First Inversion, then Recession?!

Wednesday saw plunging stocks blamed on Inversion. The answer to the above question/concern is "Yes, but...", as we have previously shared. The Headline from Thursday's WSJ:

Stocks, Bonds Flash Warning Signs

Dow has worst drop in 2019 as Treasury yields flag dangers to economic outlook

By Corrie Driebusch , Britton O'Daly and Paul J. Davies

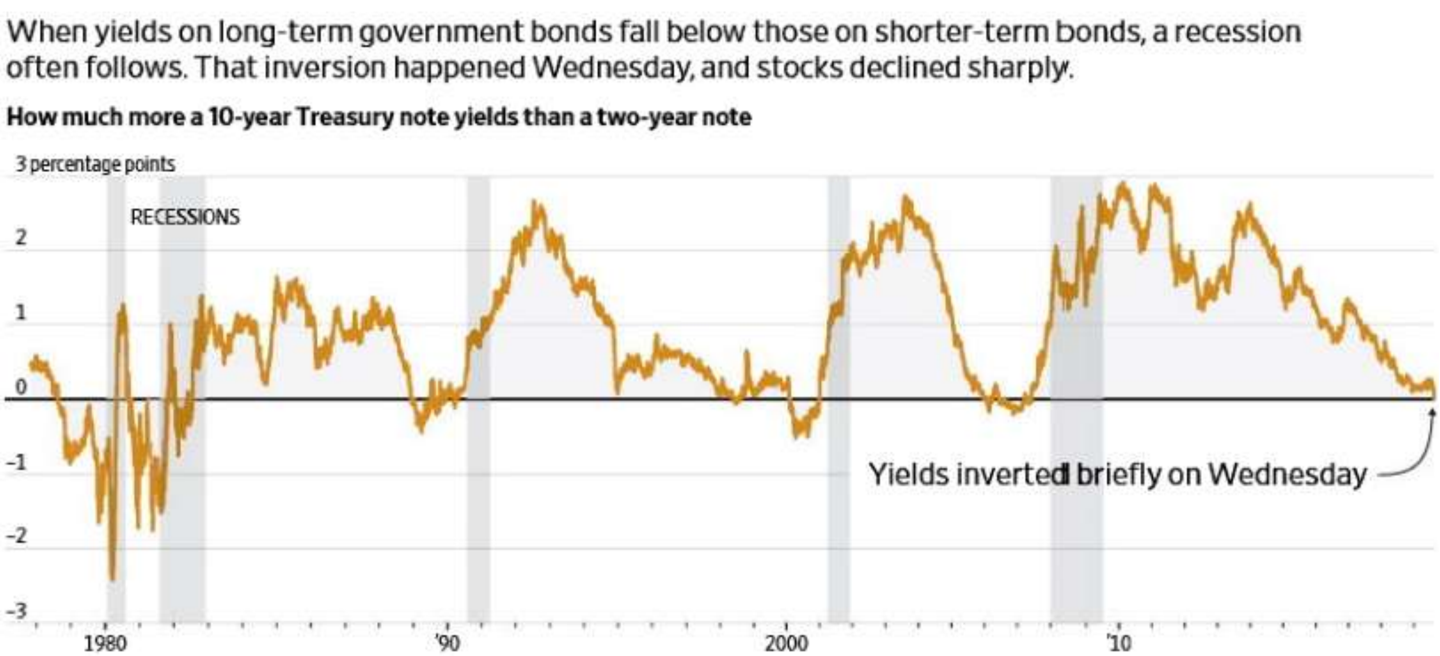
The Dow Jones Industrial Average posted its largest decline this year and government-bond markets sent a fresh warning about the risk of a recession, highlighting anxiety on Wall Street about the prospects for the decade long economic expansion.

Weak data out of Germany and China exacerbated fears that the biggest economies around the world, which less than two years ago were growing in sync, are now struggling as the effects of a trade war between America and China become more pronounced. ...

The Dow industrials slumped 800.49 points, or 3%, to 25479.42, led by sharp declines in economically sensitive industries such as banking and manufacturing. ...

