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Economy & Market Valuation

Recession and Yield curve inversion

We've enjoyed almost 9 years of a bull market run. Can the run continue? The stock market is highly correlated to the economy. The economy is measured in terms of GDP growth and the growth is influenced by Fed's policy & other factors. Two or more quarters of negative GDP signifies a recession. We are not seeing any signs of recession. The market participants spend an inordinate amount of time and effort to forecast the next recession.

Historically, the yield curve inversion has been an excellent predictor of recession. It is now showing a warning sign. We think that we are still at least 1-2 years from seeing a recession.

What is a *yield curve inversion*? First let us explain what a yield curve is. A yield refers to the interest payments on a debt or a loan. Your CD at a local bank may offer a yield of 1%. The treasury yield curve is a plot of yield of debt issued by the Uncle Sam with varying maturities. US Government issues short term loans called T-Bills (with maturities of 28, 91, 182 & 364 days) and long-term loans called Treasury notes (10 year) and bonds (20-30 years).

Here is a typical yield. You can see that long duration debt has higher yields.

Date	1 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
08/01/18	1.93	2.03	2.22	2.45	2.67	2.78	2.87	2.96	3.00	3.07	3.13
08/02/18	1.89	2.02	2.22	2.45	2.66	2.76	2.85	2.93	2.98	3.06	3.12

Thursday Aug 2, 2018

An inversion is set to occur when say, the 10-year treasury security, has a lower yield than a short term one, like the 3-month.

Most of the loans/debt borrowed by Corporations and LLCs are at a longer duration. When long term rates are lower than short term rates there is no incentive for savers to loan money to these entities. You can get the same return with less risk by investing in short term securities. This causes GDP growth to slow. The yield curve inversion is almost always triggered by the Fed raising interest rates to combat inflation.

If the Fed keeps on increasing rates, the forecast is that the yield curve could *invert* in early 2019. The past two recessions followed yield curve inversion by 12 to 18 months. So, going by the historical trend, a recession could hit the US economy in 2020 or 2021. The question for us at OCA is what action we could take to safeguard the portfolio. Yield curve inversion could be a self-fulfilling prophecy. There could be lot of selling at yield curve inversion even if recession is sometime away. We want to be ready for a yield curve inversion and recession by increasing the cash portion in the portfolio as it has two advantages

1. Higher cash portion will help us outperform the market, when the market is dropping
2. It will provide cash to invest quickly to take advantage of the opportunities created by a market drop.

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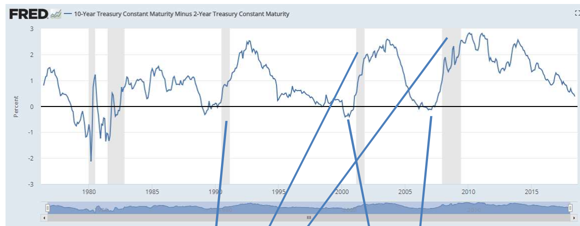
Here is the graph of yield curve for the last 5 recessions. As you can see, yield curve has inverted before each of the last 5 recessions.



Recessions Yield curve version