TAIBERKOSMALA

| Ho! Ho! Hold! | December 13, 2018 |
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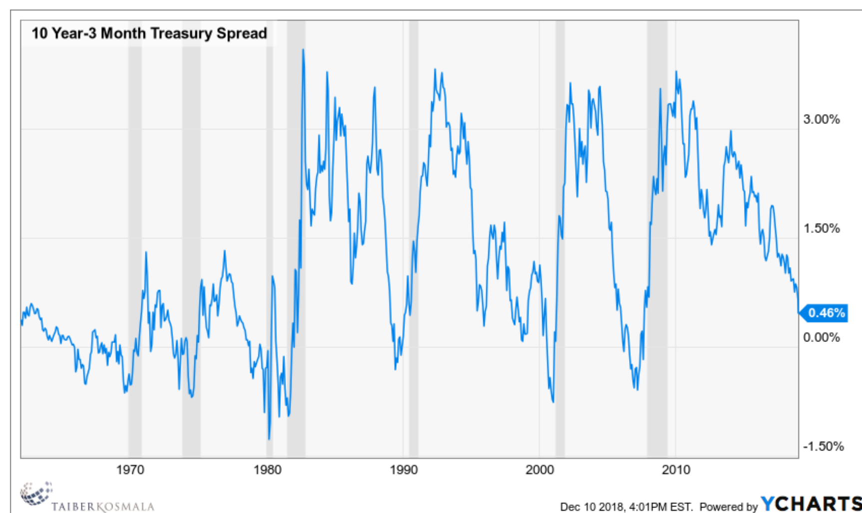
Despite hopes that the calm markets of recent years are the new norm, volatility is back. Investors seem to be having knee jerk reactions to any headlines (or Tweets) that mention trade, the Fed, oil prices, Brexit, etc. But taking a less reactionary perspective, it is helpful to remember that there have only been three bear markets since World War II that were not preceded by a recession…1962, 1966, and 1987 (albeit 2011 was a close call). Rather than succumbing to this fear/greed mentality, we focus on fundamentals and economic indicators that may help us determine if a recession is likely on the horizon. As you read further, you will see that none of our primary recession indicators are close to signaling a recession within the next twelve months.

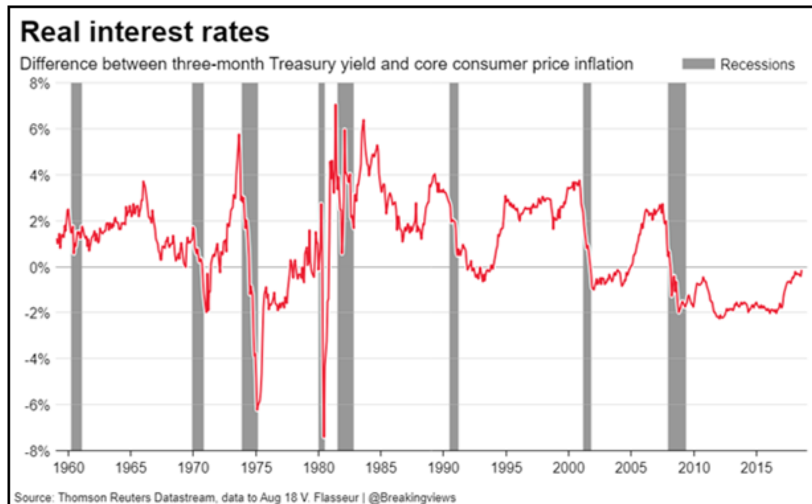
*Inverted Yield Curve*

Historically, an inversion in the yield curve (when short-term interest rates exceed long-term interest rates) has been a reasonable predicter of a recession on the horizon. During the current bout of volatility both the 2 and 3-year Treasury rates moved higher than the 5-year Treasury rate causing an inversion to a segment of the yield curve. However, the 3-month Treasury rate remained lower than the 10-year Treasury rate. Many experts cite the 3-month/10-year spread as a more important indicator since this spread directly impacts bank lending activity. As of this writing, 3-month/10-year spread is +46 basis points…which is closer to its historical average than to inversion….and banks continue to lend money. On average, a recession occurs 10 months after the yield curve inverts. As investors watch the yield curve and wonder if a recession is lurking, a look back at the last three times the 2-year/10-year curve inverted suggests that equities can rally further before a recession occurs. The curve inverted in December of 1988 and the S&P 500 peaked 19 months later after gaining 41.4%. The curve inverted again in May of 1998 and the S&P went on to hit new highs in March of 2000 gaining 43.0%. Finally, the curve inverted in December of 2005 and the S&P peaked in October of 2007 gaining 28.8%. While history seldom exactly repeats itself….it often rhymes.