The debilitating effect of trade tensions was visible in Chinese data, as industrial production in the country grew less than expected last month. Germany's economy—the largest in Europe—contracted by 0.1% in the second quarter due to further declines in exports.

The darkening outlook spurred investors to rush to the relative safety of U.S. bonds, which still offer some of the best yields among developed countries despite their recent drop. As the demand pushed up long-term bond prices, yields on the 10-year Treasury note briefly fell below two-year yields for the first time since 2007. That inversion between short- and long-term yields is viewed by many as a signal that a recession is looming. ...



Markets also tend to keep moving higher in the weeks and months following a yield-curve inversion. Since 1978, the S& P 500 has risen 13%, on average, from the first time the spread inverts on a closing basis to the beginning of a recession, according to Dow Jones Market Data. ...

The declines in U.S. stocks and bond yields erased the optimism from a day earlier—when the Trump administration abruptly suspended plans to impose new tariffs on some goods from China—and suggest the volatile swings that have defined trading in August show no signs of easing.

The S& P 500 declined 85.72 points, or 2.9%, to 2840.60, while the Nasdaq Composite lost 242.42, or 3%, to 7773.94.

The yield on the U.S. 30-year Treasury bond touched 2.018%, according to Tradeweb, below the previous intraday record low of 2.094% in July 2016. ...

This latest yield-curve inversion is particularly concerning to some investors given it comes on the heels of the Federal Reserve cutting short-term rates last month. Many traders and analysts are now looking for additional intervention by the Fed to extend the U.S. expansion.

President Trump called out the Fed in a tweet, saying the central bank raised interest rates too quickly and is now too slow to cut.

Expectations for further rate cuts jumped Wednesday, with fed-funds futures showing a market- implied probability of nearly 20% that the central bank cuts rates by 0.5 percentage point in September, up from 4% a day ago. ...

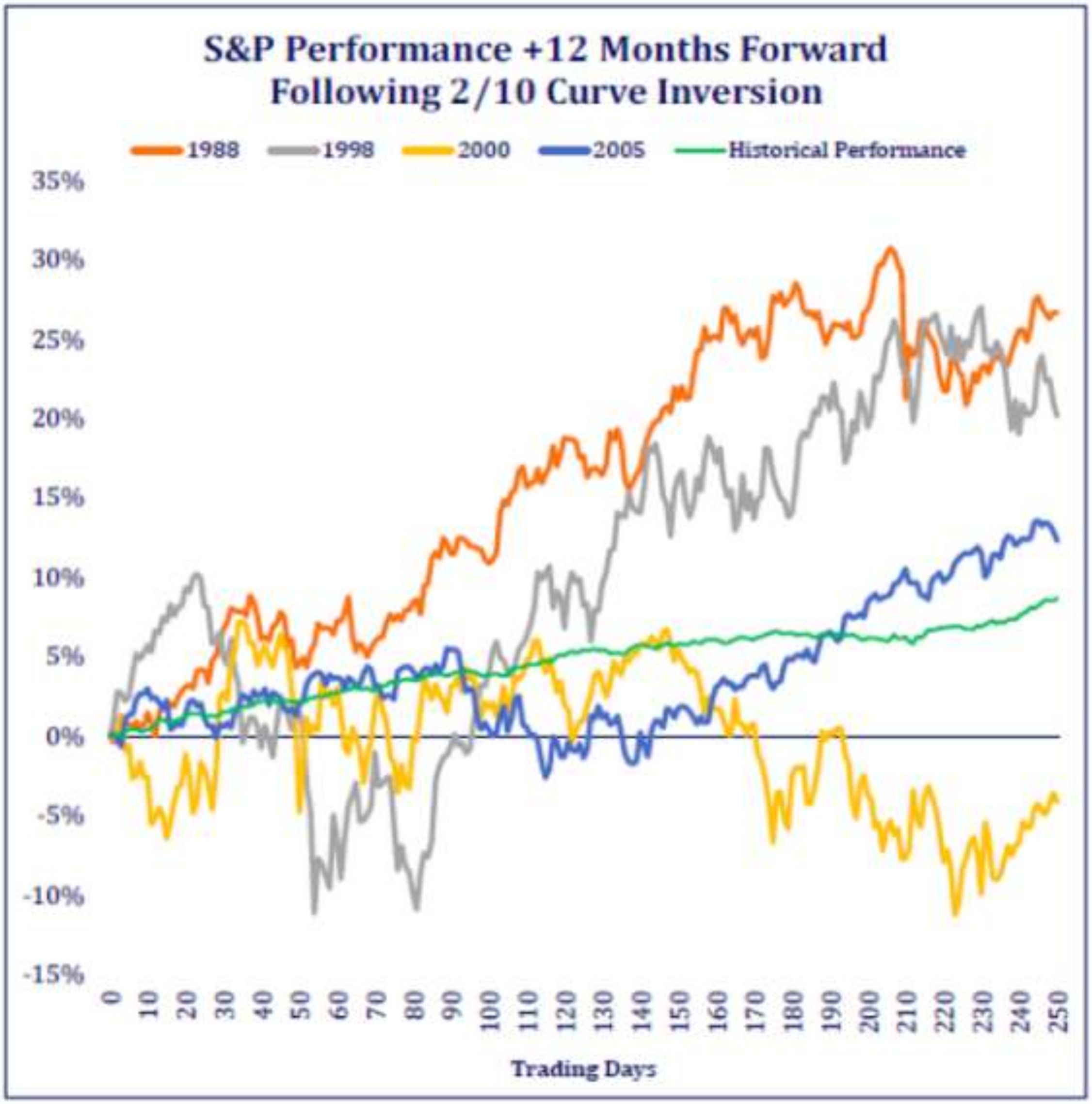
European stocks fell after data showed the German economy shrank in the second quarter. The Stoxx Europe 600 dropped 1.7%, while the German DAX fell 2.2%. The yield on the 10-year German bund touched a fresh record low of minus 0.645%, according to Tradeweb. ...

