Gluskin Sheff + Associates Inc.

The Year of the Pig (Lipstick won't help!)

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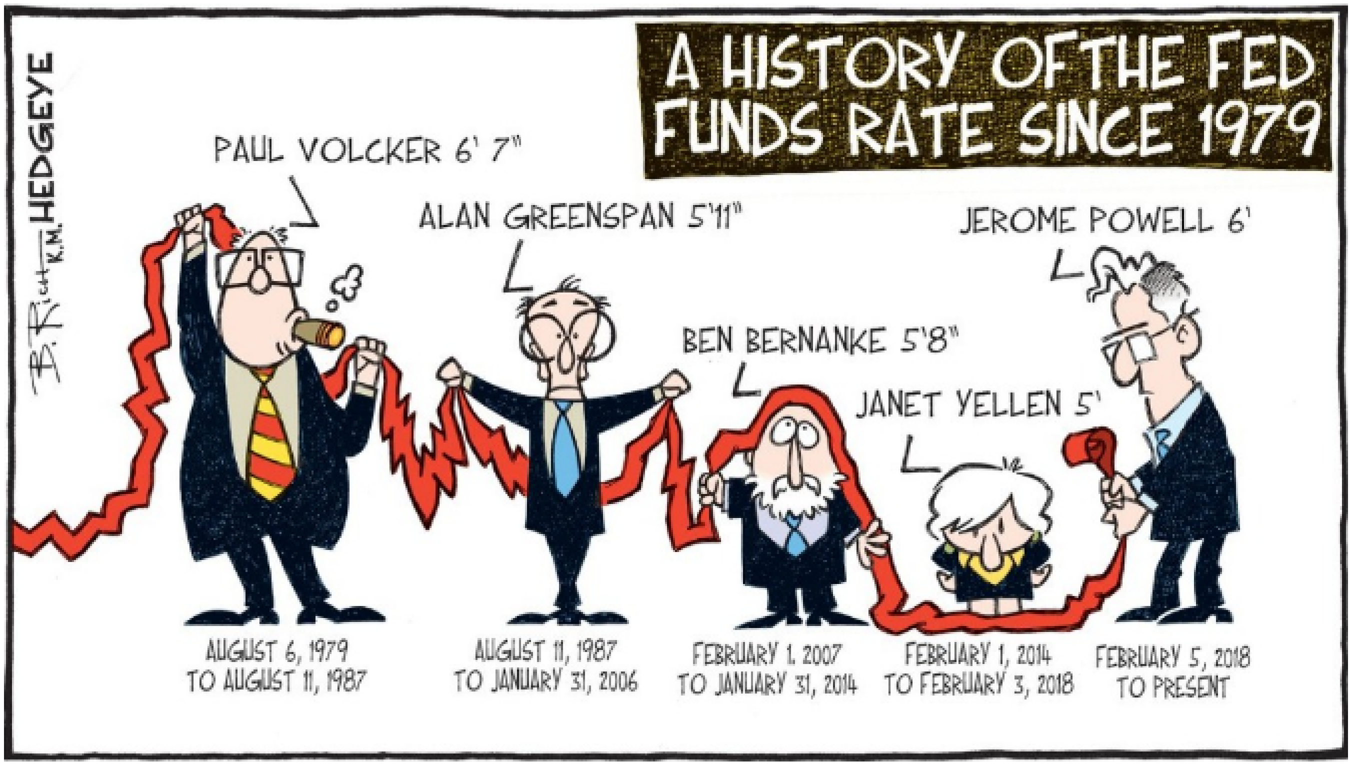
A SECULAR INFLECTION POINT?

"Change of a long term or secular nature is usually gradual enough that it is obscured by the noise caused by short-term volatility. By the time secular trends are even acknowledged by the majority they are generally obvious and mature. **In the early stages of a new secular paradigm, therefore, most are conditioned to hear only the short-term noise they have been conditioned to respond to by the prior existing secular condition.** Moreover, in a shift of secular or long term significance, the markets will be adapting to a new set of rules while most market participants will be still playing by the old rules"

- Bob Farrell Aug. 3, 2001

Notes:
Source: Bob Farrell, Theme & Profile Investing Update, August 3, 2001

RATES WILL BITE WITH EXTRA HEIGHT



A DRAMATIC SHIFT IN THE INTEREST RATE LANDSCAPE

United States: 1-Month T-Bill Yield

(percent)

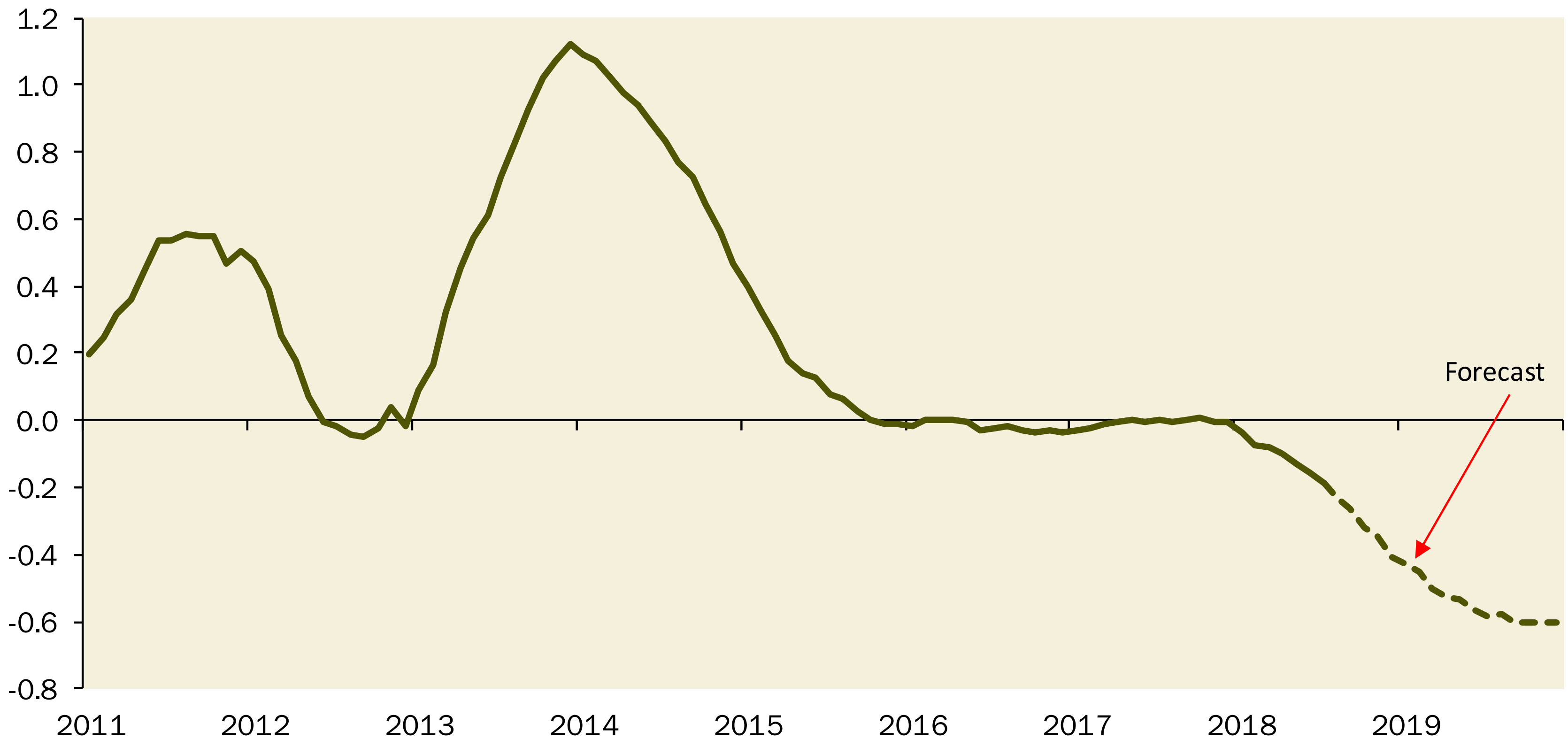
Notes:

Source: Haver Analytics, Gluskin Sheff

COUPLED WITH A SHRINKING FED BALANCE SHEET

United States: Fed Balance Sheet

(12-month change; $ trillions)

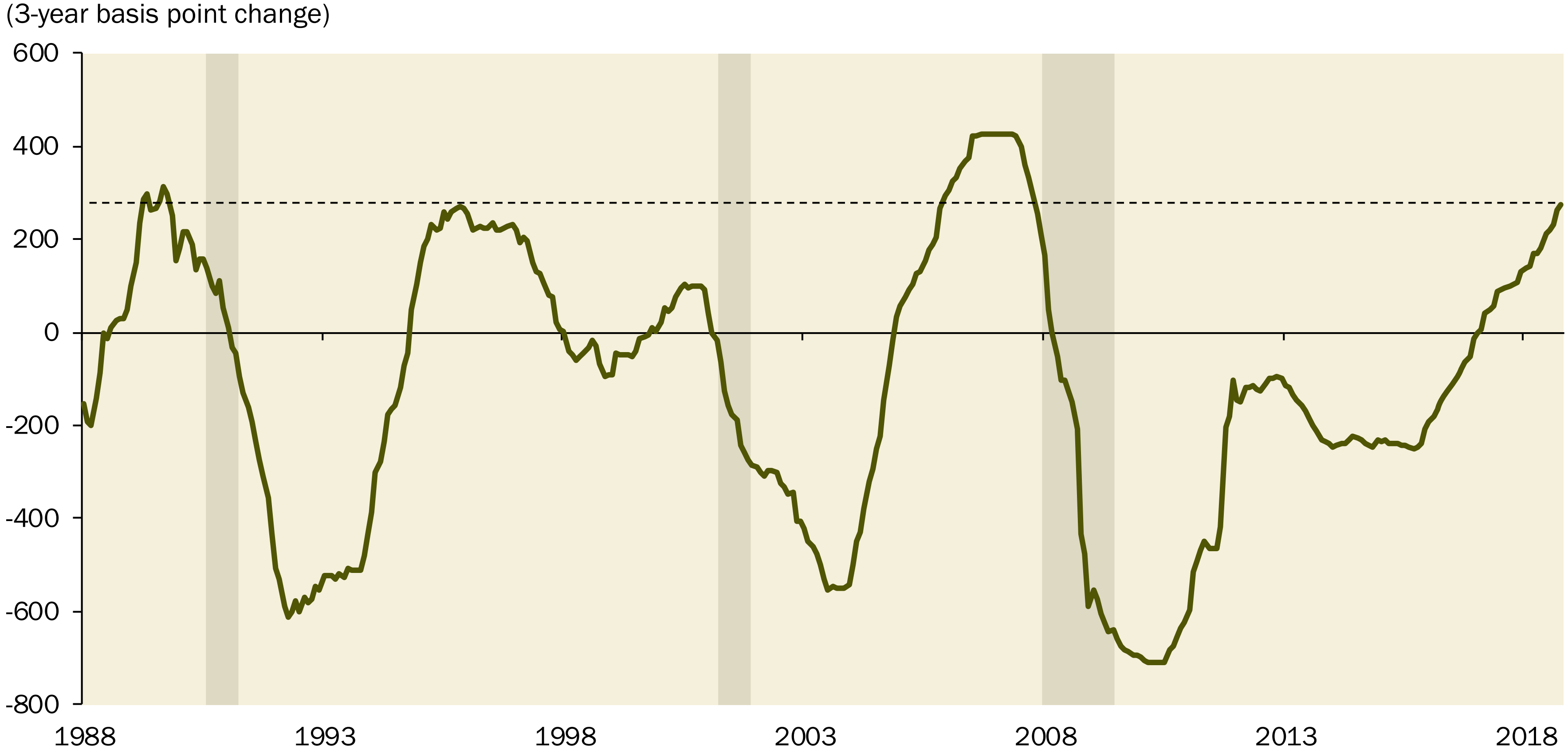


Notes:

Source: Haver Analytics, Gluskin Sheff

RECESSIONS FOLLOW FED TIGHTENING CYCLES OF 300 BASIS POINTS OR MORE

United States: ‘Balance Sheet Adjusted’ Fed Funds Rate



Notes:

Balance sheet adjustments begin with QE1; unadjusted Fed funds rate used prior

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

REVIEW & OUTLOOK

The Tax-Reform Stock Rally

Animal spirits are unleashed, but watch the Fed's great unwinding.

Equity markets took a mild breather on Tuesday afternoon after another morning rally, pausing on what has been a remarkable runup so far in 2018, following eye-popping gains since Election Day in 2016 and throughout 2017. The latest gains look like a tax-reform rally, though it will pay to be mindful that markets inevitably correct, often hard.

We've been hosting an op-ed debate on stock prices, and last week financial consultant Donald Luskin made his case for the running of the bulls as expected corporate earnings are adjusted upward due to tax reform. Harvard economist Martin Feldstein makes the case for caution nearby, arguing that equity prices are fated to fall as the Federal Reserve reverses its long period of asset purchases and low interest rates, and inflation makes a comeback. Both men could be right, depending on your investment time frame.

The bullish case is based on expectations of capitalized profits, which have risen smartly with the cut in corporate tax rates. The higher after-tax returns flow into higher asset values, all else being equal. The surprise is that stocks have kept rising this year, with the S&P 500 up some 4%. This suggests that many investors underestimated the possibility of pro-growth tax reform passing last year, and now they are catching up to the implications.

The harder question is whether rising stocks are also a harbinger of faster growth in the real economy. Business sentiment, from the Business Roundtable to the National Federation of Independent Business, is as bullish as we can recall. Business Roundtable chief Jamie Dimon, also CEO of J.P. Morgan, captured the mood last week when he said "animal spirits" have been unleashed.

