Altus
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Reaching Higher

Market Update

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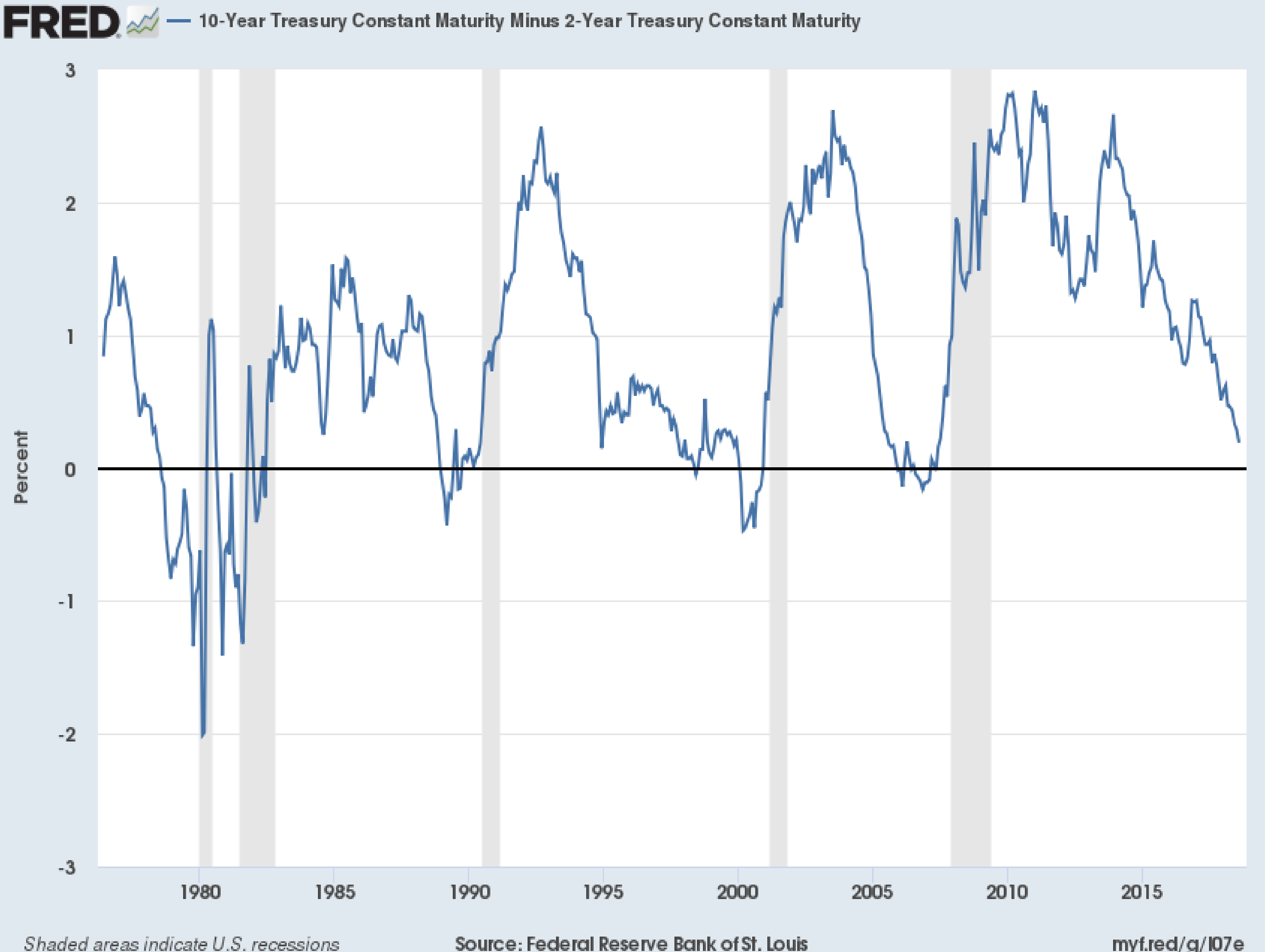
Looking Out the Windshield – Leading Indicators

The financial press has been running stories and warning investors about a possible inverted yield curve. As a result, we have received several calls from clients asking questions such as, "What is an inverted yield curve?" "Why should I care about an inverted yield curve?"

First, let's discuss the yield curve. Under normal conditions, long term interest rates are higher than short term interest rates. Investors that are willing to lock their money for longer periods of time generally demand a higher return. In this environment, if you plot interest rates at different maturities, you get an upward-sloping (yield) curve. However, there are times when investors perceive risk differently and short term interest rates are actually higher than long term interest rates. This is a downward-sloping curve, also known as an inverted yield curve.

The Federal Reserve Bank controls short term interest rates by raising and lowering the Fed Funds rate. However, the market determines long term interest rates. At times, there are differing views as to future economic growth. If the market doesn't think the economy will continue to grow they will bid longer term rates lower. Currently, the yield curve is slightly upward sloping but flattening. Meaning, short term interest rates are marginally lower than longer term interest rates.

The chart on the following page illustrates the difference (spread) between the 10 year Treasury bond and the 2 year Treasury bond and when past recessions have occurred. The spread narrowed to its lowest level since 2007. With the Fed committed to raising short term rates the curve will likely continue to flatten and an inversion of the yield curve could occur in the next twelve months.


FRED
10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity
3
2
1
0
-1
-2
-3
Percent
1980
1985
1990
1995
2000
2005
2010
2015
Shaded areas indicate U.S. recessions
Source: Federal Reserve Bank of St. Louis
myf.red/g/l07e

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Why should you care? The predictive nature of the inverted yield is evident (chart on previous page), which shows the difference between the 10 year and 2 year Treasury yields from January 1977 to August 2018. Every recession (gray shaded area) over this period has been preceded by an inversion of the yield curve and most inversions have occurred during periods when the Fed was hiking rates. The Fed has signaled strongly they will continue to raise rates, with the next increase likely in September. If the Fed keeps raising short term rates and long term yields remain flat, the yield curve could invert again. **What is also important to point out, the delay between the curve inverting and the beginning of recession has ranged between 12 to 22 months thereafter.**

This has very important ramifications for how we allocate your portfolio. If the U. S. economy goes into recession, of course corporate earnings will decrease and stocks prices will follow. We don't think we need to remind anyone how punishing a recession can be for stock prices. The U.S yield curve does measure global economic conditions and has done a remarkable job of signaling peaks in international stocks as well. The good news is, we have time to prepare should the yield curve invert. Our research suggests, the earliest a recession could occur is 2020.

We thought it would be helpful for you to know what we are watching. **More importantly, we want you to know we have a plan to protect your wealth when the next recession comes!**

We hope you find this information useful. As always, we encourage you to reach out to your advisor if you would like to talk further about any of the information presented.

Sincerely,
Your Altus Team

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A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt.

Diversification, automatic investing and rebalancing strategies do not ensure a profit and do not protect against losses in declining markets.