From Thursday's **The Finance 202: Trump is blaming the Fed for the inverted yield curve. He should look at his policies.**

Todd Sohn, a technical analyst at Strategas, points out in an email:

- The yield curve inverted in December 1988, but a recession did not follow until July 1990, a year and a half later.
- Another happened in June 1998, and a recession didn't follow until March 2001, over two and a half years later (though another inversion occurred in February 2000).
- The inversion credited with predicting the recession from the financial crisis occurred in December 2005, two years before that recession officially began.

And in the meantime, **the stock market more often than not outperforms in the year following an inversion**, as this Strategas chart shows:



Other economists warned against taking the inversion as gospel about the likelihood of a recession. “Historically, it has been a pretty good signal of recession, and I think that’s when markets pay attention to it, but **I would really urge that on this occasion it may be a less good signal,” former Federal Reserve chair Janet Yellen** said on Fox Business Network. “The reason for that is there are a number of factors other than market expectations about the future path of interest rates that are pushing down long-term yields.”

For her part, Yellen said she doesn’t think the economy is headed for a recession, “but the odds have clearly risen and they’re higher than I’m frankly comfortable with.”

From Friday's Global Investment Strategy:

Don’t Sweat The CRAZY INVERTED YIELD CURVE

Recession Risk Forces Trump’s Hand

Risk assets remain caught in the crossfire of slowing global growth, flattening yield curves, and trade war uncertainty.

Stocks received a short-lived boost on Tuesday from the Trump Administration's decision to delay raising tariffs until December 15th on roughly 60% of the Chinese imports – including smartphones, laptops, and toys – which were slated to be taxed starting September 1st. The decision followed a phone call between U.S. and Chinese trade representatives that Trump described as "very productive."

Seemingly in contradiction to his earlier claim that China will end up bearing the full cost of the tariffs, President Trump admitted that "We're doing this for the Christmas season, just in case some of the tariffs would have an impact on U.S. customers."

The fact that the trade war is weighing on growth and the stock market has not been lost on Trump. The latest Bank of America Merrill Lynch Global Fund Manager Survey revealed that 34% of managers believed that a recession is likely within the next 12 months. This is the largest share in eight years. The trade war topped the list of "biggest tail risks" for the fifth month in a row. A net 22% of investors said they had taken out protection against a sharp drop in the stock market, the highest number since the survey began asking this question in 2008.

