Be Careful What You Wish For

Weekly Review

It was a risk-off week (Thursday-Thursday) as the broader equity market (S&P500) was down 1.3%, while the tech heavy NASDAQ was off 2.2%. Bonds outperformed lead by longer duration/convexity positions, while TIPs/HY lagged. Despite a small respite, the S&P is still higher by 13% YTD and remains almost 20% above its Christmas Eve '18 low. Mid-Cap Value emerged as the top performing style, while Growth was the laggard. Real Estate and Consumer Defensive were the top-performing sectors, and positive for the week, while Healthcare and Technology were down 2.0% and 3.1%, respectively. The US$ remains strong, despite the 10yr TSY touching below 2.4%.

Inversion Incursion

We have been fielding several calls and inquiries this week regarding the "inverted yield curve" and the resulting impact it may have on client portfolios. Before we get into our views on this subject, lets first get the basics out of the way. First, "What is the yield curve and why is it important?" Basically, the yield curve is a graphical depiction of the interest rate lenders (investors) would expect to receive from borrowers (the US Government) at various points in time; it plots US Treasury yields maturing from 1-month to 30-years. And as the above URL link suggests, the slope of this curve has historically foreshadowed expectation for the economy and subsequently capital markets. Meaning, under "normal" conditions, a yield curve is upward sloping; the longer you lend money, the higher the interest rate/yield you should earn in return (this is called the term premium).

But when the yield curve "inverts," borrowing/lending rates for shorter periods (few months or a couple of years) are greater than interest rates for longer periods (i.e. 7, 10 or 30 years). This historically suggests that the "short end" of the curve is being impacted by inflation (loss of purchasing power) or the Fed's attempt to cool off the economy by increasing the Fed Funds rate. Rising short rates eventually result in more expensive consumer and corporate borrowings and ultimately slower economic growth and increased uncertainty.

However, as we pointed out in last week's note, we continue to navigate through unprecedented financial markets supported by extraordinary monetary/fiscal policy band aids both here and abroad. Therefore, the classic causation between inverted yield curves and recessions may or may not hold up. For one, softening economic conditions outside of the US has resulted in coordinated central bank easing, lowering borrowing rates in Europe far below that in the US. For example, the spread between the US 10yr and the 10yr German Bund is over +240bps (meaning the 10yr Bund is yielding practically nothing/negative, versus about +2.4% here in the US), while the spread between the US 10yr and the UK Gilt is +138bps and the spread to the French 10yr is +200bp. This implies that capital, looking for a higher guaranteed yield, will move away from European sovereign debt and toward the safe-haven US 10yr. This increased demand for the US 10yr, drives up the price, lowers the yield and further inverts the curve. In addition, let's not forget the size of the Fed's balance sheet and expectations to only modestly trim it. This too, helps depress yields at the long end and contributes to the overall inversion.

But absent the outsized growth needed in the US to push both the short and long end of the rate curve higher in a parallel manner, we remain concerned that if the Fed moves closer to cutting rates and thus signaling a week US back-drop, we believe the classic inversion/recession relationship may eventually play out.

In the graph on page 2, we plot the relationship between the Fed Funds rate, the 10-2 spread (10yr less 2yr Treasury yields) and the S&P 500. What we will illustrate is that inversion alone does not portend a recession, but a commensurate cut in Fed Funds rate, along with inversion, can result in a recession and a market sell-off. So, the market should be careful what it wishes for. And an interest rate cut (potentially as soon as June '19) could be a double-edged sword which could be interpreted more as an economic tourniquet versus a capital market band-aid. We'd love to hear your thoughts.

	Domestic Indices	1Week
1	BBgBarc US Government TR	1.0%
2	BBgBarc US Agg Bond TR	0.9%
3	US Inter Gov Bd TR Bond	0.8%
4	BBgBarc Municipal TR USD	0.6%
5	BBgBarc US MBS TR	0.5%
6	ICE BofAML US High Yield TR	0.0%
7	S&P MidCap 400	-0.9%
8	DJ Industrial Average TR	-0.9%
9	NYSE Composite PR	-1.2%
10	S&P 500 TR	-1.3%
11	Russell 2000 TR	-1.7%
12	NASDAQ Composite PR	-2.17%

	Style Stratificiation	1Week
1	US Mid Val	-0.7%
2	US Mid Core	-0.8%
3	US Core	-0.9%
4	US Large Core	-1.0%
5	US Mid Cap	-1.1%
6	US Large Val	-1.3%
7	US Market	-1.4%
8	US Large Cap	-1.4%
9	US Large Growth	-1.6%
10	US Mid Growth	-1.7%
11	US Growth	-2.0%

	Sector Stratificiation	1Week
1	US Real Estate	0.9%
2	US Consumr Dfnsve	0.8%
3	US Utilities	-0.3%
4	US Industrials	-0.4%
5	US Consumr Cyclcl	-0.8%
6	US Cyclcl Sup Sec	-0.9%
7	US Dfnsve Sup Sec	-0.9%
8	US Commun Svc Capped	-1.1%
9	US Financial Services	-1.3%
10	US Energy Capped	-1.7%
11	US Basic Materials	-1.9%
12	US Healthcare	-2.0%
13	US Snstve Sup Sec	-2.0%
14	US Technology	-3.1%

	Bond Indices	1Week
1	US Lng Gov Bd TR Bond	2.3%
2	US Lng Core Bd TR Bond	2.0%
3	US Lng Corp Bd TR Bond	1.7%
4	US Corp Bd TR Bond	1.1%
5	US Gov Bd TR Bond	1.0%
6	US Core Bd TR Bond	0.9%
7	US Inter Gov Bd TR Bond	0.8%
8	US Inter Corp Bd TR Bond	0.7%
9	BBgBarc Municipal TR USD	0.6%
10	US Inter Core Bd TR Bond	0.6%
11	Mortgage TR Bond	0.5%
12	US Shrt Gov Bd TR Bond	0.4%
13	US TIPS TR	0.2%
14	ICE BofAML US High Yield TR	0.0%

