CHART OF THE DAY

December 21, 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 525 points, or 17.8%, from its all-time high last September. A stock market recession is generally defined as a drop of 20%, so we are getting close. 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, yields in both the USA (and Canada) have been declining.

The U.S. 10s, at Friday's close of 2.79%, are well below the benchmark 3.00%. More important, the U.S. yield spread has dropped significantly since November 8, from 0.26x to the current 0.16x. In Canada, the decline has been even more marked. The Canadas 10-2 yield spread is just 0.08x, also down substantially 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 0.45x; (2) but the 30-year/5-year spread has actually risen, from 0.35x a month ago to the current 0.39x; (3) and the 30-year/10-year ratio equally has risen, from 0.21x on November 8 to 0.24x today; (4) the 5-year/2-year ratio actually inverted recently and currently sits at 0.01x.

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 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, will probably not occur until mid-2020 (see comment on page 5).

● The 10-year U.S. Treasuries yield rose slightly two weeks ago and then continued its decline this past week. It touched a low of 2.77% on Wednesday and closed the week at 2.79%.

● The 2-year U.S. Treasuries yield generally drifted downwards and closed the week at its two-week low of 2.63%.

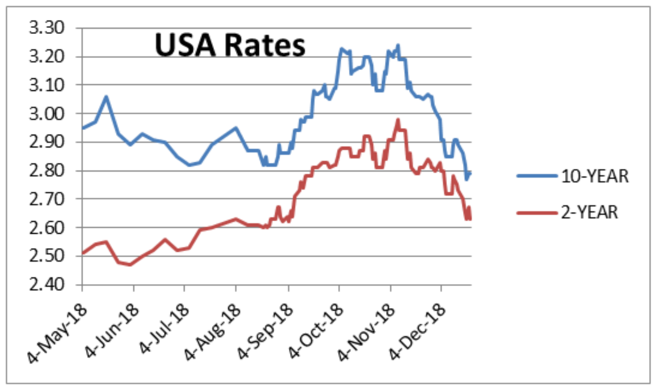
● The 10/2 yield spread ("diff" in the table below) narrowed to 0.12x this past week, just above its recent low of 0.11x. However, it widened on Friday to end the week at 0.16x.

● The table below shows the trend in rates for the past two weeks.

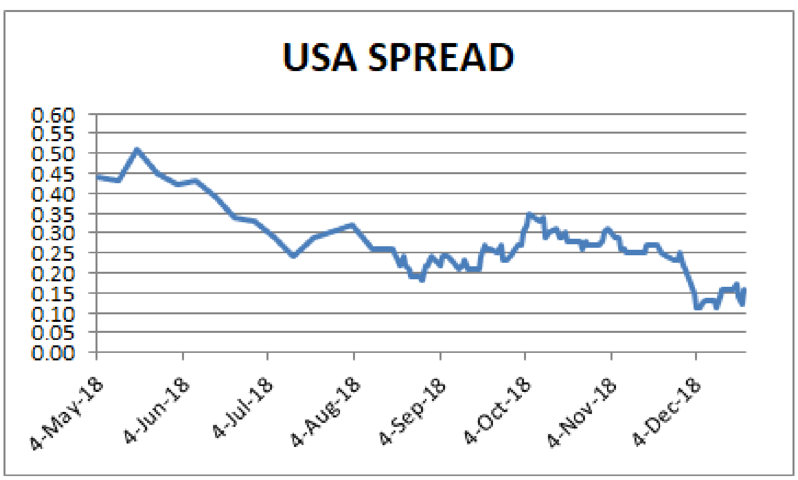
● The accompanying chart, with plots from the beginning of May, shows the dramatic drop in both the 10-year and the 2-year since their respective highs on November 8.

May 1, 2018 – December 21, 2018

DATE	10-YEAR	USA 2-YEAR	DIFF
10-Dec-18	2.85	2.72	0.13
11-Dec-18	2.89	2.78	0.11
12-Dec-18	2.91	2.77	0.14
13-Dec-18	2.91	2.75	0.16
14-Dec-18	2.89	2.73	0.16
17-Dec-18	2.86	2.70	0.16
18-Dec-18	2.82	2.65	0.17
19-Dec-18	2.77	2.63	0.14
20-Dec-18	2.79	2.67	0.12
21-Dec-18	2.79	2.63	0.16



● Until Friday's up-tick, the 10-year/2-year spread had been falling again this past week. It now stands at 0.16x, still well above the 0.00x that denotes the fear level for an impending recession.