He cited tax reform and "proper smart regulation," while the global economy is also growing in sync for a change. With investors willing to take more risks, emerging markets are seeing capital inflows as are Japan and Europe. This greater appetite may explain why the U.S. dollar has been relatively weak despite signs of better U.S. policy and faster growth. Maybe investors feel a reduced need to park money in the safety of dollar assets or Treasurys.

But don't forget Mr. Feldstein's warning about the Fed and its great monetary unwinding. Former Fed Chairman Ben Bernanke justified quantitative easing (QE) as a tool to drive investors into riskier assets, including stocks, which would create a "wealth effect" to spur the real economy. H[...] succeeded on asset prices but failed on growth, which didn't accelerate until better tax and regulatory policies arrived. But if QE lifte[d] stocks as it expanded, will the reverse happe[n] as it unwinds?

It's certainly possible, and students of financial history know that sooner or later rising interest rates will weigh on stock prices. This [is] another way of saying that the biggest thre[at] to growth and financial markets—Dona[ld] Trump's trade agenda or a Speaker Pel[osi] aside—may be the Federal Reserve as it re[verses] Mr. Bernanke's experiment. Mr. Bernanke has already taken a half dozen victo[ry] laps, but they'll have been premature if the [un]winding leads to asset selloffs that create financial disruption and a recession.

All of which underscores the importance [of] timing of the GOP tax reform. The current [ex]pansion is already historically long, if also [his]torically weak, and it has needed a second w[ind]. Businesses have had plenty of capital, at h[ome] and abroad, but they had been reluctant to [em]ploy it given the uncertainty of how and w[hat] the Obama regulators and taxers might s[trike] next. Donald Trump's deregulators hav[e re]moved the fear of arbitrary political pu[nish]ment, and now tax reform is raising the ex[pec]tations of returns on investment.

This is the cause for economic optimism [and] bullish equities, but keep in mind that [we've] never lived through a monetary-policy re[versal] like the one that is coming.

THE WALL STREET JOURNAL.

*"This is the cause for economic optimism, and bullish equities, **but keep in mind that we've never lived through a monetary-policy reversal like the one that is coming.**"*

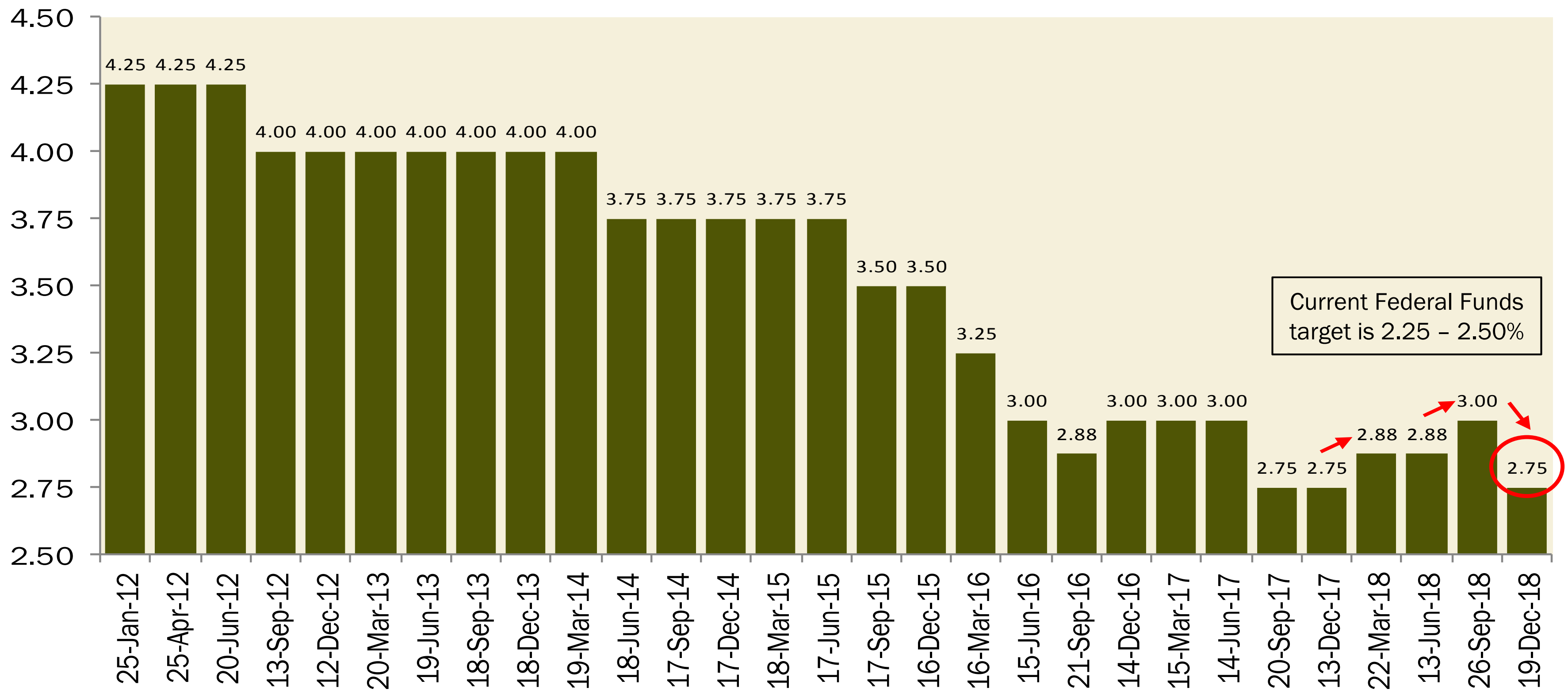
Notes:
Source: Wall Street Journal (January 17, 2018)


LET'S LOOK AT THAT MAP AGAIN.
THE FED
B. Rich
HEDGEYE

THE "NEUTRAL" POLICY RATE: A HISTORY OF THE ESTIMATE

United States: Median FOMC Terminal Funds Rate Forecast

(percent)



Notes:

Source: Federal Reserve, Gluskin Sheff

POWELL STARTS OUT AGGRESSIVELY

THE WALL STREET JOURNAL.

Senate Confirms Powell as Fed Chairman

Yellen's successor is likely to continue raising rates to keep the expansion on track

By David Harrison

The Senate confirmed Jerome Powell to become the 16th chairman of the Federal Reserve, clearing the way for a new leader likely to continue raising interest rates to keep the nation's economic expansion on track.

Mr. Powell, who was confirmed Tuesday by an 84-13 vote, will take over when Chairwoman Janet Yellen's four-year term as chief ends Feb. 3. She has said she would leave the Fed board of governors once her successor is sworn in.

Although Mr. Powell's nomination attracted broad bipartisan support, it also drew opposition from several potential contenders in the 2020 presidential race. On the Democratic side, those voting against his confirmation included Sens. Elizabeth Warren of Massachusetts, Kamala Harris of California and Cory Booker of New Jersey. On the Republican side, Sens. Ted Cruz of Texas, Rand Paul of Kentucky, Mike Lee of Utah and Marco Rubio of Florida voted no. Independent Sen. Bernie Sanders of Vermont also opposed the nomination.

Jerome Powell, confirmed by an 84-13 vote, will take over next month.

Mr. Powell, a Fed governor since 2012, will inherit an economy on the upswing fueled by a booming labor market and strong global growth. His task will be to sustain the economy's expansion without letting it pick up so much momentum that the Fed would be forced to cool it off with sharp rate increases, risking a downturn.

The Fed has been gradually raising short-term interest rates since late 2015 and last year started shrinking its portfolio of assets purchased to bolster the economy during and after the financial crisis.

Officials in December raised the Fed's benchmark rate by a quarter percentage point to a range between 1.25% and 1.5% and pencilled in three more such moves this year.

Mr. Powell is likely to stick with Ms. Yellen's cautious approach to raising rates.

"We've been patient in removing accommodation, and I think that patience has served us well," Mr. Powell said at his confirmation hearing Nov. 28, after being nominated by President Donald Trump on Nov. 2. Now that growth has picked up, "it's time for us to be normalizing interest rates," he added.

But those plans could change depending on how the economy evolves. If inflation remains stuck below the Fed's 2% target, Mr. Powell and his colleagues could decide to hold off on rate increases to let price pressures build. Or if the economy shows signs of overheating, they might want to move more aggressively.

A spurt of growth driven by the tax overhaul could lead the Fed to raise rates more quickly to cool off the economy. That could place Mr. Powell at odds with the White House, which would welcome a stronger expansion.

"We can afford to go more slowly if we determine that inflation is going to perform lower than we thought, and we can move more quickly," Mr. Powell said in November.

Mr. Powell, a lawyer and former private-equity partner, moves into his new role with less formal training in economics and monetary policy than many of his predecessors. He will be the first Fed chairman in three decades who doesn't have a Ph.D. in economics.

Mr. Powell is the second of Mr. Trump's Fed nominees to be confirmed, following Randal Quarles.

But Mr. Powell still will have to contend with a depleted Fed board: The seven-member panel has three vacancies.

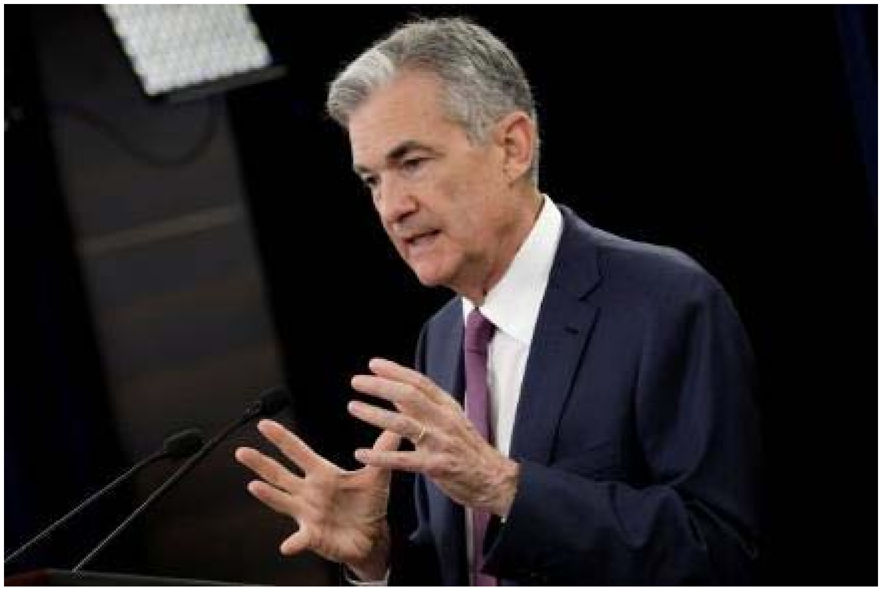
Mr. Trump has nominated Marvin Goodfriend, a Carnegie Mellon University professor and former Fed economist, to fill one of those positions. The Senate Banking Committee held his confirmation hearing Tuesday.

◆ FDIC nominee backs small banks........ B12

"We've been patient in removing ***accommodation, and I think that patience has served us well****, Mr. Powell said at his confirmation hearing Nov. 28, after being nominated by President Donald Trump on Nov. 2. Now that growth has picked up,* ***"it's time for us to be normalizing interest rates" he added****"*

Notes:
Source: Wall Street Journal (January 24, 2018)

TO NEUTRAL…AND BEYOND?



*"…interest rates are still accommodative, but we're gradually moving to a place where they will be neutral…***we may go past neutral.*** But we're a long way from neutral at this point, probably."*

- *October 3, 2018*

Notes:
Source: Interview with PBS (October 3, 2018)

POWELL WALKS BACK HIS "HAWKISHNESS"… A LITTLE

"We therefore began to raise our policy rate gradually toward levels that are more normal in a healthy economy. Interest rates are still low by historical standards, ***and they remain just below the broad range of estimates of the level that would be neutral for the economy*** *-- that is, neither speeding up nor slowing down growth."*

Notes:
Source: The Federal Reserve's Framework for Monitoring Financial Stability (November 28, 2018)

POWELL NEUTERS "NEUTRAL"

"We think that our policy is at the __appropriate__ point right now. We think our policy stance is __appropriate__ right now – we do. ***We also know that our policy rate is now in the range of the Committee's estimates of neutral.*** *So we'll be – again, we think our policy stance is __appropriate__."*

"So the range of estimates on the Committee starts at 2½ percent and that's kind of roughly where we currently are. And as I've said a couple of times, when you get to that range – ***you know that we can't directly observe the neutral rate. We only know it by its works.*** *And so we have to put aside our own priors of what that rate might be and let the data speak to us. So we can do that. We're in the range."*

Notes:
Source: Chairman Powell's Press Conference (January 30, 2019)

THE FED JUST TERMINATED THE INTEREST RATE CYCLE

*“**The Committee judges that some <u>further gradual increases</u> in the target range for the federal funds rate** will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term.”*

- December 19, 2018

*“In light of global economic and financial developments and muted inflation pressures, **the Committee will be <u>patient</u> as it determines what future adjustments to the target range for the federal funds rate** may be appropriate to support these outcomes.”*

- January 30, 2019

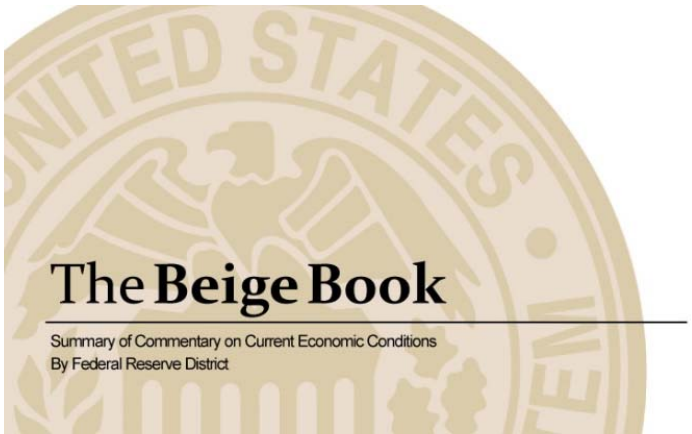
Notes:
Source: Press Release from the Federal Open Market Committee (December 19, 2018; January 30, 2019)