	International Markets	1Week
1	MSCI Pacific Ex Japan PR LCL	0.3%
2	SSE Composite PR CNY	-0.4%
3	MSCI Pacific NR USD	-0.6%
4	FSE DAX TR EUR	-1.0%
5	MSCI Pacific PR LCL	-1.2%
6	MSCI World Ex USA PR LCL	-1.3%
7	MSCI EM PR LCL	-1.5%
8	MSCI World ex USA NR USD	-1.5%
9	MSCI Europe PR LCL	-1.5%
10	Euronext Paris CAC 40 NR EUR	-1.5%
11	FTSE 100 TR GBP	-1.6%
12	MSCI Japan PR LCL	-2.0%
13	MSCI Europe NR USD	-2.1%
14	MSCI EM PR USD	-2.3%

Source: Morningstar.com

Weekly Capital Market Comments

March 29, 2019

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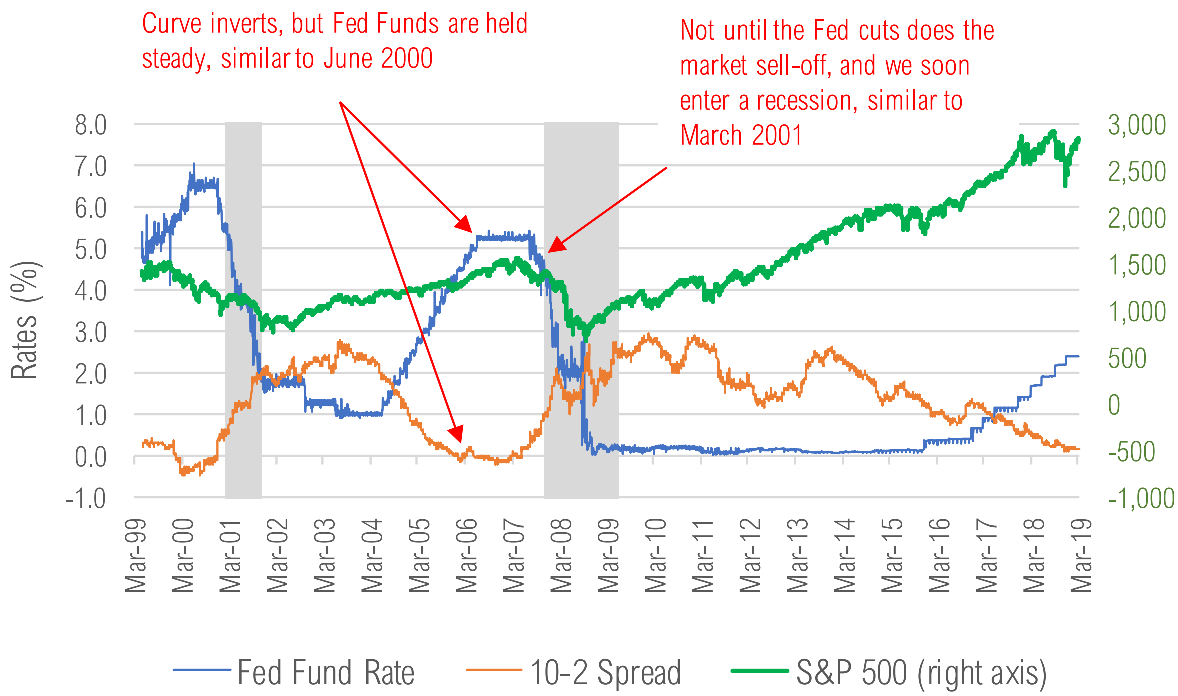
Exhibit 1: Inversions, Fed Funds and the S&P 500



Source: NEPCG and FactSet

Exhibit 2: Markets at A Glance

Index	Last	5DΔ
S&P 500 (TR)	2,815	(1.3%)
NASDAQ	7,669	(2.2%)
Russell 1000	1,560	(1.4%)
DJ Industrials	25,717	(0.9%)
Russell 2000 (TR)	7,679	(1.7%)
S&P Global 1200	2,332	(1.6%)
Euro STOXX	366	(2.2%)
Japan Nikkei 225	21,206	(1.8%)
Germany DAX (TR)	11,516	(1.6%)

Government Bonds	Yield	Spread
US 10Yr	2.39%	--
German 10Yr	-0.08%	-2.46%
UK 10Yr	0.99%	-1.39%
Japan 10Yr	-0.09%	-2.48%
US 2-Year	2.23%	-0.15%
Credit Bonds	**Yield**	**Spread**
Baa	4.01%	1.62%
Ba to B	5.92%	3.54%
High Yield	6.73%	4.34%

Currencies	Last	5DΔ
EUR/USD	$ 1.12	(1.33%)
USD/JPY	$ 110.80	(0.05%)
GBP/USD	$ 1.30	(0.32%)
US$ Spot	$ 97.13	0.65%
Futures	**Last**	**5DΔ**
Brent	$ 67.82	(0.06%)
WTI	$ 59.30	(1.13%)
Gold	$ 1,302	(0.43%)
Silver	$ 15	(2.22%)

Source: NEPCG and FactSet. Charts are for illustrative purposes and are not intended to suggest a particular course of action or represent the performance of any particular financial product or security. Past performance is not a guarantee of future results.

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