CHART OF THE DAY

December 7, 2018

Spotlight on : 10-2 Yield Curve

COMMENT: *There has been a considerable amount of press lately concerning the narrowing in the 10-year/2-year yield spread. Historically, whenever the U.S. Treasuries 10-year yield is less than the 2-year yield, called a yield inversion, an economic recession soon follows. There can be a false positive where a yield inversion does not lead to a recession. But, since the end of World War II, almost every time the yield has inverted, a recession followed. The length of time between the inversion and the commencement of the recession has varied quite widely, from a matter of months to up to two years.*

As we show below, lately the 10-2 yield curve ratio has been narrowing dramatically. Since the recession of 2008-2009, global economies have shown slow but steady growth, some better than others. A recession now seems to be on the horizon, although the "horizon" could still be a long way off. As we well know, the stock market has been rattled lately, with the S&P 500 having dropped just over 300 points, or 10.5%, from its all-time high last September. A stock market recession is generally defined as a drop of 20%. Much of the recent decline has been attributed to the specter and actuality of rising interest rates. However, having reached a high of 3.24% on November 8, exactly one month ago, yields in both the USA (and Canada) have been declining rather quickly.

The U.S. 10s, at Friday's close of 2.85%, are well below the benchmark 3.00%. More important, the U.S. yield spread has dropped in half since November 8, from 0.26x to the current 0.13x. In Canada, the decline has been even more marked. The Canadas 10-2 yield spread is just 0.09x, also down by half from the 0.18x a month ago. Inversion in both countries, on the 10-2 metric, is creeping closer.

For comparison, other yield curve metrics show differing trends: (1) 10-year/3-month spread has dropped from 0.93x on November 8 to the current 0.49x; (2) but the 30-year/5-year spread has actually risen, from 0.35x a month ago to the current 0.44x; (3) and the 30-year/10-year ratio equally has risen, from 0.21x on November 8 to 0.29x today.

So, for recession-watchers, which one do you rely on the most? Generally, investors prefer the 10-2 and academics favour the 10-year/3-month. Corporations watch the 30-5 and the 30-10 to gauge their willingness to invest.

The bottom line? The yield curve is narrowing quickly but is still comfortably above the 0.00x level required to denote a recession is near. Our best guess at this point is that a recession, as defined above, might occur in 2019, or it might get delayed until 2020. However, history shows that the stock market actually rallies once the recession starts. See below.

● The 10-year U.S. Treasuries yield fell below the bench-mark 3.00% level on Monday, December 3 and closed the week at 2.85%.

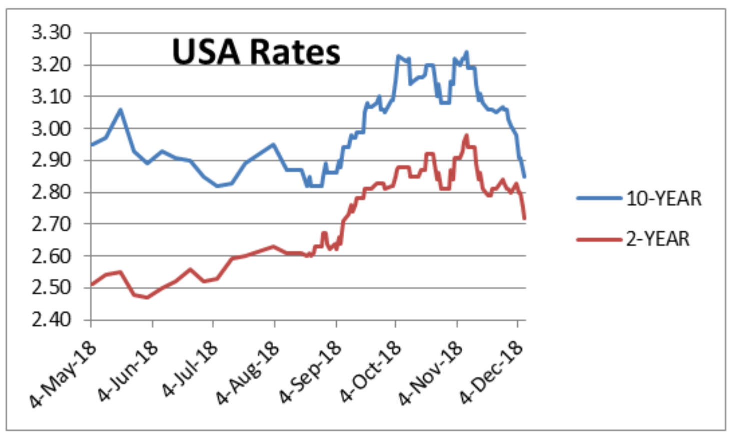
● The 2-year U.S. Treasuries yield declined from 2.80% on November 30 to the current 2.72%.

● The table below shows the trend in rates since November 1.

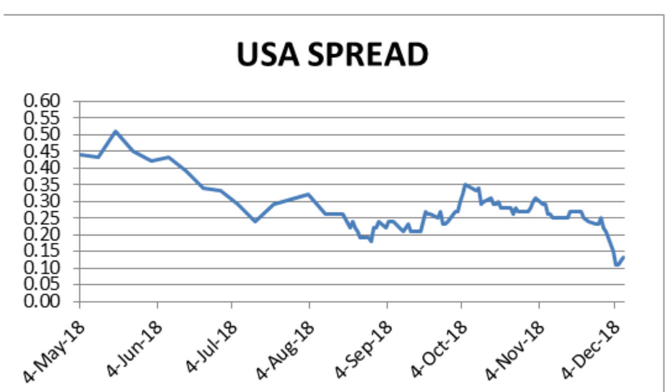
● The accompanying chart shows the dramatic drop in both the 10-year and the 2-year since their respective highs on November 8.