The question is whether Trump's half-hearted attempt to hold out an olive branch to the Chinese is too little, too late. The fact that the Chinese government indicated on Thursday that it will still go ahead and take "necessary countermeasures" suggests that Trump's overture does not go far enough. More worryingly, the meltdown in bond yields and the stock market's failure to hold Tuesday's gains imply that many investors think that the trade war has already pushed the global economy past the breaking point.

Industrial Activity Struggling To Find A Bottom

It is not helping matters that industrial activity outside the U.S. remains in a slump. It was confirmed this week that the German economy contracted in the second quarter on the back of flagging export demand. The decline in the expectations component of the German ZEW survey in August to the lowest level since 2012 suggests that growth has remained weak in the third quarter.

Chinese economic activity also disappointed in July. Industrial production growth slowed significantly. Retail sales decelerated, led by a relapse in automobile sales.

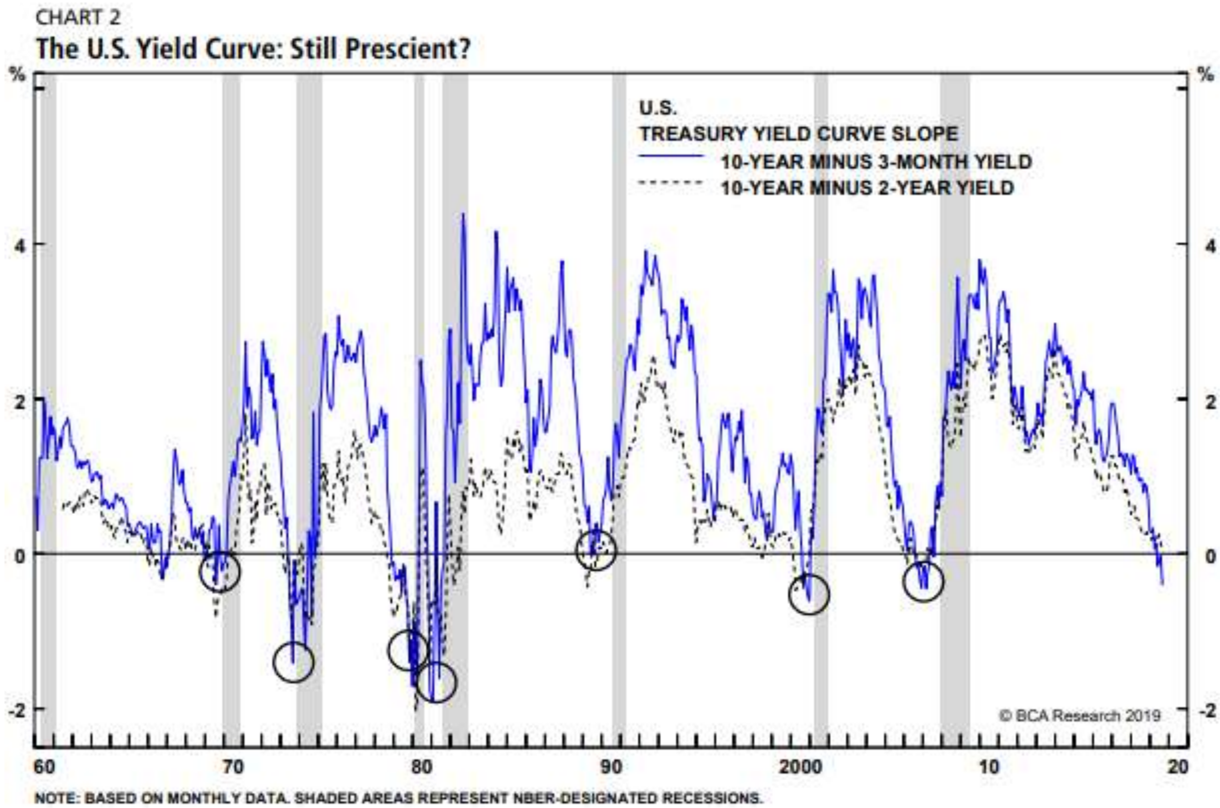
A variety of political developments around the world have further undermined market confidence. The protests in Hong Kong have become increasingly violent, causing severe disruptions to air travel in the region. The risks of a hard Brexit are rising. Italy's coalition government has collapsed. And in one of the biggest daily moves on record, the Argentine stock market fell by 48% in dollar terms on Monday after its current reform-minded president, Mauricio Macri, was trounced by his left-wing rival in primary elections.