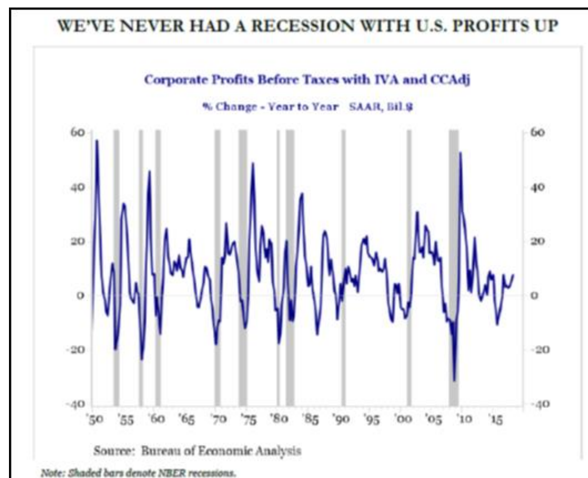
*Real Interest Rates*

Real short-term rates (the difference between 3-month rates and core consumer price inflation) are still hovering around negative to zero. Real rates at current levels means that holding cash is punitive to investors (cash underperforming inflation). In every recession since 1950, real rates have risen to at least 1.5%. Positive real interest rates give investors the opportunity to take chips off the table without eroding purchasing power. Additionally, the Fed has blinked indicating that interest rates might not be moving as high or as quickly as has been speculated.



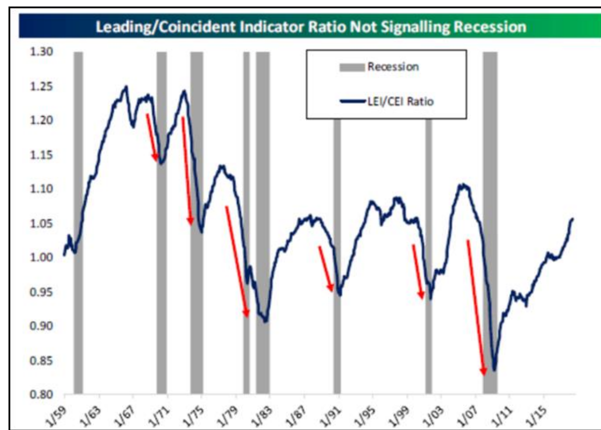

*Corporate Profits*

Although the 25% earnings growth we have seen over the past two quarters is clearly unsustainable, corporate pre-tax profitability continues to look very constructive. In fact, corporate profits are up over 11% for the trailing 12 months and are still accelerating. There has never been a recession with profits expanding. This is consistent with earnings growth which is projected at upwards of 10% for 2019.



*Leading Economic Indicators*

Lastly, the Conference Board's ratio of Leading/Coincident Economic Indicators hit a post Great Financial Crisis high. When this indicator rolls over, it has signaled every recession since 1950. Both ISM Manufacturing and Non-Manufacturing numbers registered robust results at 59.3 and 60.7 respectively. The November jobs report of 155,000, an unchanged employment rate of 3.7% and moderate wage growth are all positive signs for the near-term fundamental outlook.




While sensational headlines have fueled volatility in recent days, this fear-driven overreaction is not supported by underlying fundamentals and economic indicators. Though buyers and sellers have been vacillating from exuberance over a 90-day China/U.S. negotiation window to gloom over POTUS's "tariff man" comments or the arrest of a Chinese CFO in Canada, a recession does not appear to be on the horizon and the probability of a bear market in the near term remains low. However, we do expect that low holiday season trading volume will contribute to volatility for the balance of the year. As always, our message to long-term investors is to resist the emotionally driven fear/greed approach to investing and focus on fundamentals.