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INVESTMENT MANAGEMENT

What is the Rates Market Telling Us?

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The rates market interprets the recent breakdown in U.S.-China trade negotiations and risk of tariffs with Mexico as a signal that growth, and therefore inflation pressures, will be slower and lower than previously expected. This is true not only in the U.S., but globally as well, and the decline in U.S. yields and flattening of the yield curve are both logical price adjustments to this new information.

Explaining the decline in yields

We think about bond yields as a mechanism that discounts the path of short-term interest rates, in order to estimate the level of longer term bond yields. There are four main components to the mechanism and what follows is the *current* status of each:

1. **Growth outlook**: *lower/declining due to trade related concerns*
2. **Inflation outlook**: *lower/declining due to pressure on global growth, i.e. oil and commodity prices*
3. **Central bank outlook**: *dovish*
4. **Term premia**: *falling due to all of the above, i.e. investors in longer maturity bonds are demanding less risk compensation for rising inflation risks*

Given that all four components are pointing toward lower yields, our framework leads us to conclude that rates may fall further, where a **2.00% yield for the U.S. Treasury (UST) 10-year would not be unreasonable.** However, we are careful to specify this is the *current* status, which means economic conditions could get better or worse and change the expected level of long-term bond yields.

What the flattening of the UST yield curve means

The market broadly agrees that a flattening, and especially an inversion, of the yield curve is an indication of recession risk. However, there is notable disagreement on the **strength of this signal**.

As we see it, **the signal strength is weak.** Why? Because historically the yield curve has inverted when the U.S. Federal Reserve (Fed) was in a process of TIGHTENING, i.e. intentionally raising rates too high in order to slowdown an overheating economy and contain inflation from rising well above target.

We cannot emphasize enough that this is NOT the case today**.** The Fed has not tightened, they have simply removed excess accommodation and moved to neutral. The yield curve is flattening because investors currently believe growth and inflation are less likely to accelerate in the future. Therefore the risk premia, aka term premia, of holding longer maturity bonds have fallen dramatically. We believe this explains why longer term yields have fallen and the yield curve subsequently flattened.

We think the yield curve today represents weak signal strength for a recession, but a strong signal for slower growth and inflation. To the extent that slower growth and inflation increase the probability of recession, it is valid to currently attribute some *coincident* connection between curve flattening and recession risk, with the understanding that it is not a *causal* relationship.

Investment Strategies:

- Growth is slowing, not collapsing. This means the risk of a recession remains low, thus default risks also remain low
- Increase allocation to higher quality duration products (USTs and investment grade credit)
- Selective opportunities in domestic, real economy sectors in U.S. high yield (transports, home builders, building materials) vs. reduce exposure to “trade” sensitive sectors such as tech
- Selective emerging market exposures (Central Eastern Europe countries are good candidates)
- Non-agency mortgage-backed securities and select sectors in asset-backed securities that are underpinned by a strong U.S. consumer

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