Will The U.S. Be Dragged Down?

The U.S. economy has held up relatively well compared with the rest of the world. Retail sales rose by 0.7% in July, the fastest pace in four months, and more than twice what analysts were expecting. While industrial production was somewhat softer than expected, both the Philly and New York Fed manufacturing surveys surprised on the upside. The forward-looking new orders component increased in both surveys.

With this week's data in hand, the Atlanta Fed's GDPNow model is forecasting that U.S. real GDP will rise by 2.2% in Q3. Real final domestic demand, which excludes the contribution from net exports and inventories, is set to grow by an even-healthier 3%.

Given the still reasonably firm U.S. data, why are so many pundits and market participants fretting about a recession? One key reason is that the yield curve has inverted. An inverted yield curve has historically been a reliable predictor of recessions (**Chart 2**).



Yield Curve Angst

President Trump wasted little time on Wednesday sarcastically thanking “clueless” Jay Powell and the Federal Reserve for the “CRAZY INVERTED YIELD CURVE” (emphasis his).

Trump and the investment community should relax a bit. In contrast to the consensus view, we see flatter yield curves around the world as a “glass half full” story, mainly reflecting the shift to an ultra-dovish stance by most central banks.

Not only has the Fed turned more dovish, but other central banks have cranked up monetary stimulus. A Wall Street Journal story published earlier today quoted Olli Rehn, the current governor of the Finnish central bank and member of the ECB’s rate-setting committee, as saying that the ECB is looking to unveil a “significant and impactful policy package” in September, adding that “When you’re working with financial markets, it’s often better to overshoot than undershoot.”

Since short-term rates in the euro area and in a number of other countries cannot fall much from current levels, the only way for the ECB to ease financial conditions is to signal that short-term rates will stay lower for longer and to buy up long-term bonds through large-scale asset purchase programs. This naturally leads to lower bond yields and flatter yield curves. Falling bond yields in Europe and around the world have, in turn, dragged down U.S. yields.

Unlike in the past, term premia are negative across the major economies. This means that investors today can expect to earn more by rolling over a short-term government security than by buying a long-term government bond.

In addition to central bank asset purchases, rising demand for bonds from institutional investors has depressed term premia. Desperate to match their long-duration liabilities with equally longduration assets, insurance companies and pension funds have been forced to purchase bonds with low (and sometimes even negative) yields.

Term premia have also come down as investors have grown accustomed to seeing bonds as a good hedge against equity risk in particular, and recession risk in general.

As such, one should take the purported recessionary signal from an inverted yield curve with a grain of salt. Today, the U.S. 10-year term premium stands at -1.2%. In late 1994, when the yield curve almost inverted, the term premium was 1.9%. Had the U.S. term premium in the mid-1990s been anywhere close to present levels, the yield curve would have surely inverted, causing yield curve obsessed investors to miss out on the biggest equity bull market in history.

