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YIELD CURVE INVERSIONS PREDICT HYPER STOCK MARKET RETURNS

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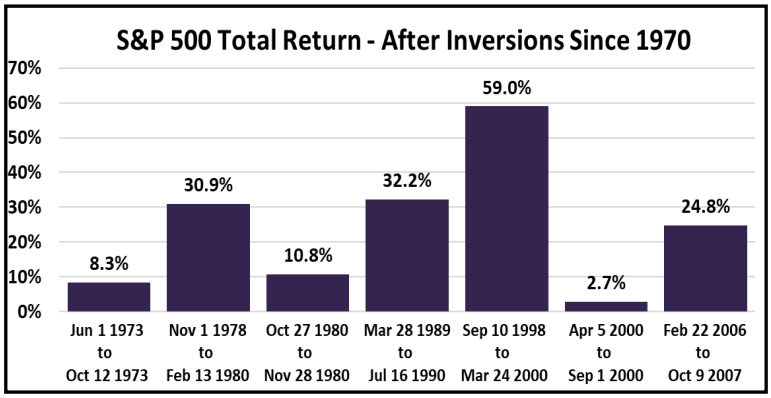
Last year's fourth quarter equity market sell-off sparked much discussion in the media, around kitchen tables and in Uber rides alike, about the potential demise of the North American economic expansion. Paradoxically, feckless human nature is to fret most about risks after the damage is done, rather than in times abundant.

As I wrote in previous editions of the Thornmark *Perspective*, the common precursors to a contraction were not existent, including at the end of 2018. However, towards the end of March, a potential recession precursor did emerge when the U.S yield curve inverted. It is perilous to invest based on an over simplified rule of thumb such as inversions. As explained in this edition of the *Perspective, w*hile yield curve inversions help us frame our investment outlook, they also offer evidence that stock markets normally surge higher. Inversions should be neither ignored nor feared.



INVERSIONS ≠ RECESSIONS

While it's true that all six recessions since 1970 followed an inversion, three other inversions did NOT result in a contraction. The average time from inversion to recession is 1.2 years. Thus, a lot can and DOES happen after an inversion before a recession (if one occurs at all).

A deeper dive into the data reveals an astonishing and little-known post-inversion opportunity. As shown in the chart on this page, **ALL U.S. inversions were followed by positive stock market returns**. Significantly, 71% of inversions delivered a period of **hyper stock market performance** (greater than 10%). The average hyper return was a staggering 32% total return from the S&P 500 Total Return Index, with an average duration of fourteen months. Therefore, we should celebrate the brief March inversion, which has already reverted!

RECESSION PRECURSORS REVISITED

Typically, one or more of these four things precede a recession:

1. Inflation.
2. An energy shock.
3. Yield curve inversion.
4. An exogenous shock, otherwise known as the unknowable Black Swan.

There is a myriad of other underlying economic and market dynamics that percolate into these precursors. Until March, none of these symptoms existed.

At December there were several government-related market headwinds. These included the U.S. government shutdown, Brexit, obliviously hawkish Fed testimony, and the U.S./China trade war, to name a few. Despite the tumultuous political environment and a significant Q4 market decline, we expected "markets should rebound from the December lows as the economic expansion continues into 2020". Therefore, we implemented a barbell portfolio approach with defense on one side and more aggressive strategies on the other, depending on the mandate. Since then, all but Brexit have been resolved or are near resolution, driving equity markets to a rapid rebound. Therefore, we must now focus more on the yield curve inversion, since it has come (and gone again).

INVERSIONS EXPLAINED

An inverted yield curve is an interest rate environment in which long-term interest rates are lower than short-term interest rates of the same credit quality. Inversions are an oddity since people "normally" charge higher and higher interest rates for borrowing money for longer and longer periods. That makes sense since more extended borrowing periods mean a higher risk of non-repayment. Naturally then, the lender charges a higher interest rate to offset the higher repayment risk. However, sometimes the U.S. Federal Reserve, created in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system, raises short-term rates to cool excessive economic growth. The Fed never intends to create a recession. Instead, it aims to protect against the threat of inflation and an unstable economy. By raising short-term rates, the Fed can create a rare inverted yield curve, considered to be a predictor of economic recession.