DATE	USA		
	10-YEAR	2-YEAR	DIFF
1-Nov-18	3.14	2.84	0.30
2-Nov-18	3.22	2.91	0.31
5-Nov-18	3.20	2.91	0.29
6-Nov-18	3.22	2.93	0.29
7-Nov-18	3.22	2.96	0.26
8-Nov-18	3.24	2.98	0.26
9-Nov-18	3.19	2.94	0.25
12-Nov-18	3.19	2.94	0.25
13-Nov-18	3.14	2.89	0.25
14-Nov-18	3.09	2.84	0.25
15-Nov-18	3.11	2.86	0.25
16-Nov-18	3.08	2.81	0.27
19-Nov-18	3.06	2.79	0.27
20-Nov-18	3.06	2.79	0.27
21-Nov-18	3.06	2.81	0.25
23-Nov-18	3.05	2.81	0.24
26-Nov-18	3.07	2.84	0.23
27-Nov-18	3.06	2.83	0.23
28-Nov-18	3.06	2.81	0.25
29-Nov-18	3.03	2.81	0.22
30-Nov-18	3.01	2.80	0.21
3-Dec-18	2.98	2.83	0.15
4-Dec-18	2.91	2.80	0.11
5-Dec-18	2.91	2.80	0.11
6-Dec-18	2.87	2.75	0.12
7-Dec-18	2.85	2.72	0.13

May 1, 2018 – December 7, 2018



● Until Friday's small up-tick, the 10-year/2-year spread has been falling steadily, and now stands at 0.13x, still well above the 0.00x that denotes the fear level for an impending recession.



- Both the 10-year and the 2-year Canadian rates continued to decline this past week, with the 2-year actually falling below 2.00% to close at 1.99%.

DATE	---------------- CANADA	----------------	
	10-YEAR	2-YEAR	DIFF
1-Nov-18	2.49	2.33	0.16
2-Nov-18	2.48	2.32	0.16
5-Nov-18	2.53	2.35	0.18
6-Nov-18	2.52	2.34	0.18
7-Nov-18	2.53	2.35	0.18
8-Nov-18	2.53	2.35	0.18
9-Nov-18	2.54	2.36	0.18
12-Nov-18	2.54	2.36	0.18
13-Nov-18	2.50	2.33	0.17
14-Nov-18	2.46	2.30	0.16
15-Nov-18	2.42	2.27	0.15
16-Nov-18	2.38	2.24	0.14
19-Nov-18	2.36	2.22	0.14
20-Nov-18	2.35	2.21	0.14
21-Nov-18	2.34	2.21	0.13
23-Nov-18	2.36	2.24	0.12
26-Nov-18	2.34	2.23	0.11
27-Nov-18	2.35	2.24	0.11
28-Nov-18	2.33	2.22	0.11
29-Nov-18	2.33	2.21	0.12
30-Nov-18	2.30	2.19	0.11
3-Dec-18	2.27	2.16	0.11
4-Dec-18	2.24	2.16	0.08
5-Dec-18	2.18	2.12	0.06
6-Dec-18	2.12	2.05	0.07
7-Dec-18	2.08	1.99	0.09

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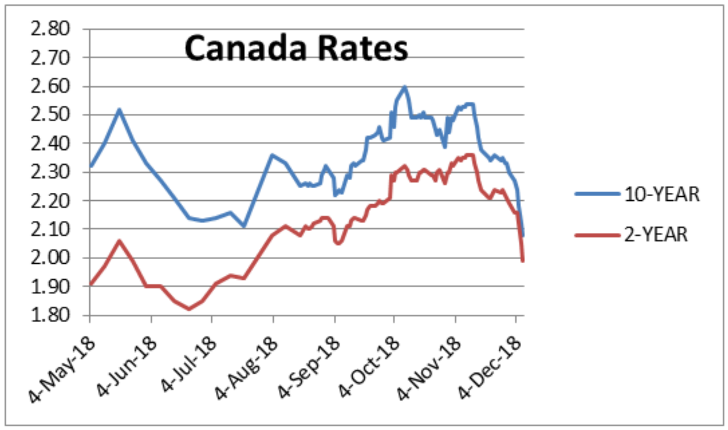
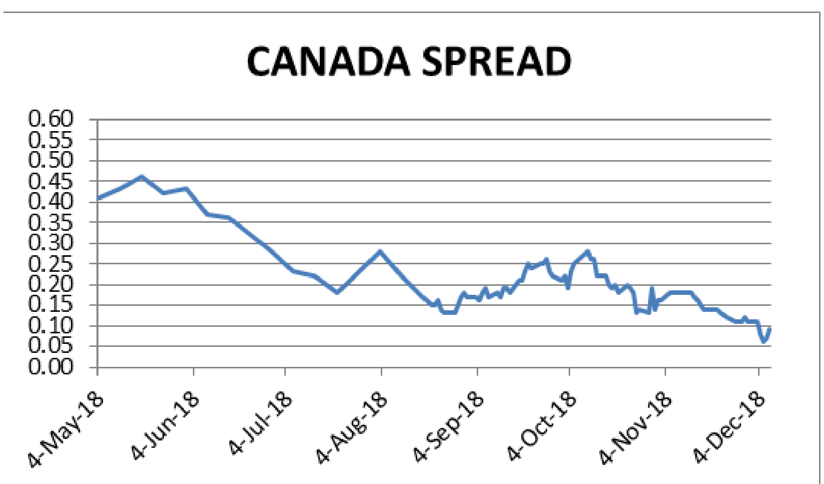