THE FED OFTEN SHIFTED ON A DIME

March 28, 1995	July 6, 1995
"…giving careful consideration to economic, financial, and monetary developments, ***somewhat greater reserve restraint would*** *or slightly lesser reserve restraint might be acceptable in the intermeeting period."*	*"…members indicated that they favored or could support a directive that called for some* ***slight easing in the degree of pressure*** *on reserve positions and that included a bias toward possible further easing of reserve conditions during the intermeeting period."*
July 1, 1998	**September 29, 1998**
"…giving careful consideration to economic, financial, and monetary developments, ***a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period."***	***"The Federal Open Market Committee decided today to ease the stance of monetary policy slightly, expecting the federal funds rate to decline 1/4 percentage point to around 5-1/4 percent."***
November 15, 2000	**January 3, 2001**
"…the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future."	***"The Federal Open Market Committee decided today to lower its target for the federal funds rate by 50 basis points to 6 percent."***
August 7, 2007	**September 18, 2007**
"Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected."	***"The Federal Open Market Committee decided today to lower its target for the federal funds rate 50 basis points to 4-3/4 percent."***

Notes:
Source: Minutes of the Federal Open Market Committee (March 28, 1995; July 5 – 6, 1995; June 30 - July 1, 1998); FOMC Press Statement (September 29, 1998; November 15, 2000; January 3, 2001; August 7, 2007; September 18, 2007)

LOOK AT WHAT THE FED BEIGE BOOK HAD TO SAY



*"Economic activity increased in most of the U.S., **with eight of twelve Federal Reserve Districts reporting modest to moderate growth.**"*

*"Nonauto retail sales grew modestly…**Auto sales were flat on balance.**"*

*"The majority of Districts indicated that manufacturing expanded, **but that growth had slowed**, particularly in the auto and energy sectors."*

*"**New home construction and existing home sales were little changed**, with several Districts reporting that sales were limited by rising prices and low inventory."*

*"Commercial real estate activity was also **little changed** on balance."*

*"Most Districts reported modest to moderate growth in activity in the nonfinancial services sector, **though a few Districts noted that growth there had slowed.**"*

*"Overall, lending volumes grew modestly, **though a few Districts noted that growth had slowed.** Outlooks generally remained positive, **but many Districts reported that contacts had become less optimistic…**"*

*"Most Districts indicated that firms' input costs had risen, **but reports were mixed on whether they could pass the higher costs on to customers.**"*

Notes:
Source: Fed Beige Book; January 16, 2019

BARRON'S

Can the Fed Stave Off the Next Recession?

The central bank believes it doesn't need to raise rates much more, if at all, to keep the economy on an even keel

THIS PAST WEEK'S FEDeral Reserve meeting gave investors both good news and bad news.

The good news is that, as I had expected after the mid-December meeting, America's monetary-policy makers ended up listening to the message coming from financial markets: The Fed is now wary of accidentally strangling growth by raising interest rates too high and by shrinking its bond portfolio too much.

The bad news is that the Fed's caution reflects its concerns about the next recession—something more than 80% of U.S. chief financial officers believe will start before the end of 2020, according to a recent survey by Duke University.

According to the Fed's latest statement, released on Wednesday, "further gradual increases" in the level of short-term interest rates are no longer necessary to pre-

Federal Reserve Chairman Jerome Powell

The downturn in inflation expectations could lead to slower price increases and give the Fed even less room to cut real interest rates in a downturn, undermining confidence even further. As Williams put it in a recent paper with Thomas Mertens, "the inherent asymmetry of the lower bound" on interest rates means that central banks will consistently undershoot their inflation targets during downturns, which in turn "exacerbates the effects of the lower bound on the economy."

The solution, according to Williams, is to systematically run the economy hot during expansions to offset the times when prices rise too slowly during recessions. In other words, monetary policy might have to become systematically looser than it has been to have a hope of achieving the Fed's longer-run goal of 2% annual inflation. Regular yearly price increases would have to be significantly larger than 2% to cancel out the impact of those periods when the Fed will

Notes:

Source: Barron's (February 4, 2019)

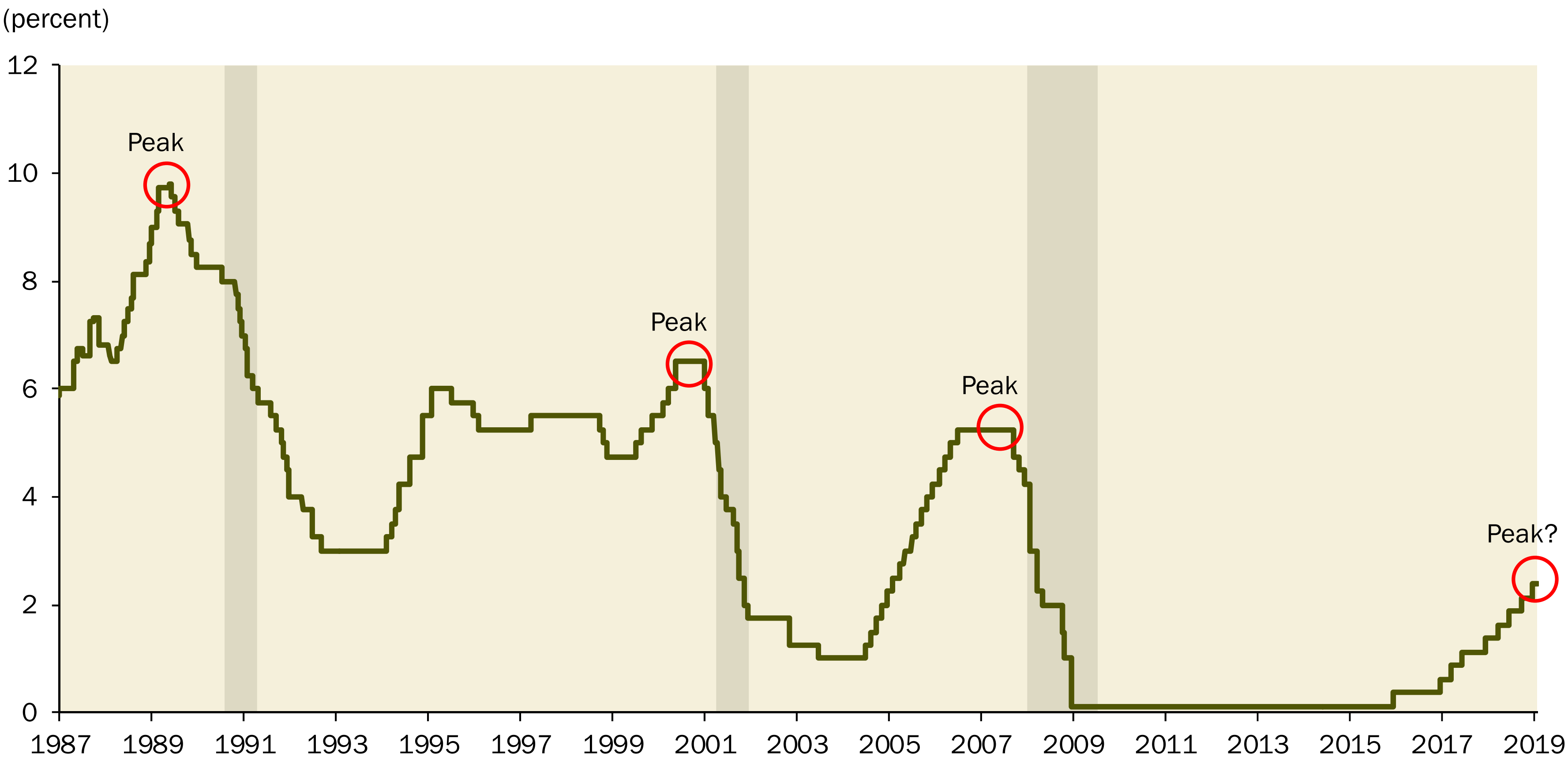
MIND THE LAGS!!!

*"We also know that the economic effects of our gradual rate increases are uncertain, **and may take a year or more to be fully realized**."*

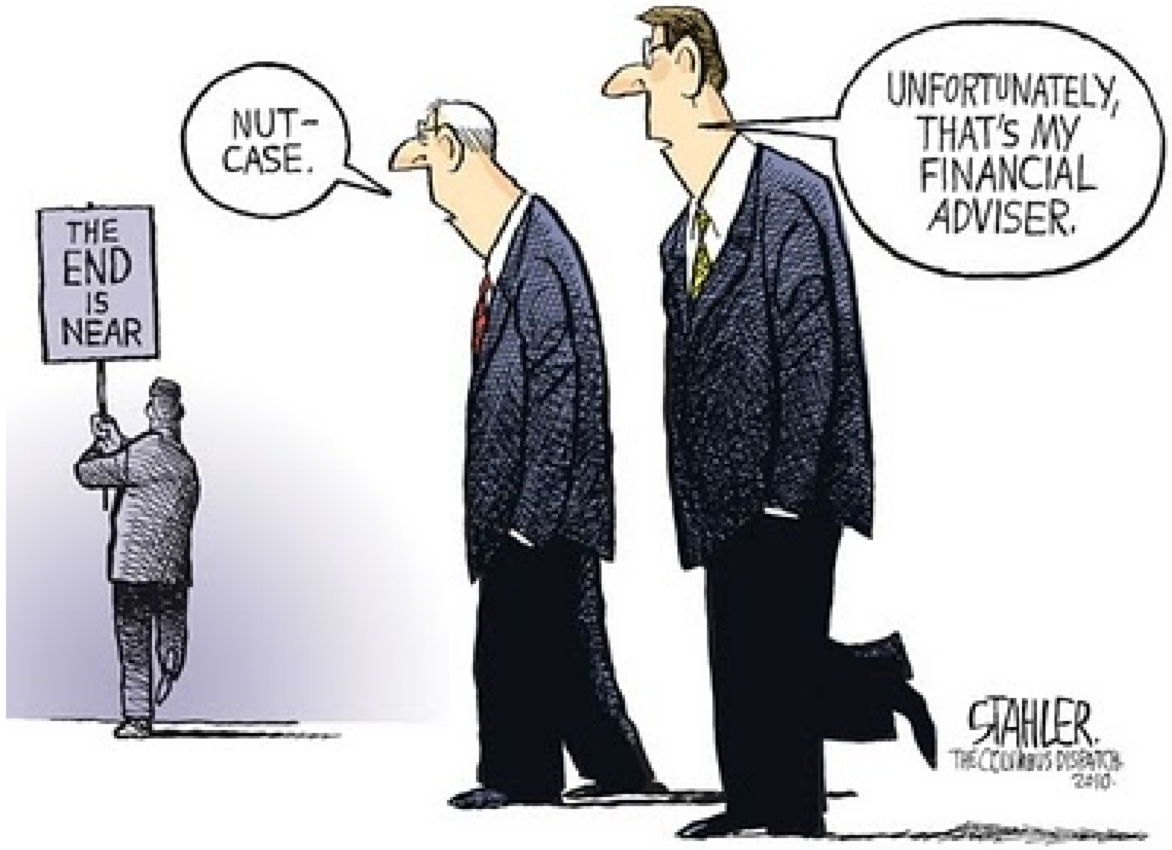
Notes:
Source: The Federal Reserve's Framework for Monitoring Financial Stability (November 28, 2018)

CYCLE PEAK FOLLOWS FED FUNDS PEAK

United States: Fed Funds Rate



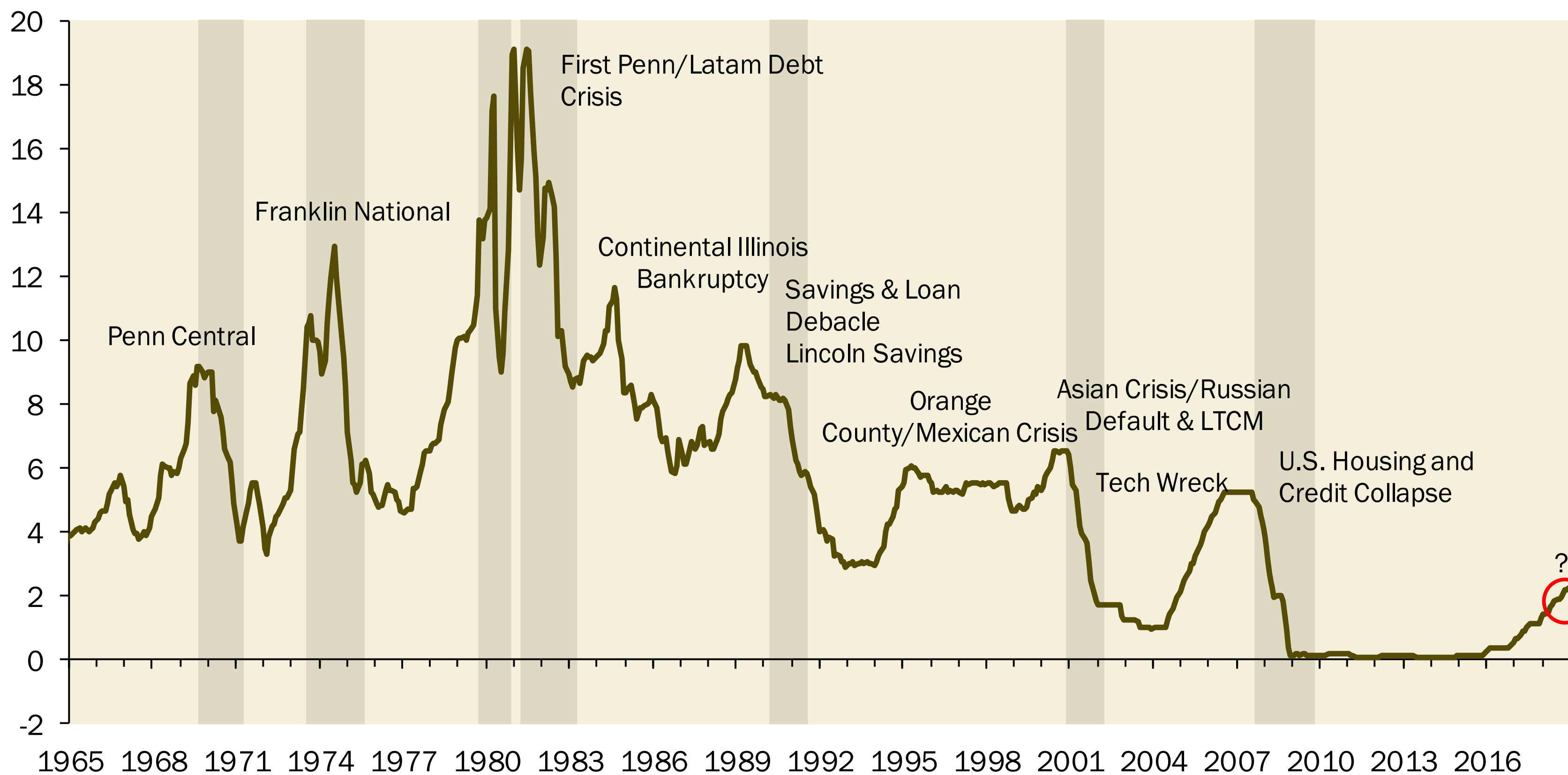
Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff