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WHEN INVERSIONS = RECESSIONS

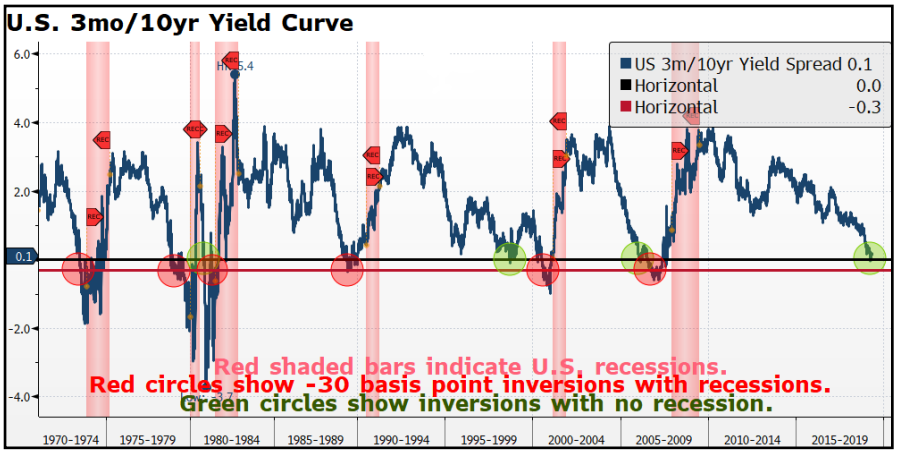
There is a big challenge to Fed interest rate policy. When the Fed hesitates and waits too long to raise rates, economic growth can overheat. When this happens, the Fed reacts desperately to keep inflation in check and increases short-term rates rapidly.

As it turns out, inversions that predict recessions don't simply whiff the inversion line; historically they have inverted rapidly in excess of -30 basis points. Consistent with a reactive Fed that is behind the economic curve and trying to catch up, those episodes tends to lead to a recession. However, even in those cases, investors have an average of 1.2 years before the actual recession, with significant stock market upside in the interim.

Therefore, inversion alone is not a sufficient indicator to conclude there will be a recession. Rather, it is the convergence of three yield curve conditions that create a high probability of recession:

1. the yield curve inverts;
2. the rate of change in the slope of the yield is high; and
3. the slope of the yield curve is less than -30 basis points.

As it turns out, in **100% of cases where the yield curve inverts by more than 30 basis points, a recession has occurred**. Typically, a Fed desperately reacting to an overheating economy results in the three conditions noted above. This does not appear to be the case this time around. So, the question is now, what's next? The temporary yield curve inversion in March helps us to answer that question.



WHERE ARE WE NOW?

Indeed, as shown in the chart on this page, all recessions (shaded in red) are preceded by a decisive and continued inversion of the yield curve that crosses the -30 horizontal yield curve line (also in red). Each -30 basis point instance is indicated by a red circle. That did NOT happen in March. For clarity, the green circles are inversions that did not exceed -30 basis points and did not result in a recession before a subsequent inversion.

This cycle, the Fed seems to be ahead of the curve. In December of 2015, the Fed commenced a series of interest rates hikes moving the benchmark Fed Funds Rate from 0.25% to 2.50%. They did so gradually with nine raises over three years. Despite the rate hikes, the federal funds rate remains low compared to the past two recessions. For context, the Fed Funds Rate was 5.25% and 6.5% before the 2008 and 2001 recessions respectively. Since March, rather than steepen further, the yield curve has flattened and should normalize as the year unfolds. Our baseline outlook is that **inflation remains in check and that Fed policy is now balanced with sustainable economic growth.**

INVESTMENT THESIS & TACTICAL STRATEGY

Stepping back from the yield curve, the balance of our investment outlook is also positive. After a spate of disappointing economic data from major economic regions (US, China and Eurozone), the Citi Economic Surprise indices (discussed in previous editions of the *Perspective*) were all at range lows at the end of March. The Surprise Indices are a reliable contrarian indicator that economic data releases will begin to exceed weak expectations. The upcoming reversal should give a credible boost to equity markets.

The first quarter earnings cycle also benefits from overly depressed expectations. If earnings exceed expectations, as we expect, this will further lift North American stock markets. Stimulus in China boosted prospects for sustained growth while emerging economies are already rebounding. The dovish stance adopted by the U.S. Fed earlier this year is the final piece in the puzzle for a pick-up in North American economic growth.

Earnings growth has slowed into 2019 as a result of the year-end government shutdown, geopolitical turmoil and the lapsing of tax reduction benefits. However, the current consensus estimate of only 2% U.S. EPS growth in 2019 is overly pessimistic. The consensus rebound of 11.5% EPS growth in 2020 is reasonable and will be re-evaluated later in 19H2.

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