- The 10-year/2-year spread in Canadian rates continued to narrow this past week, and into single digits. A low of just 6 basis points was reached on December 5. The spread at the end of the week was 0.09x.



COMMENTARY

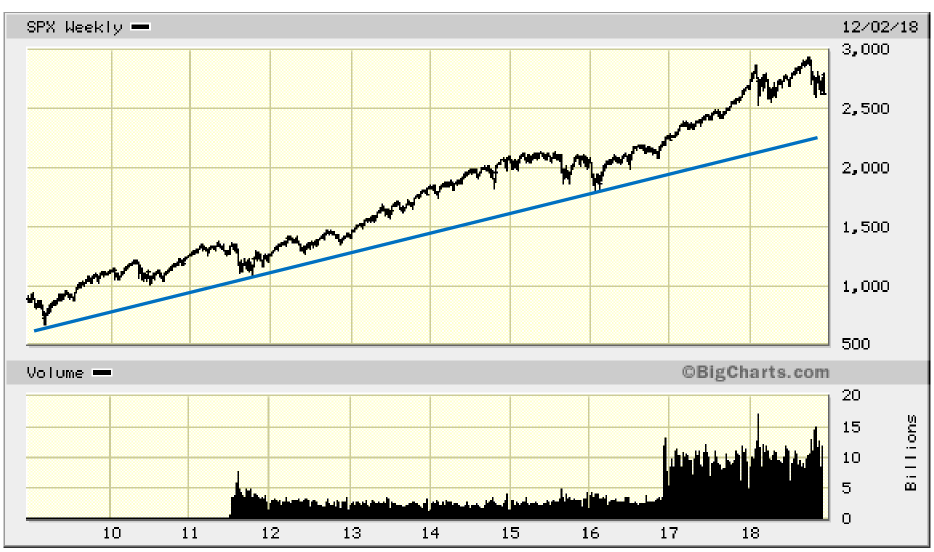
- A declining spread that approaches 0.00x or that actually goes negative (or inverts) signifies slowing economic growth and, even, the likelihood of a recession.
- A recession usually occurs a few months (or possibly up to two years) after the yield curve inverts (see the long-term chart on page 5).
- Sometimes, a negative yield curve gives a false positive (again, see the long-term chart).
- A negative or inverted yield curve indicates that long-term debt instruments have a lower yield than short-term debt instruments, given that these debt instruments are of the same or similar credit quality.
- Historically, inversions of the yield curve have preceded most U.S. recessions. Thus, the yield curve is considered an important barometer for predicting turning points in the business cycle.

<continued>

U.S. Treasuries 10-2 Yield Ratio Since January 1, 2000 (18 Years)

Here is a look at the 10-2 yield curve going back to January 2000. It shows the negative occurrences (below 0.0x) and the corresponding recessions (shaded areas) that soon followed. Currently, despite the falling trend-line, there is still further to go to reach the inversion level and the possibility of a resulting recession. The current ratio is 0.13x, down from 0.21x last week.

● Even with the recent pull-back, we are still experiencing the longest stock market up-trend in history. To date, the S&P 500 Index, as shown below, has retreated only 10.5% from its recent all-time high. A decline of 20% is required before a bear market is declared. However, after such an extended period of growth, it is natural to expect, eventually, that the economy will fall into recession. As the long-term chart above shows, once the 10-2 yield curve goes negative, an economic recession soon follows, but it is not coincidental and, interestingly, the recession occurs well after the yield curve has returned to positive and started a sharp rise. Also, as shown in early 2006 in the chart above, it can give a false positive. Despite the discouraging down-trend that is currently occurring, U.S. economic growth still continues positively and, therefore, the possibility of a near-term recession in the United States still seems remote at this point.



For greater clarity, let us have a look at the chart for the past five years, corresponding to about the time when the current down-trend started. Since the end of August, the spread rose slightly and then has trended sideways. The overall trend still portends a coming recession, but until it approaches 0.00x, that risk is not on the cards.

For a short-term view, here is the chart since the beginning of 2018:

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