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MACROSCOPE the market bulletin from Luft Financial

No.20 **28-March-2019**

Yield curve concerns resurface as Federal Reserve turns dovish

A week ago – on March 20, to be precise – the U.S. Federal Reserve (the "Fed") confirmed one of the most remarkable turnarounds in its monetary stance in years. Specifically, the Fed reiterated that it would be patient in making future adjustments to its benchmark interest rate. Concurrently, the median projection of Fed officials for future interest-rate increases this year (visualized through the so-called "dot plot") dropped to zero, compared with two rate hikes in Fed forecasts as recently as December[1].

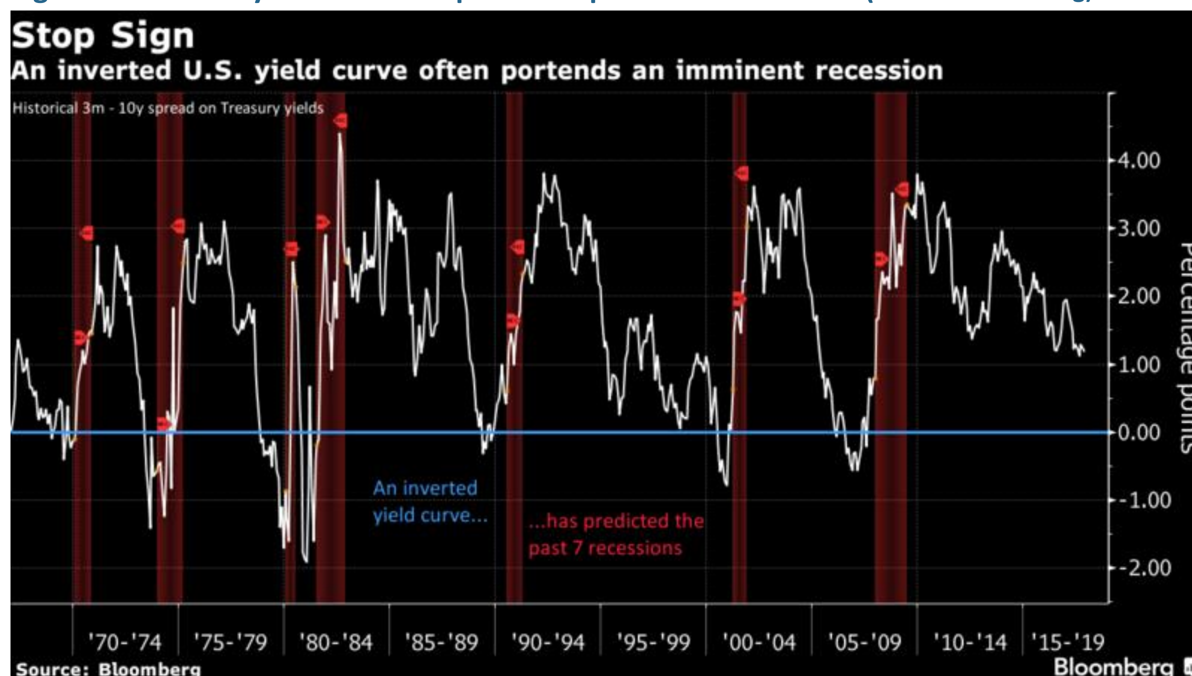
A few market experts questioned whether the Fed was justified in giving up its flexibility to raise interest rates this year if required, given the double-digit year-to-date gains in U.S. equity indices and an unemployment rate that is close to 50-year lows.

However, on March 22, the Fed's caution was somewhat vindicated as weak economic data from Germany and France rekindled concerns about global growth, while an inversion in the U.S. yield curve for the first time in over a decade (Figure 1) also affected investors' risk appetites. As a result, U.S. equities had their biggest decline in two months on March 22, a day after reaching five-month highs.

A yield curve gets inverted when short-term interest rates are higher than long-term interest rates. As of March 26, the yield on 3-month U.S. Treasury bills was 2.45%, while the yield on 10-year U.S. Treasuries was 2.41%. The spread between 10-year yields and 3-month yields was thus *negative* 4 basis points, compared with +111 basis points a year ago.

Figure 1: U.S. 3-month to 10-year yield curve inverts for first time since 2007 (Source: Bloomberg)

Figure 2: Inverted yield curve has predicted past 7 US recessions (Source: Bloomberg)



As we had observed in the November 2017 issue of this publication, yield curve inversions are closely watched because they have accurately predicted each of the past seven recessions in the U.S. (Figure 2). But some leading institutions such as Goldman Sachs[3] and bond gurus like Mohamed El-Erian have cautioned against reading too much into the current yield curve inversion. Former Fed chair Janet Yellen said at a conference this week that the inversion may signal the need to cut rates at some point rather than an impending recession. Note that money markets are already pricing in a full quarter-point interest-rate cut in the U.S. by year-end[4] and another cut in 2020[5].

The yield curve is similarly inverted in Canada. Earlier this week, the yield on 10-year Government of Canada bonds fell to 1.57%, or 10 basis points lower than the yield on the 3-month Canadian Treasury bill. Canada has been mired in a soft patch in recent months, with the economy barely growing in the fourth quarter and retail sales declining for the third straight month in January. Growth forecasts for the Canadian economy are being ratcheted lower. In its "Economic Outlook" released on March 6, the OECD revised its 2019 growth forecast for the Canadian economy down by 0.7 percentage points to 1.5%.

Tepid domestic growth and a deteriorating global outlook (Figure 3) have led to rising expectations that the Bank of Canada (BoC) may be on hold for the foreseeable future. Toronto-Dominion Bank economists expect the BoC's benchmark rate to stay at 1.75% through end-2020, while swaps rates indicate that the odds of a rate cut at the BoC's meeting in September have risen to about 36%, from 23% a week ago.

Overall, we believe that the signals emanating from bond markets – such as yield curve inversion, and the fact that bonds with negative yields have risen to over $10 trillion or 20% of the global market –are flashing amber for the global economy. Against this dismal backdrop, the sustained rebound in the TSX Composite and S&P 500 from their December lows to within 5% of their all-time highs presents an opportunity to take some money off the table in investment portfolios, in our opinion.

Figure 3: Citigroup's Economic Surprise Index (Source: Bloomberg)

References

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