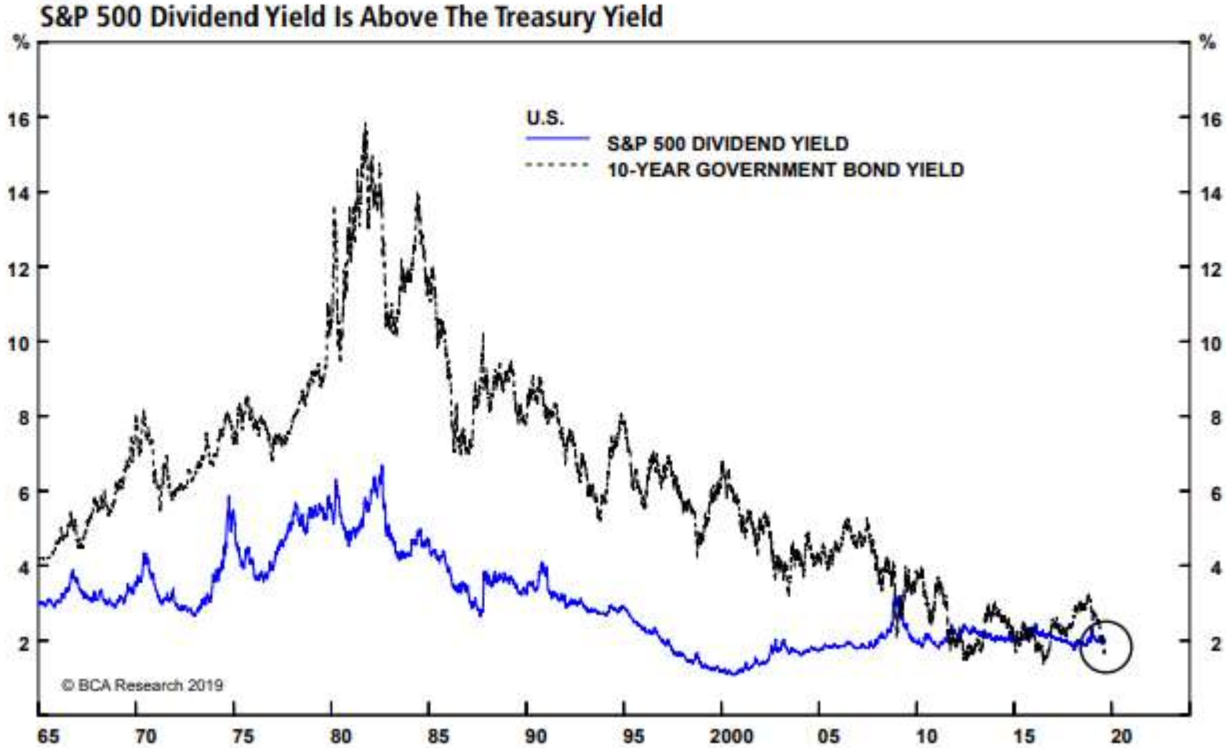
TINA's Siren Song

For investors, the collapse in bond yields increasingly means that There Is No Alternative to equities. We will have much more to say about "TINA" in a forthcoming special report; but for now, suffice it to say that ultra-low bond yields have improved the relative attractiveness of stocks.

The S&P 500 dividend yield is currently 2.03%, 51 bps above the yield on 10-year Treasury notes (**Chart 4**). To put things in perspective, even if S&P 500 companies did not increase cash dividends at all for the next ten years, the real value of the index would still have to fall by 28% (assuming 2% inflation) for bonds to outperform stocks.