THE END IS NEAR
NUT-CASE.
UNFORTUNATELY, THAT'S MY FINANCIAL ADVISER.
STAHLER.
THE COLUMBUS DISPATCH

FED TIGHTENING CYCLES AND FINANCIAL EVENTS

United States: Federal Funds Rate

(percent)

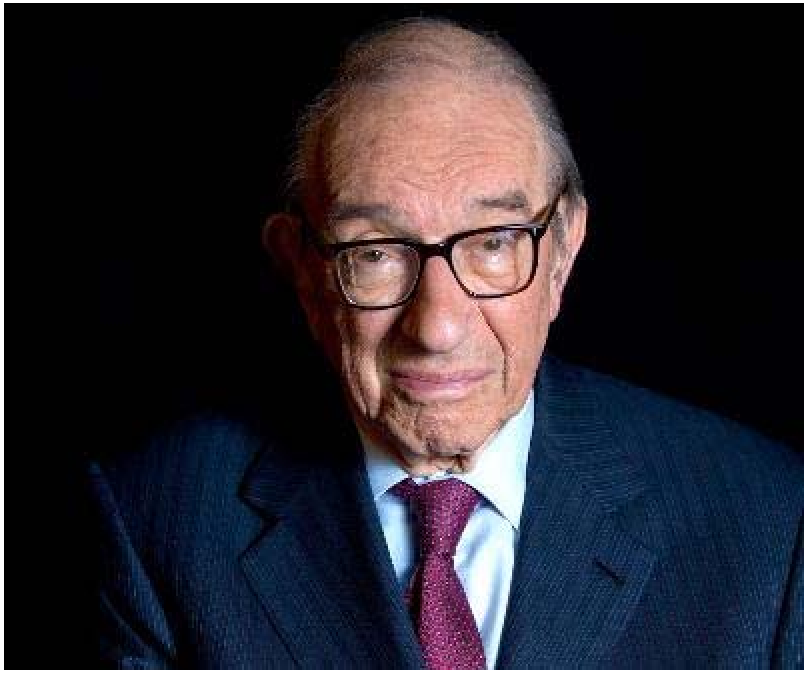


Notes:

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

HE KNOWS BUBBLES BETTER THAN ANYBODY



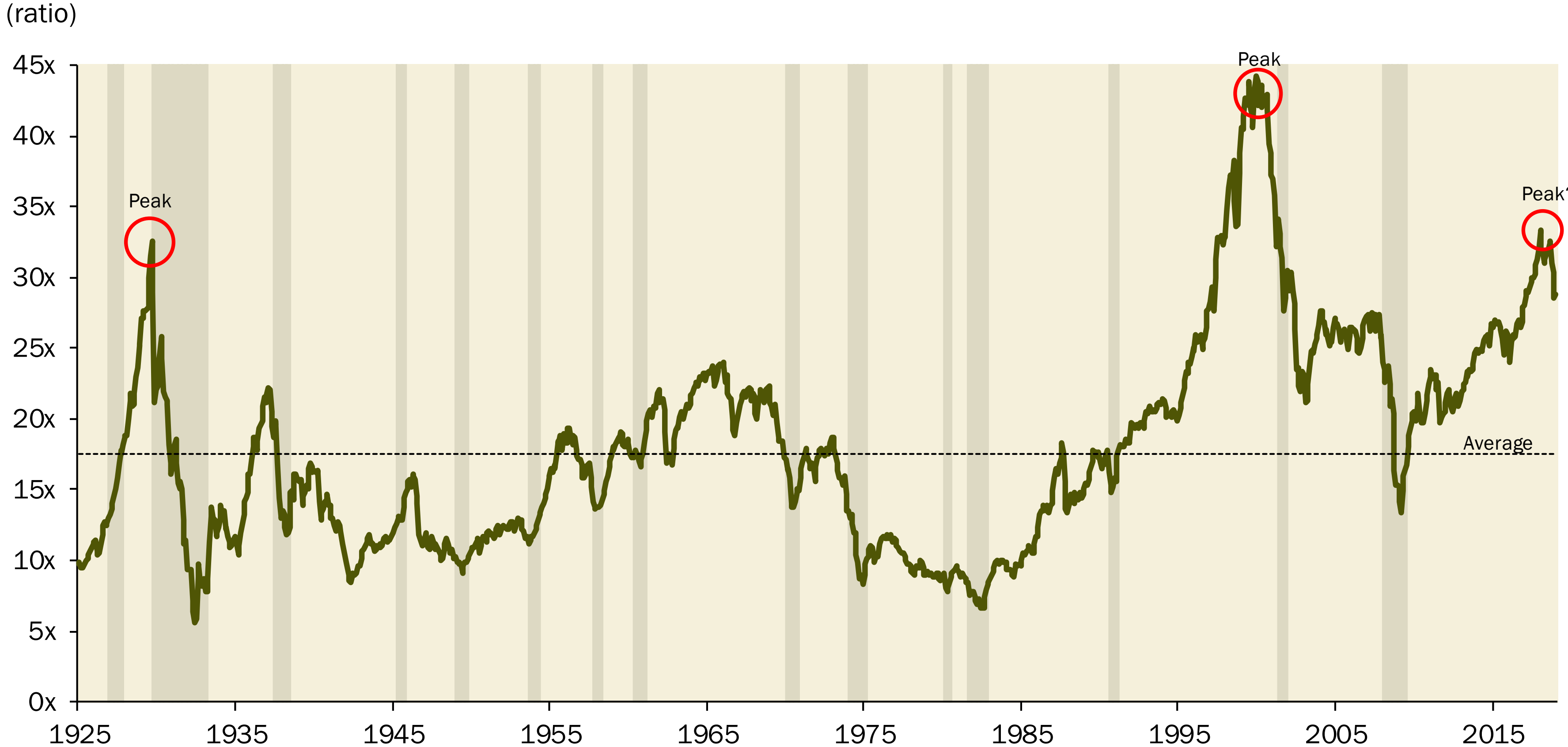
*“**There are two bubbles: We have a stock market bubble, and we have a bond market bubble**…what’s behind the bubble? Well the fact, that, essentially, we’re beginning to run an ever-larger government deficit. As a share of GDP debt has been rising very significantly and we’re just not paying enough attention to that.”*

— January 31, 2018

Notes:
Source: Alan Greenspan, Bloomberg TV, January 31, 2018

THIRD MOST OVERVALUED STOCK MARKET

United States: Cyclically Adjusted Price-to-Earnings Ratio



Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

The Economist

Buttonwood | Where will the next crisis occur?

Corporate debt could be the culprit

INTEREST rates are heading higher and that is likely to put financial markets under strain. Investors and regulators would both dearly love to know where the next crisis will come from. What is the most likely culprit?

Financial crises tend to involve one or more of these three ingredients: excessive borrowing, concentrated bets and a mismatch between assets and liabilities. The crisis of 2008 was so serious because it involved all three—big bets on structured products linked to the housing market, and bank-balance sheets that were both overstretched and dependent on short-term funding. The Asian crisis of the late

The A to B of decline

S&P Global median corporate-credit rating

Source: S&P Global

the London Business School, Alex Brazier, the director for financial stability at the Bank of England, compared the yield on corporate bonds with the risk-free rate (the market's forecast for the path of official short-term rates). In Britain investors are demanding virtually no excess return on corporate bonds to reflect the issuer's credit risk. In America the spread is at its lowest in 20 years. Just as low rates have encouraged companies to issue more debt, investors have been tempted to buy the bonds because of the poor returns available on cash.

Mr Brazier also found that the cost of insuring against a bond issuer failing to re-

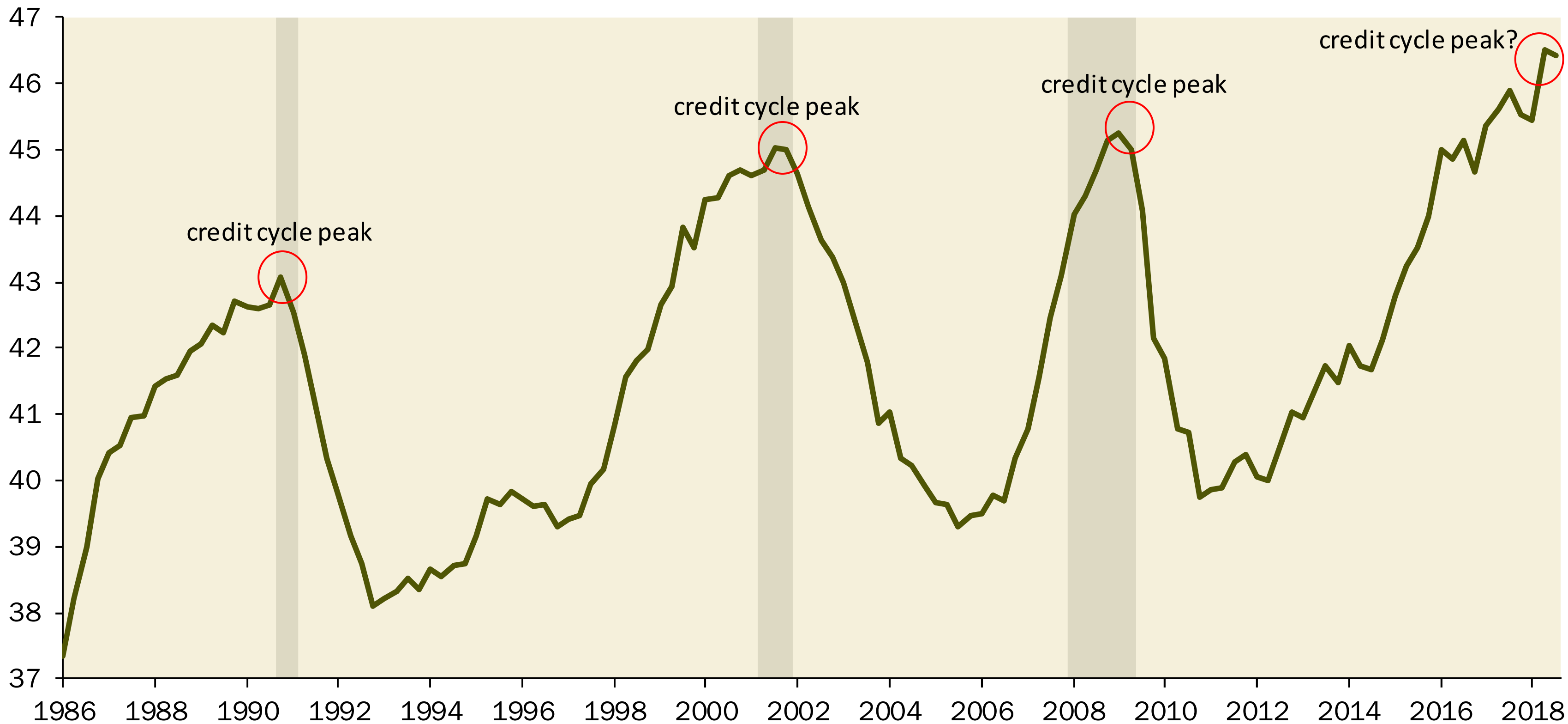
Notes:

Source: The Economist (May 5th – 11th, 2018)

CORPORATE BALANCE SHEETS ARE NOT IN GOOD SHAPE!

