A DOVISH SENTIMENT

The shape of the yield curve, as well as the Federal Reserve's next interest rate hike, have been key focuses of the market over the last six months. The Fed raised its benchmark rate four times in 2018 to a range of 2.25% to 2.5%, and as recently as December, estimated two additional rate hikes in 2019. At the Fed's March 21st meeting, however, it was decided to hold the funds rate with no more hikes anticipated this year. On March 22nd, the yield curve inverted for the first time since 2007, with the 10-year yield dipping below the 3-month yield. The yield on the 10-year note was at 3.09% at the end of September, and ended March at 2.40%, while the three-month yield increased by about 20 basis points in the same period. The yield curve inversion and the Fed's pivot to a dovish sentiment, both typically associated with slowing economic growth, have some investors wary of an impending recession.

It is important to first understand what exactly the Treasury yield curve is and how the bond market has changed since the financial crisis. The Treasury yield curve plots the yields of short-term Treasury bills with long-term Treasury notes and bonds, and is most frequently comparing three-month, two-year, five-year, 10-year and 30-year debt. Through its monetary policy, the Federal Reserve dictates the Fed funds rate, which is the rate banks lend reserve balances to each other on an overnight basis. It is also the rate which forms the basis for adjustable-rate consumer debt, such as credit cards and home equity loans. As the Fed sought to stimulate the economy and housing market after the financial crisis, short-term rates were kept historically low as the Fed funds rate was held near zero. The Fed also utilized a process called Quantitative Easing ("QE"), where government bonds and other securities were purchased from the market in order to increase the money available for banks to lend.

The global bond market has changed since the financial crisis, and there are new factors at play that some argue caused this inversion to be different from past. The term premium, which is the additional yield demanded for holding a longer-term security, has been nonexistent or negative in recent years, as global central bank asset purchases have lowered these longer-term yields. Specifically, in the U.S., the effects of QE have kept longer-term rates low. At the same time, the U.S. is also funding its deficit by issuing more Treasury bills, pushing the short-term end of the curve up. From a global perspective, German and Japanese 10-year yields are currently in negative territory, driving investors to U.S. Treasuries with comparatively higher yields, thus pushing those rates down even further. These dynamics of the global bond market are causing the yield curve to invert in ways it has not before.

While the inverted yield curve is historically the market's most reliable recession indicator, with an inversion preceding each of the last seven recessions, it can take several months or up to two years to occur. Where the curve inverts and for how long also matters, as markets prefer watching the spread between the 10-year and 2-year yield, which is still positive. An inversion can lead to "false alarms" as well, suggesting just that the Fed should lower short-term rates, or that there is an impending economic slowdown. Despite the strong U.S. labor market and solid 2018 GDP growth, a slowdown would not be a surprise to the market, as the economy is in the later part of the business cycle, as shown by recent weaker consumer spending and lower inflation figures. Regardless of what this inversion may precede, our portfolios are constructed with a long-term focus to meet portfolio objectives and weather a variety of interest rate environments.

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