CHART 4

S&P 500 Dividend Yield Is Above The Treasury Yield

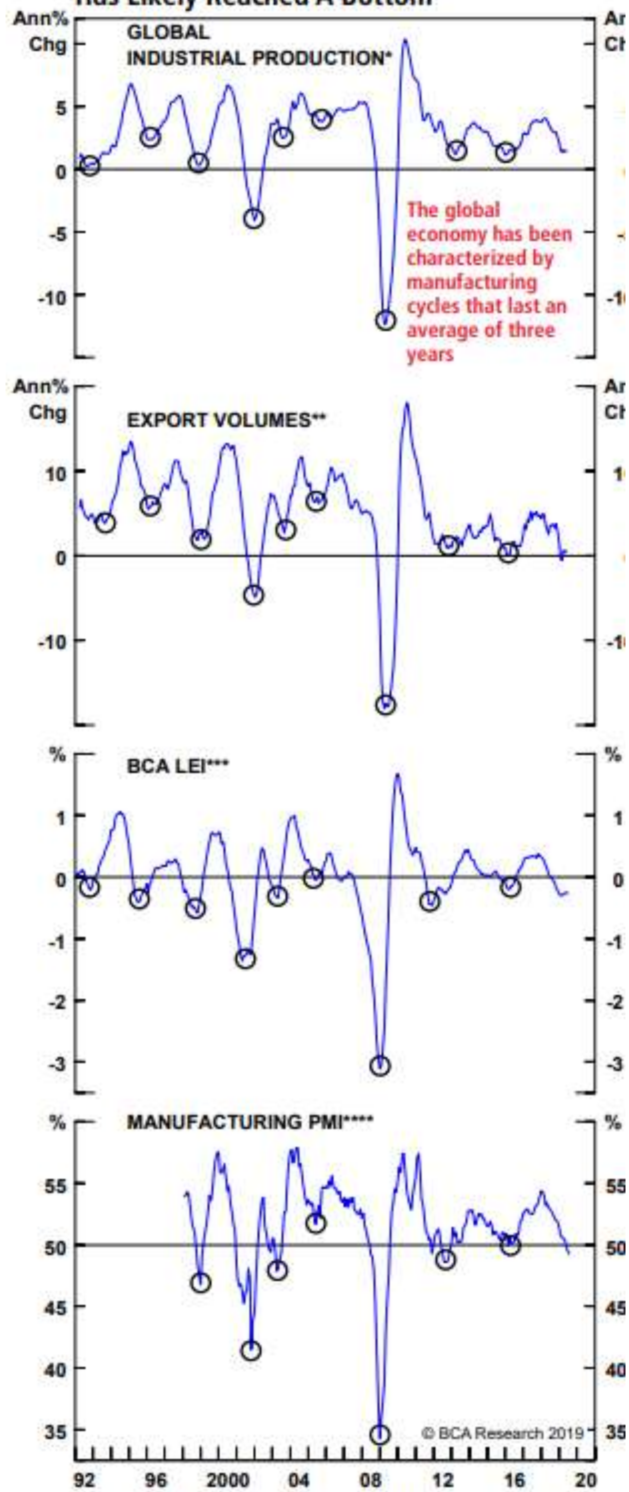


... the equity risk premium in the U.S. remains well above its historic norm. The equity risk premium is even higher outside the U.S., reflecting both the fact that valuations are cheaper abroad and that interest rates are generally lower.

It is useful to contrast today's high equity risk premia with the fact that global cash allocations in the latest BofA Merrill Lynch survey stood at 5.2% in August (1.5 standard deviations above their long-term average). Bond allocations were also 1.1 standard deviations above their long-term average.

On the flipside, asset allocators were net 12% underweight stocks (1.7 standard deviations below their long-term average). In fact, aside from June of this year, this represents the biggest equity underweight since March 2009. Given this backdrop, stocks are likely to continue to climb the proverbial wall of worry.

CHART 7
The Global Manufacturing Cycle Has Likely Reached A Bottom



* INDUSTRIAL PRODUCTION VOLUME EXCLUDING CONSTRUCTION. SHOWN AS A 3-MONTH MOVING AVERAGE; SOURCE: NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.
** SHOWN AS A 3-MONTH MOVING AVERAGE; SOURCE: NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.
*** BASED ON 23 COUNTRIES, BCA CALCULATIONS.
**** SOURCE: MARKIT/ J.P. MORGAN.

Investment Conclusions

... Yes, global growth, at least outside the U.S., remains weak. Encouragingly, however, the slowdown has been largely confined to the manufacturing sector. Unlike in 2008, the service sector has remained fairly resilient. Even in Germany, the service PMI has actually risen since late last year.

Global manufacturing cycles tend to last three years – 18 months up, 18 months down (**Chart 7**). The last downleg began in early 2018. Provided the trade war does not spiral out of control, we are due for another upturn in manufacturing activity.

A bit more fiscal stimulus should help. Chinese credit growth came in much weaker than-expected in July. With growth still soggy there, we expect the Chinese authorities to redouble stimulus efforts over the coming months. Fiscal policy in the euro area is also being loosened (Chart 8). Further easing is likely in Germany, where support for a German version of a "Green New Deal" is gaining traction.

All this means that global growth is probably close to a bottom. This, in turn, implies that the meltdown in bond yields is likely to end soon. Investors should favor stocks over bonds over the next 12-to-18 months. We expect to upgrade EM and European equities during the next few months.