good case study for the potential impact of a trade war. Last year, Harley sold close to 40,000 bikes to the important European market. In retaliation for Trump's steel and aluminum tariffs, the EU raised its tax on American-exported Harleys to 31% from 6%, resulting in an approximate $2,200 tax on each motorcycle exported from the U.S. to the EU. Instead of raising prices, Harley made the business decision to cover the expected $90 to $100 million increased annual cost. However, to combat these penalties longer-term, Harley announced that it will scale back U.S. operations and manufacture more bikes overseas over the next eighteen months. In addition to the potential for job losses related to tariff trade wars, other manufacturers may find it necessary to hike prices, potentially boosting inflation and making fulfillment of the Fed's dual mandate more difficult. Should the economic cycle be nearing an inflection point as earlier suggested concurrent with any tariff-induced burst of inflation, fears of "stagflation" may replace the flattened yield curve as the economic worry-du-jour.

The S&P 500 presently trades at 17.5x expected earnings for 2018 and a more reasonable 15.9x expected earnings for 2019. However, consensus earnings expectations that seemed to be a lock on the heels of President Trump's tax reform plan become murkier should the ongoing trade war accelerate. Meanwhile, S&P 500 companies are on track to repurchase as much as $800 billion of stock this year, eclipsing the all-time previous high $589.1 billion set in 2007.

A full-blown trade war seems to be the greatest immediate threat to the global economy and stock market, a threat that could conceivably confirm what the flattening yield curve may portend, the looming end to the second longest expansion in U.S. history. While we still believe that Washington and Beijing are likely to strike a bargain, the potential warning of the yield curve ought to be heeded.

Barring an imminent trade war, the stock market seems poised to extend its push beyond the 2800 plateau. A very healthy sign, the recent advance has broadened and has included sectors and stocks previously left behind. As risk of trade war and even recession grow in the wake of a flattened yield curve, attention to value will ultimately prove rewarding.