United States: Corporate Debt-to-GDP

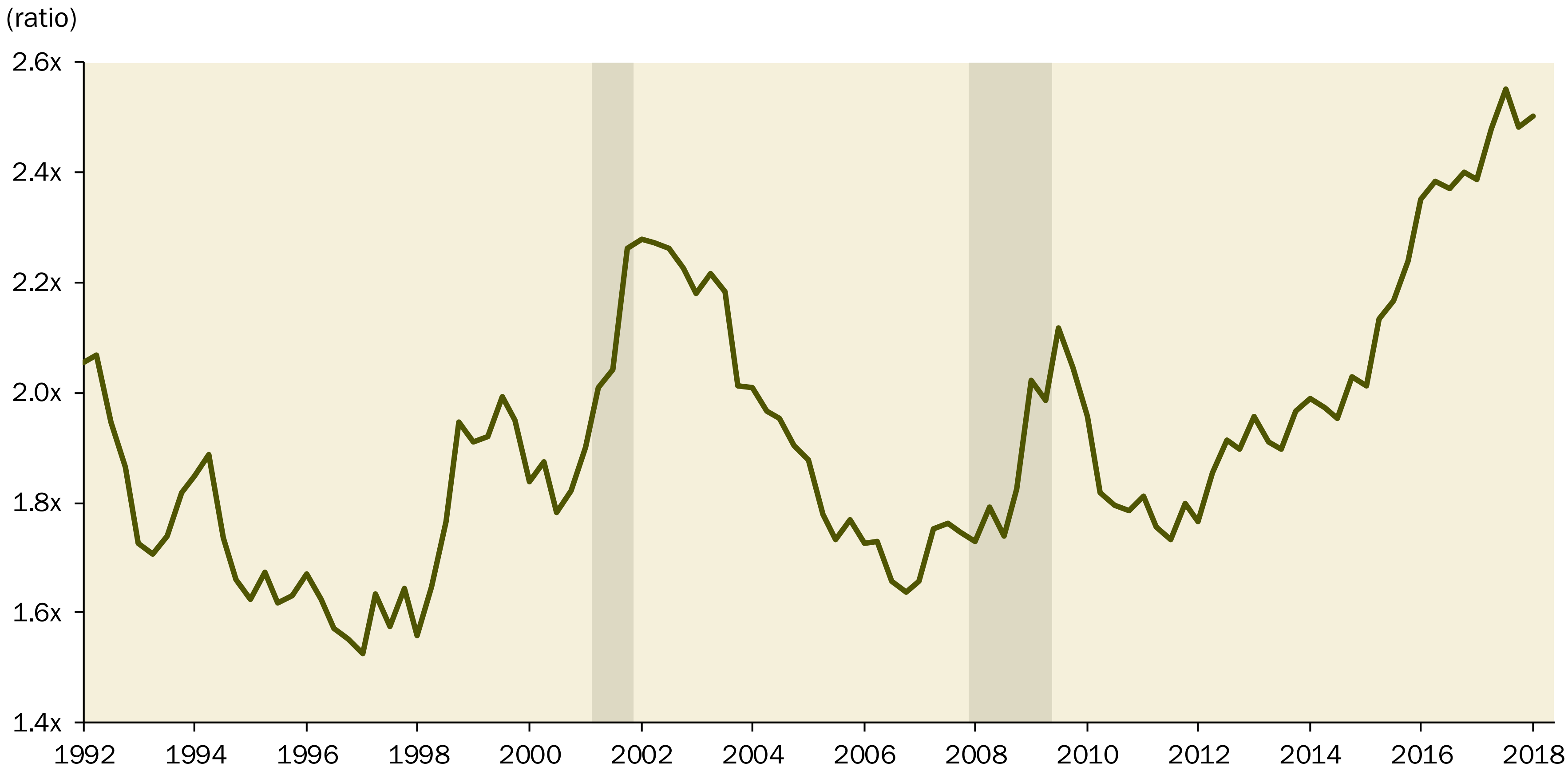
(percent)



Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

LEVERAGE CONTINUES TO INCREASE

United States: Investment Grade Leverage (Debt-to-EBITDA)



Notes:
Shaded areas represent periods of U.S. recession
Source: Morgan Stanley

THE WALL STREET JOURNAL.

STREETWISE | By James Mackintosh

There Have Never Been So Many Bonds That Are Almost Junk

Investors often turn to corporate-bond markets for early warning of trouble, and currently find reassurance that all is well. But look closer and the real message is that hidden risks are building. The next downturn could be more painful than usual for creditors, with knock-on effects for shareholders.

Credit markets send two classic signals: The first shows excessive risk taking, when companies pay very little above Treasury bonds—as in the late 1990s and 2007, and again today. This is a handy reminder that shareholders realize the danger. Trouble appeared in U.S. junk bonds months before the S&P 500 peaked in 2007, and gave several weeks' notice of the 2011 selloff. It isn't infallible—the dot-com bubble carried on for two years after the 1998 bond selloff—but is worth watching.

At the moment investors may be scratching their heads. The first signal is flashing, but the second is confused. U.S. junk bonds have been doing great, suggesting nothing is wrong, even as higher-quality bonds sell off.

The option-adjusted spread—a standard measure of the extra yield over Trea-

Federal Reserve rate rise. What is going on?

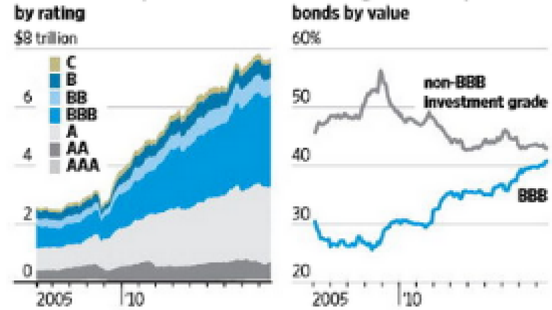
The explanation is that high-quality bonds aren't as high-quality as they used to be, while junk bonds are a little safer than they were. This summer for the first time more than 40% of the value of U.S. corporate bonds was rated BBB, just eking over the line into investment grade, and an even higher proportion was BBB in Europe.

Back in 2007, bond spreads were a little lower than today, but a smaller slice of bonds was on the bottom rung of investment grade and so at risk being downgraded to junk; only 26% of U.S. bonds were rated

BBB My Baby

The explosion of corporate bonds since the last recession has been led by the lowest investment-grade rating, BBB.

The lowest investment-grade rating category makes up more than 40% of all U.S. corporate bonds for the first time.



Source: ICE Data Services

THE WALL STREET JOURNAL.

amount to about half of the existing size of the $1 trillion U.S. junk market. In Europe those close to the edge would add about 35% to the €347 billion ($405 billion) junk market if all were downgraded.

The good news is that after the 2008 crunch, lots of bond-fund managers changed their rules to allow them to hold at least some bonds that weren't part of their benchmark, so they wouldn't have to dump downgraded paper immediately. But it isn't clear whether they could cope with the scale of downgrades that might result from the changed structure of the market.

All this is bad news for in-

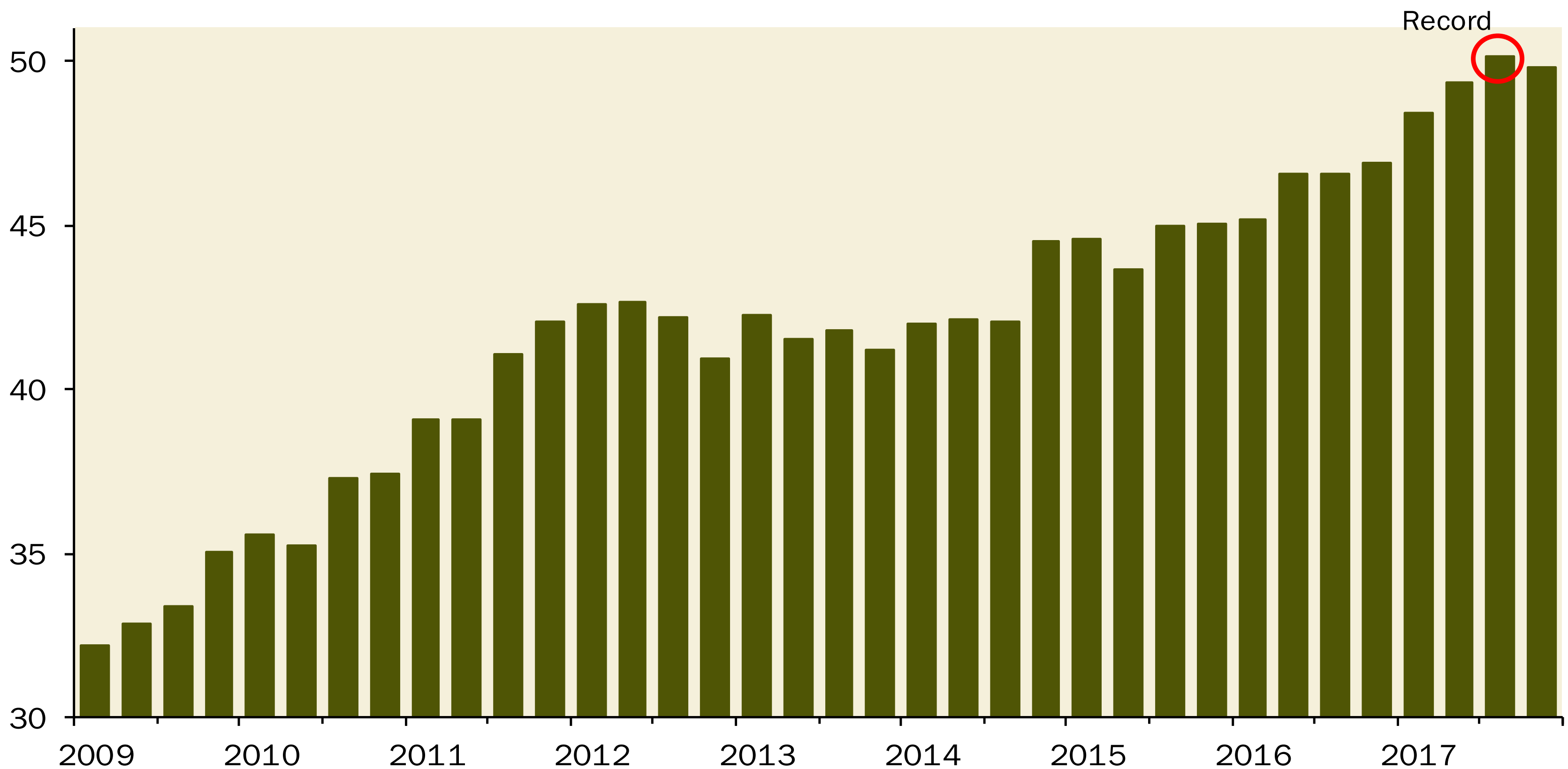
Notes:

Source: Wall Street Journal (September 21, 2018)

HALF OF INVESTMENT-GRADE COMPANIES ARE RATED BBB

United States: BBB Share of Investment-Grade Bonds

(percent)



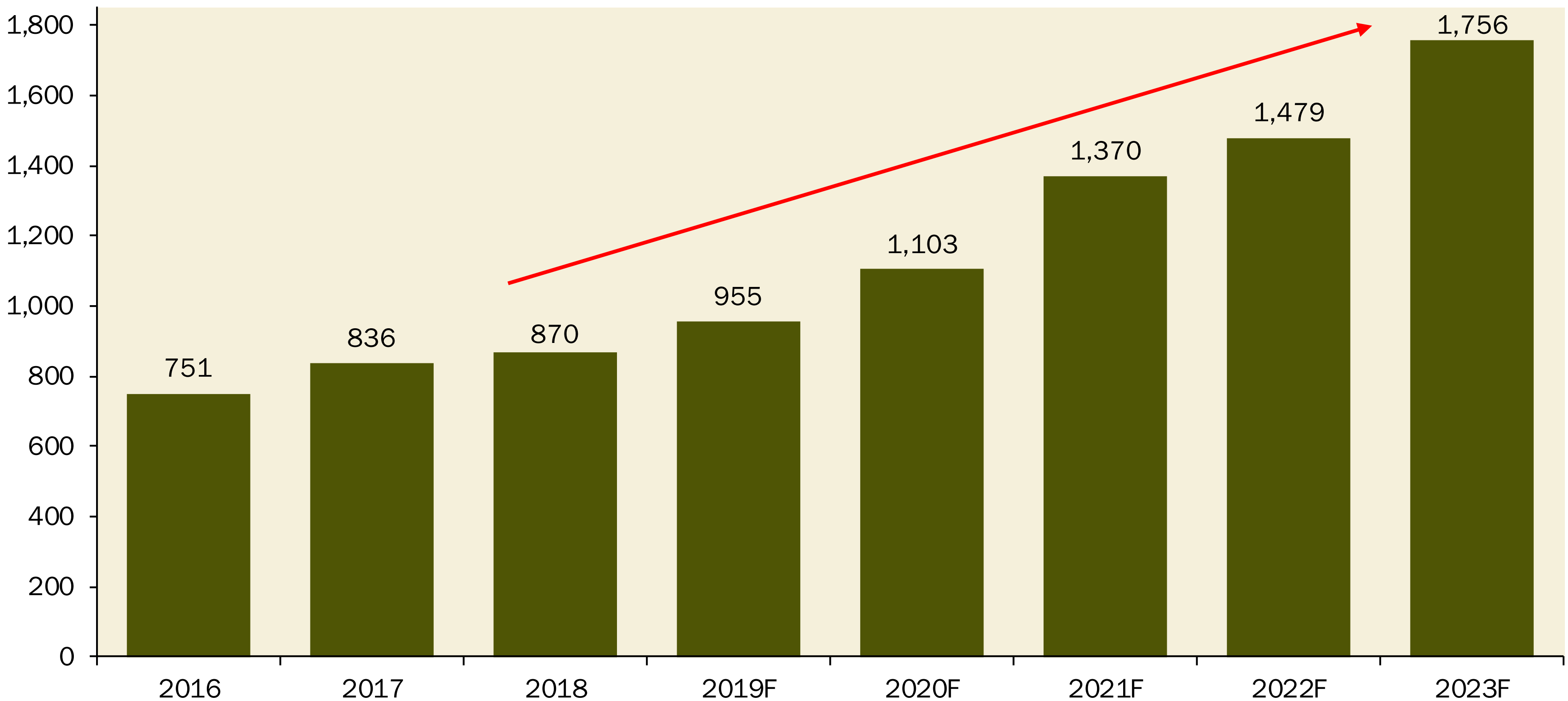
Notes:

Source: Bloomberg, Gluskin Sheff

A RECORD AMOUNT OF CORPORATE DEBT IS COMING DUE

United States

($ billions)



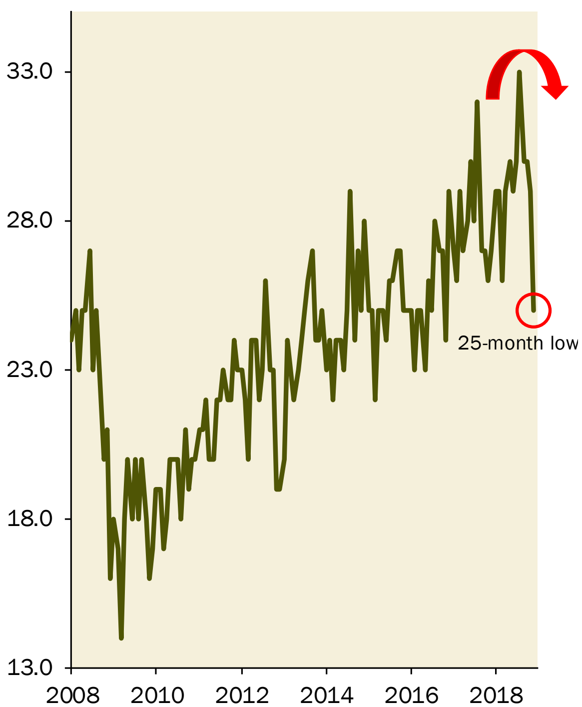
Notes:
Combination of High Yield, Leveraged Loans and Investment Grade bonds
Source: Bloomberg, Gluskin Sheff

BUSINESSES CURBING THEIR 2019 CAPEX PLANS

United States

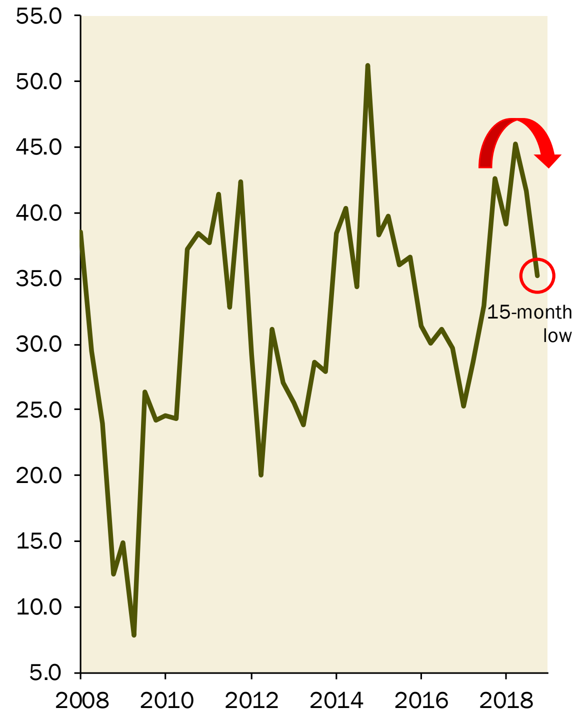
NFIB Small Business Survey

(percent share of respondents)



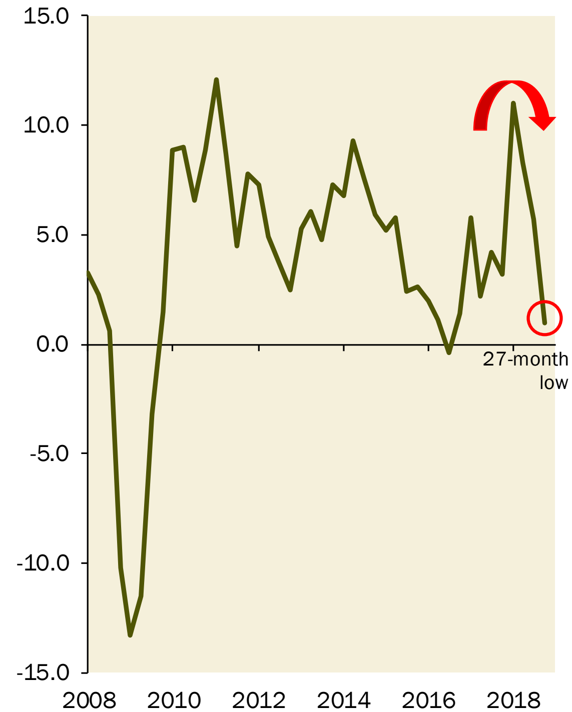
NABE Business Conditions Survey

(percent share of respondents)



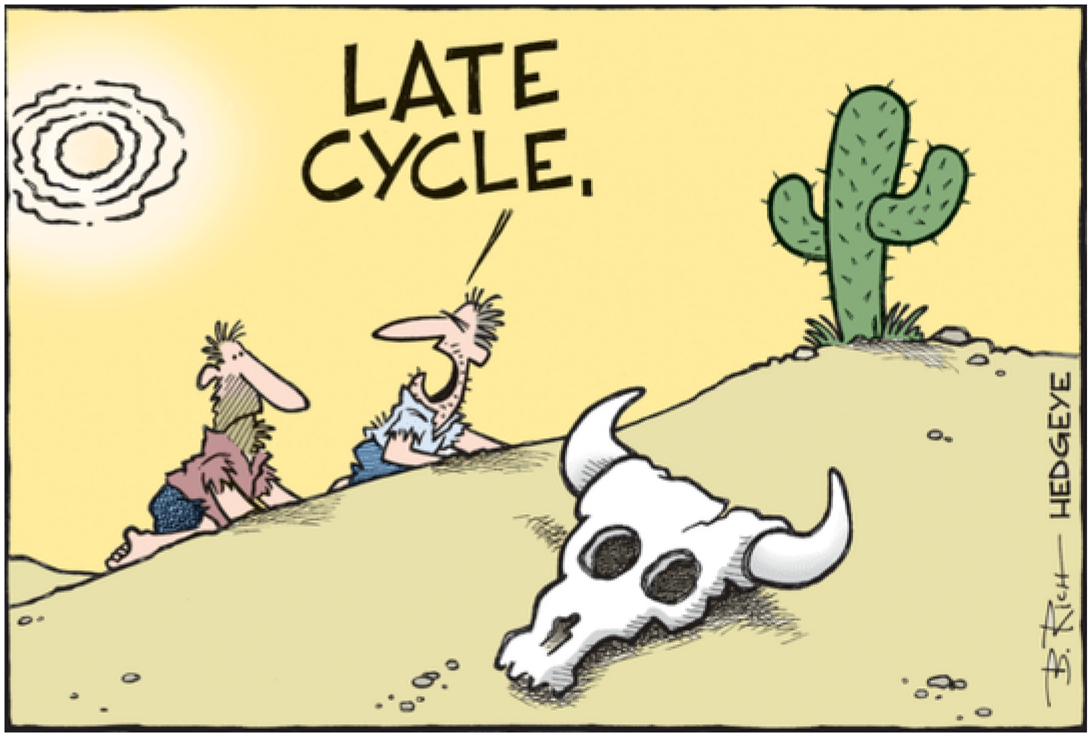
Duke CFO Outlook Survey

(percent)



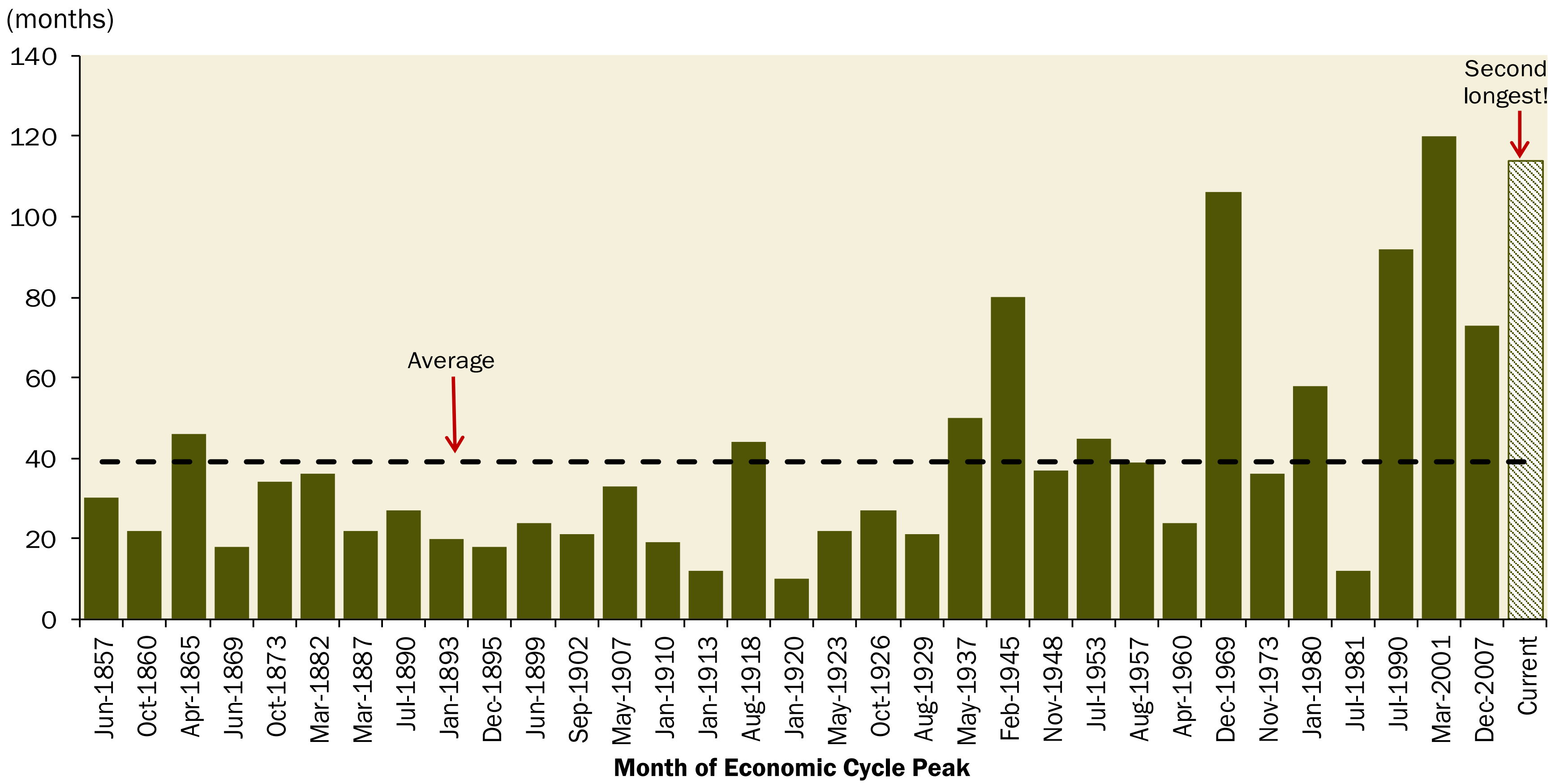
Notes:

Source: Haver Analytics, Gluskin Sheff


LATE
CYCLE.
HEDGEYE
B. RICH

SECOND LONGEST EXPANSION ON RECORD!

United States: Duration of Economic Expansions



Notes:

Source: National Bureau of Economic Research, Gluskin Sheff

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Flattening Yield Curve Splits Investors

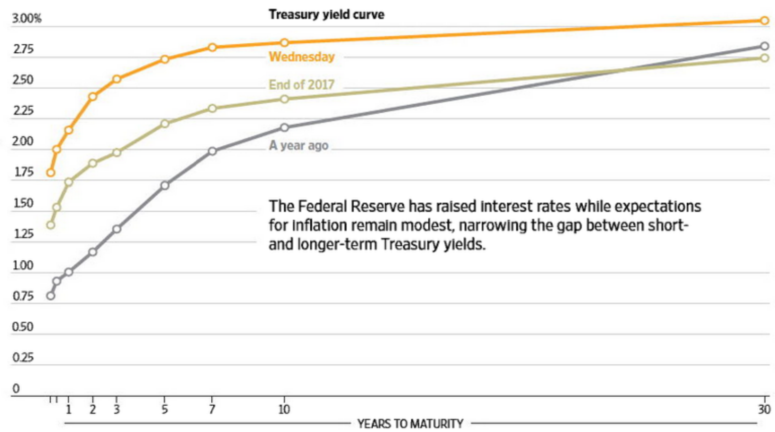
Treasurys' move often warns of a recession, but current economic growth remains steady

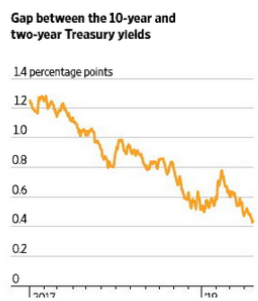
BY DANIEL KRUGER AND SAM GOLDFARB

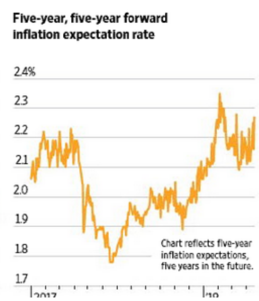
The gap between short- and long-term Treasury yields is at its narrowest in more than a decade, reflecting investors' confidence that the Federal Reserve will maintain its current pace of interest-rate increases despite continuing skepticism about the longer-term outlook for economic growth and inflation.

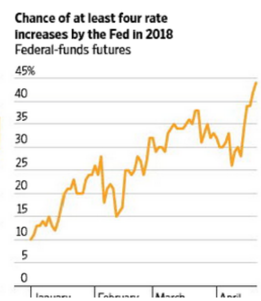
The difference between the two-year Treasury yield and the 10-year Treasury yield, known on Wall Street as the 2-10 spread, settled Tuesday at 0.428 percentage point, its tightest since 2007, before steepening modestly Wednesday. Two-year yields tend to rise along with investors' expectations for tighter Fed interest-rate policy, while longer-term yields are more responsive to sentiment about prospects for the economy.

The so-called yield curve, which measures the spread between short- and long-term rates, is a key indicator of sentiment about the prospects for economic growth, but investors remain split on what the signal shows now. Because short-term rates have exceeded longer-term rates before each recession since at least 1975—a phenomenon known as an in-









helps manage the BMO TCH Core Plus Bond Fund. "We don't necessarily believe the market will be able to withstand a terribly hawkish Fed."

Ms. Mardarovici said she is betting that the yield curve will continue to flatten. Her portfolios are overweight 10- and 30-year Treasurys and underweight three-to-five-year government debt, she said.

On the other hand, higher short-term yields suggest investors have confidence that inflation will reach the Fed's 2% target, but stable longer-term yields suggest a lack of concern that policy makers will lose control, said Michael Pond, head of inflation-linked strategies at Barclays PLC. The Fed "has shown its ability to control inflation" and prevent an overshoot, he said.

After dipping below 0.5 percentage point in early January, the 2-10 spread reached as high as 0.779 percentage point in February as investors saw signs that persistently tight labor markets might be translating into higher wages. Though those signs of rising wages were subsequently revised lower, leading the yield curve to resume its trend toward flattening, policy makers have expressed confidence in forecasts that growth and inflation will continue as they raise rates.

Investors and analysts are unsure how closely Fed officials will watch the bond market to help guide monetary policy, said Aaron Kohli, an interest-rate strategist at BMO Capital Markets. Mr. Kohli, who is fore-

Notes:

Source: Wall Street Journal (April 19, 2018)

THE SAN FRAN FED: ECONOMIC FORECASTS WITH THE YIELD CURVE

FRBSF Economic Letter

2018-07 | March 5, 2018 | Research from Federal Reserve Bank of San Francisco

Economic Forecasts with the Yield Curve

Michael D. Bauer and Thomas M. Mertens

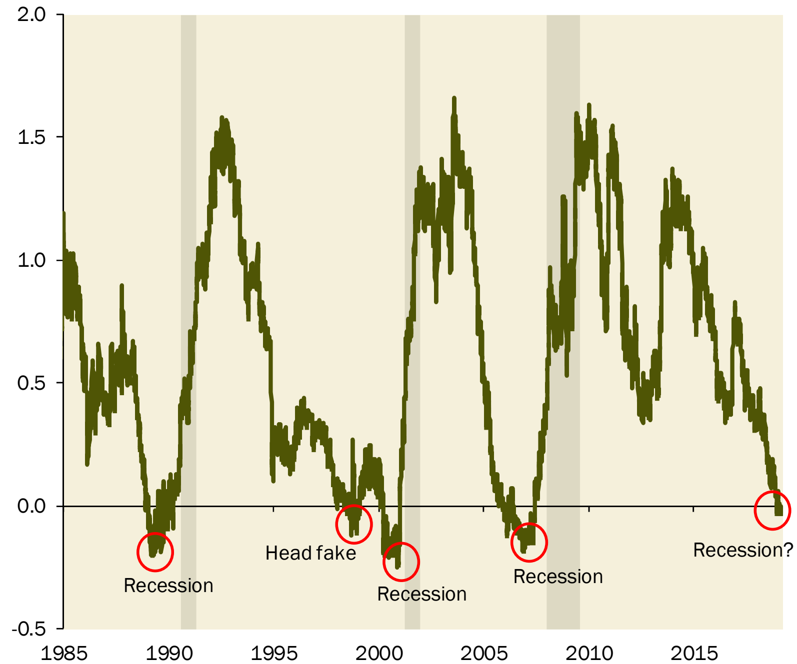
"The term spread—the difference between long-term and short-term interest rates—is a strikingly accurate predictor of future economic activity. Every U.S. recession in the past 60 years was preceded by a negative term spread, that is, an inverted yield curve. Furthermore, a negative term spread was always followed by an economic slowdown and, except for one time, by a recession. ***While the current environment is somewhat special—with low interest rates and risk premiums—the power of the term spread to predict economic slowdowns appears intact."***

Notes:
Source: Economic Forecasts with the Yield Curve; San Francisco Fed (March 5, 2018)

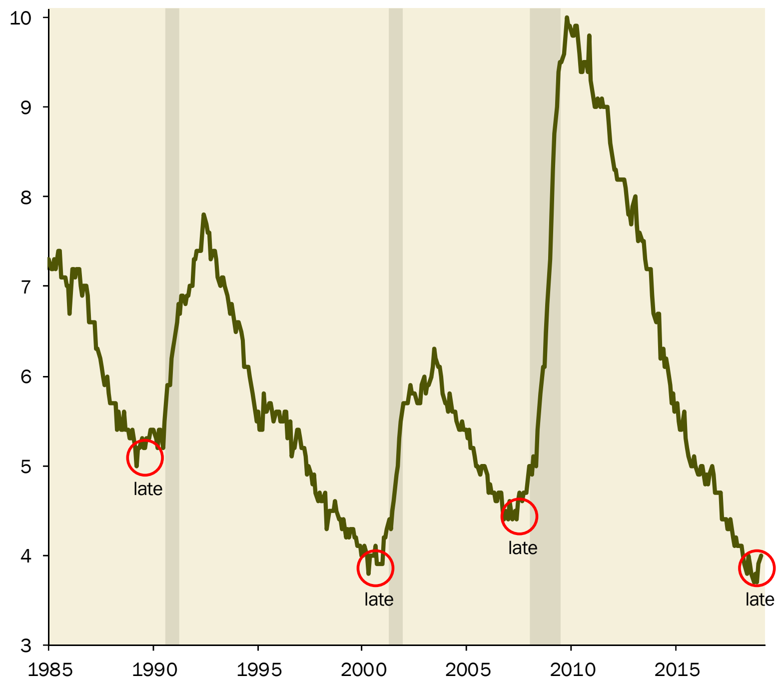
THIS IS WHAT THE ST. LOUIS FED HAS TO SAY...

United States

U.S. 5-Year T-Note Yield LESS U.S. 2-Year T-Note Yield
(percent)



Unemployment Rate
(percent)



"On average, since 1969, the unemployment rate trough occurred nine months before the NBER-determined recession trough, while the yield curve inversion occurred 10 months before...based on this evidence, it appears that both indicators tend to be reliable predictors of a business recession."

Notes:
Shaded regions represent periods of U.S. recession
Source: St. Louis Fed Economic Synopses; Recession Signals: The Yield Curve vs. Unemployment Rate Troughs (June 1, 2018), Haver Analytics, Gluskin Sheff

WE ARE MORE THAN 90% OF THE WAY THROUGH THE U.S. ECONOMIC CYCLE

Variable	Average change in expansions (start to peak/trough)	This cycle	Percent of average recovered this cycle
Core CPI (bps)	82.0	60.0	73.2%
CRB Commodity Index (%)	37.0%	48.2%	100.0%
2s/10s Yield Curve (bps)	-183.0	-209.0	100.0%
Industry Capacity Utilization Rate (ppts)	9.0	12.9	100.0%
Unemployment Rate (ppts)	-2.9	-5.7	100.0%
Real GDP (ppts)	8.9	7.8	87.6%
Profit Margins (ppts)	3.9	5.6	100.0%
ISM Manufacturing (pts)	25.0	15.0	60.0%
Auto Sales (%)	56.0%	85.8%	100.0%
Housing Starts (%)	63.5%	128.5%	100.0%
Cyclical GDP Share (ppts)	3.2	4.3	100.0%
Trailing P/E Multiple (pts)	7.8	9.1	100.0%
High Yield Spread (bps)	-662.7	-817.7	100.0%
Employment-to-Population Ratio (ppts)	2.5	1.0	40.3%
Consumer Confidence (pts)	43.9	80.7	100.0%
Average			90.7%

Notes:
Source: Haver Analytics, Gluskin Sheff

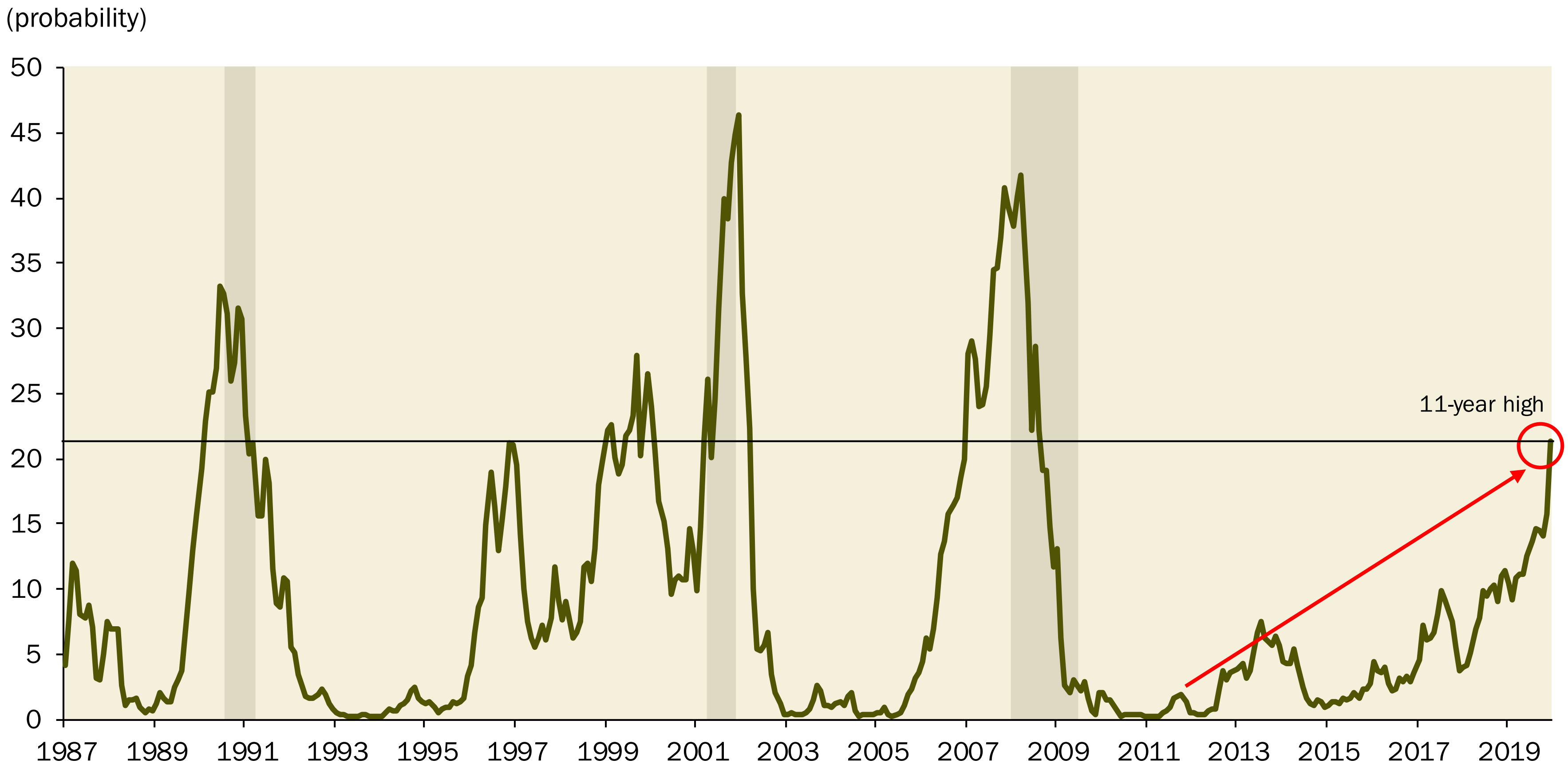

WE CAN'T GET TO ALL OF THE PROBLEMS FACING THE COUNTRY, BUT WE WILL BE TAKING ON PARTS VERY SOON!
Congress
RECESSION
VACATION, BABY!
WOO-HOO!
RECESS~~ION~~

THERE HAVE BEEN 13 FED HIKING CYCLES, 10 LANDED IN RECESSION!

First Hike	Last Hike	Result
October 1950	May 1953	**Recession**
October 1955	August 1957	**Recession**
September 1958	September 1959	**Recession**
December 1965	September 1966	Soft Landing
November 1967	June 1969	**Recession**
April 1972	September 1973	**Recession**
May 1977	March 1980	**Recession**
August 1980	December 1980	**Recession**
March 1983	August 1984	Soft Landing
January 1987	May 1989	**Recession**
February 1994	February 1995	Soft Landing
June 1999	May 2000	**Recession**
June 2004	June 2006	**Recession**
December 2015	???	???

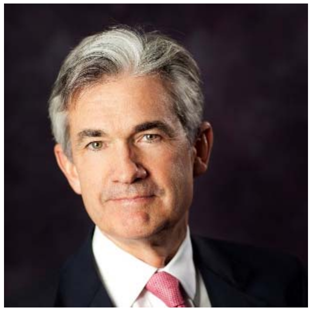
RECESSION PROBABILITIES ARE INCREASING

United States: NY Fed Probability of U.S. Recession 12-Months Ahead



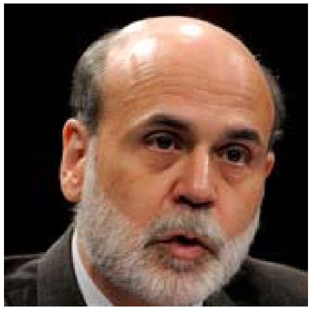
Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

FAMOUS LAST WORDS



"There's no reason to think that the ***probability of a recession*** *in the next year or two is at all elevated."*

- ***Jay Powell, September 27th, 2018***



"The Federal Reserve is not currently ***forecasting a recession.****"*

- ***Ben Bernanke, January 10th, 2008***

"The rate of economic growth continues to fall, although it's by no means a breakaway on the down side…we're certainly not yet in a free fall… ***we are observing an inventory readjustment process.****"*

- Alan Greenspan, January 3rd, 2001

Notes:
Source: "Brief Remarks on the U.S. Economy" (September 7, 2018); "Women in Housing and Finance" luncheon (January 10, 2008); FOMC conference call (January 3, 2001)

THE FED DOESN'T SEE RECESSIONS WHEN IT IS STARING THEM IN THE FACE

United States

Recession Start	Forecast Growth Coming Year (%)	What Actually Happened (%)	Delta (%)
Dec-69	1.2	-0.1	-1.3
Nov-73	2.4	-1.9	-4.3
Jul-81	0.9	-2.6	-3.5
Jul-90	2.0	0.0	-2.0
Mar-01	2.6	1.4	-1.2
Dec-07	1.3	-2.7	-4.0
Average	**1.7**	**-1.0**	**-2.7**

Notes:

Note: data represents four quarter average of subsequent QoQ (annualized) GDP growth

Source: Haver Analytics, Gluskin Sheff

THE OTHER "ROSIE" ISN'T SO ROSEY

*"**The empirical record of policymakers' ability to engineer a growth recession that nicely lands the economy at full employment without morphing into a full-blown recession is not comforting**. Similarly, a soft landing from an overheated economy — whether unexpected or not — to full employment has been a recurrent feature of past forecasts, **but not of actual outcomes**."*

— September 13-14, 2018

Notes:
Source: Eric Rosengren, Jeffrey Fuhrer, Giovanni Olivei, and Geoffrey Tootell; Should the Fed Regularly Evaluate its Monetary Policy Framework?; September 13-14, 2018

WHAT ‘IF’ WE GET A RECESSION?

United States: S&P 500

Expansion Date		Peak to Recession Start		Recession Start to Recession Trough		Peak to Recession Trough	
		Months	% Decline	Months	% Decline	Months	% Decline
Oct-49	Jul-53	6	-7.2	2	-8.2	8	-14.8
May-54	Aug-57	12	-9.1	2	-13.8	14	-21.6
Apr-58	Apr-60	8	-10.4	6	-3.8	14	-13.9
Feb-61	Dec-69	13	-15.1	5	-24.7	18	-36.1
Nov-70	Nov-73	10	-20.2	11	-35.1	21	-48.2
Mar-75	Jan-80	0	-0.9	2	-14.0	2	-14.7
Jul-80	Jul-81	8	-6.8	13	-21.8	21	-27.1
Nov-82	Jul-90	0	-3.5	3	-17.0	3	-19.9
Mar-91	Mar-01	12	-24.0	6	-16.8	18	-36.8
Nov-01	Dec-07	2	-6.2	15	-53.9	17	-56.8
Average		**7.1**	**-10.3**	**6.5**	**-20.9**	**13.6**	**-29.0**

Notes:
Source: Haver Analytics, Gluskin Sheff

YIELDS DECLINE DURING RECESSIONS

United States: 10-Year Yield Before, During and After Recessions

(percent)

Expansion Date		Peak Before Recession	Recession Start	Low in Recession	End of Recession
Feb-61	Dec-69	8.1	7.9	6.3	6.5
Nov-70	Nov-73	7.6	6.7	6.7	8.1
Mar-75	Jan-80	11.2	11.3	9.5	10.8
Jul-80	Jul-81	14.7	15.0	10.4	10.7
Nov-82	Jul-90	9.1	8.3	7.8	8.1
Mar-91	Mar-01	6.8	5.0	4.2	4.8
Nov-01	Dec-07	5.3	4.0	2.1	3.6

The 10-year yield declines 160 basis points in recessions

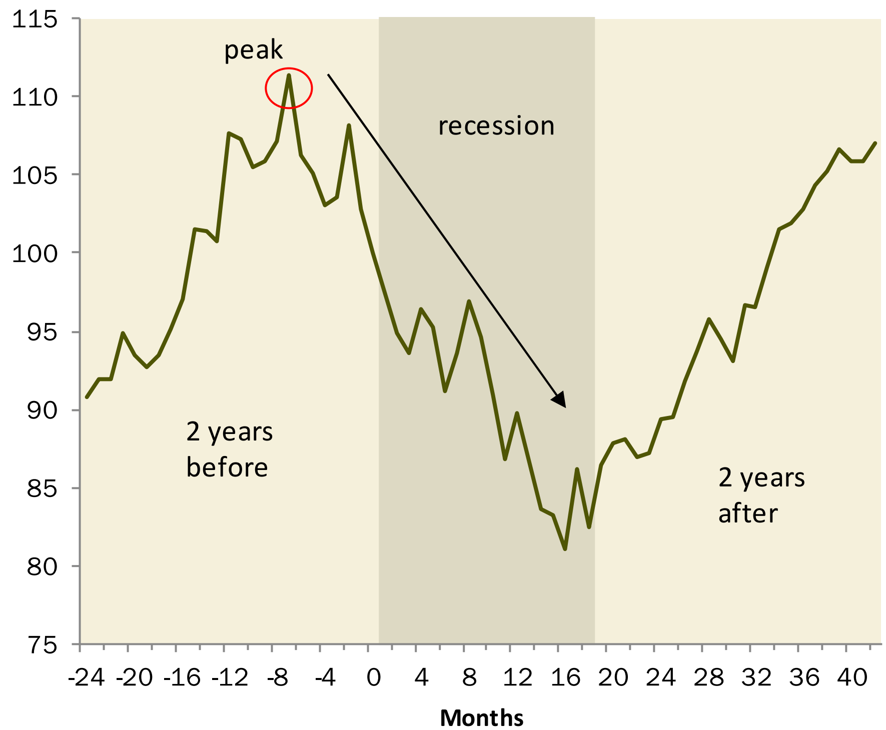
Notes:
Source: Haver Analytics, Gluskin Sheff

STOCKS AND BONDS THROUGH THE CYCLE

United States

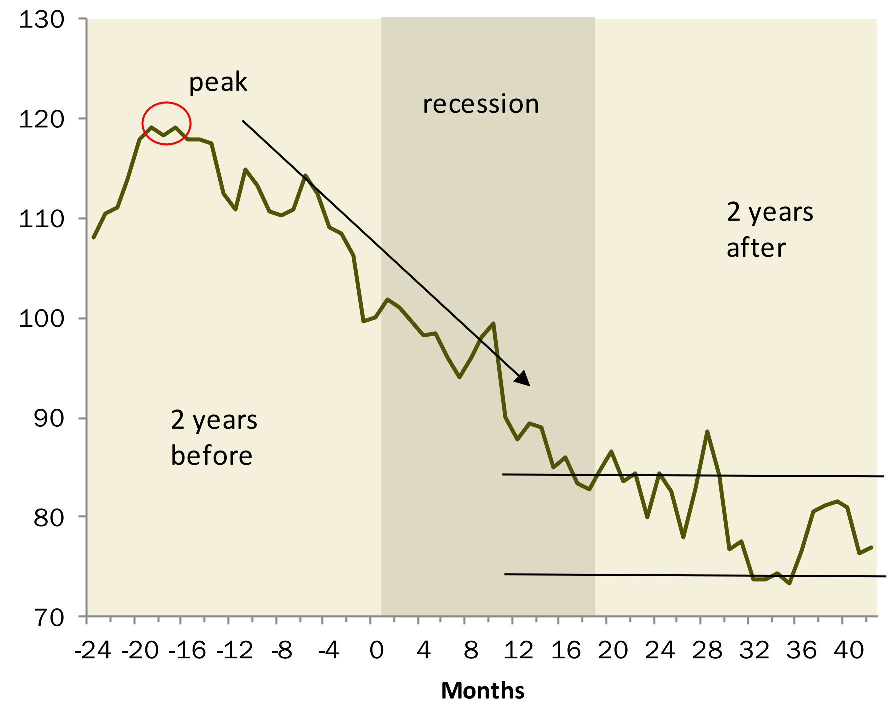
S&P 500

(start of recession = 100)



10-Year T-Note Yield

(start of recession = 100)



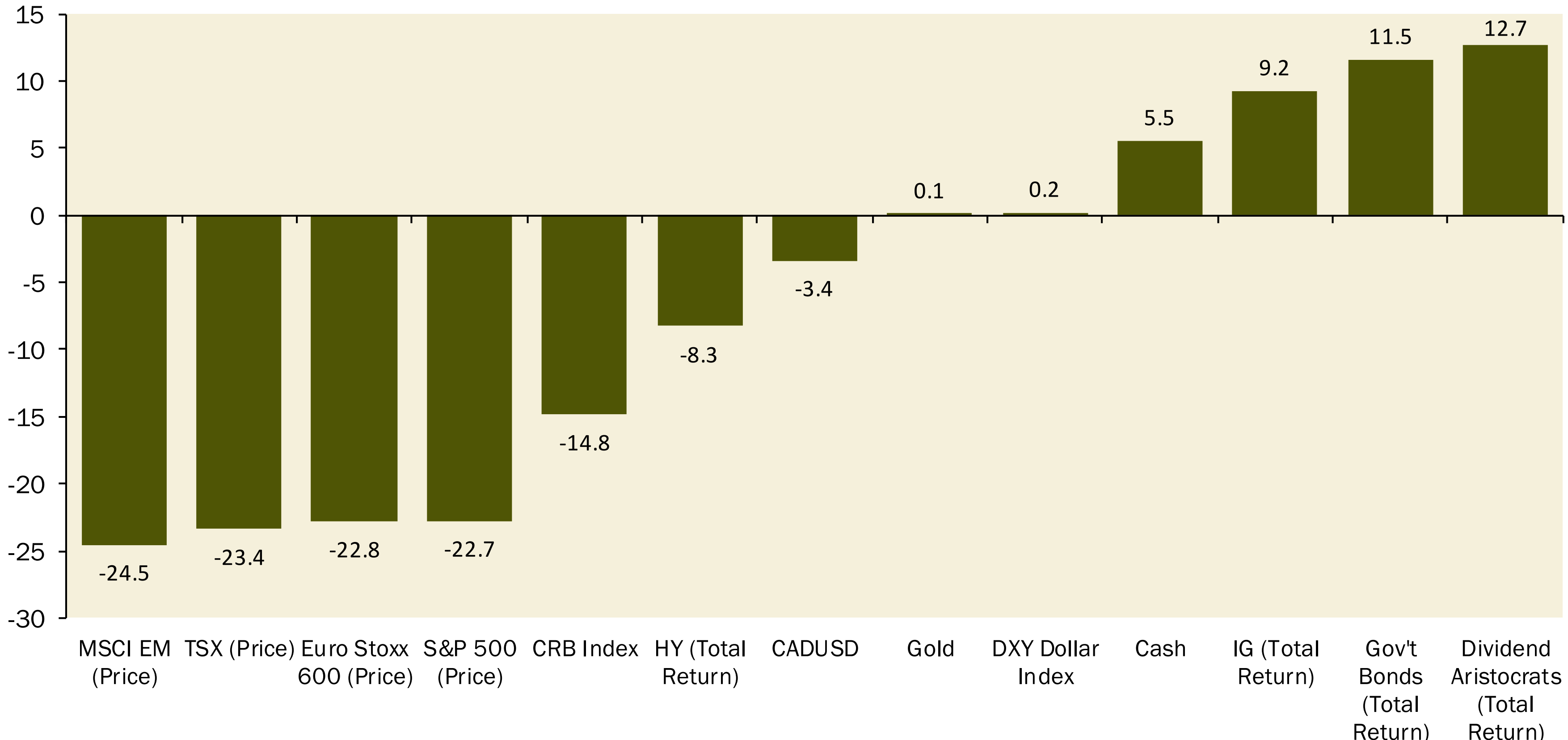
Notes:

Source: Haver Analytics, Gluskin Sheff

HOW TO BE POSITIONED IN A RECESSION

Median Return

(annualized percent change)



Notes:

Returns calculated from six months prior to recession to three months before it ends

Source: Bloomberg, Gluskin Sheff

Mark Hulbert
Special to USA TODAY

Now is time to prepare for end of bull market

Don't be surprised when next bear comes calling

The vast majority of investors will be caught by surprise when this bull market in stocks finally comes to an end. Cultivating a healthy sense of skepticism will help protect you from the irrational exuberance that invariably accompanies a market top.

This is far easier said than done, however. Bull markets often end with a burst of impressive performance, leading even die-hard skeptics to question themselves and throw in the towel on their bearishness.

Over the last six months of the bull market that ended in March 2000, for example, the Nasdaq doubled in value. By then, not surprisingly, most of that era's erstwhile bearishness had given way to enthusiasm and euphoria.

We all know what happened next.

That early-2000 experience was hardly unique. Consider the average recommended stock market exposure among several dozen market timers monitored by my *Hulbert Financial Digest* performance-monitoring service. At bull market tops of the last three decades, their exposure level averaged more than 70 percentage

USA TODAY

*"**Invest in "boring" companies:** Another way of preparing for an eventual bear market is to begin to shift your holdings away from riskier companies towards firms with the strongest balance sheets – as measured by financial quality ratings like those given by companies such as Standard & Poor's. The stocks of such firms are likely to go up as long as the bull market continues but lose a lot less than the market when it turns down. Wal-Mart stock, to provide one spectacular example, actually went up during the 2007-09 financial crisis, gaining 7% even while the S&P 500 fell 57%.*

To be sure, these higher quality companies, much of whose long-term return comes from dividends, can seem boring at a time when the stock market is regularly hitting all-time highs. But if it's excitement that you crave, just wait until the next bear market. One will begin someday."

Notes:
Source: USA Today (January 15, 2018)

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