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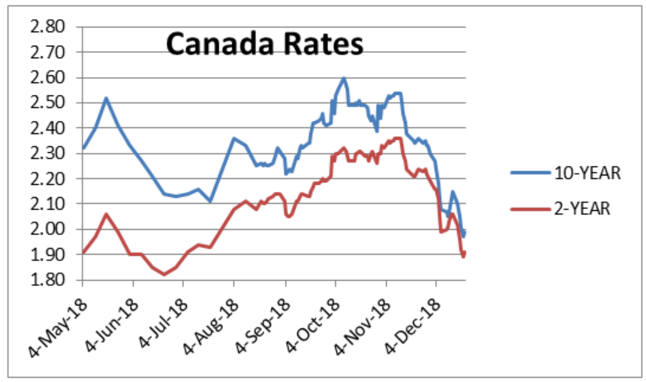
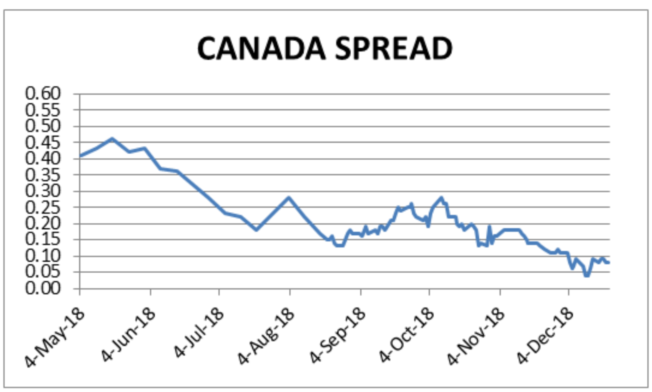
- Both the 10-year and the 2-year Canadian rates rose two weeks ago and then declined this past week.

May 1, 2018 - December 21, 2018

DATE		CANADA	
	10-YEAR	2-YEAR	DIFF
10-Dec-18	2.07	2.00	0.07
11-Dec-18	2.05	2.01	0.04
12-Dec-18	2.07	2.03	0.04
13-Dec-18	2.12	2.06	0.06
14-Dec-18	2.15	2.06	0.09
17-Dec-18	2.10	2.02	0.08
18-Dec-18	2.05	1.96	0.09
19-Dec-18	2.01	1.92	0.09
20-Dec-18	1.97	1.89	0.08
21-Dec-18	1.99	1.91	0.08



- The 10-year/2-year spread in Canadian rates got really narrow two weeks ago, at 0.04x, but widened out again immediately after and closed the week at 0.08x, which is one-half of the U.S. 10/2 yield spread. Is Canada really that much closer to a recession?

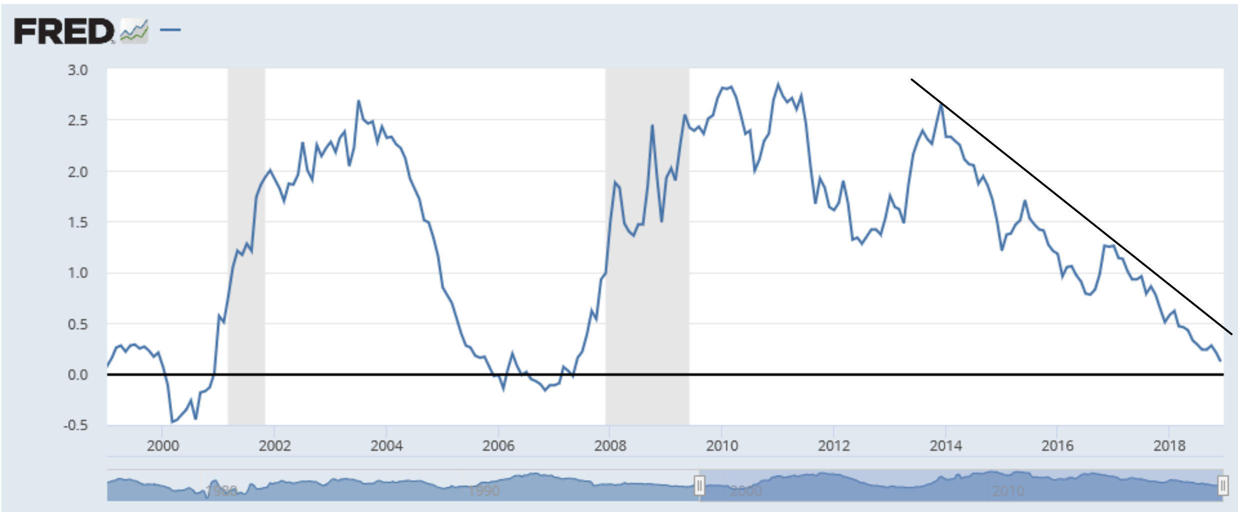


COMMENTARY

- 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 business cycle turning points.

U.S. Treasuries 10-2 Yield Ratio Since January 1, 1999 (20 Years)

Here is a look at the 10-2 yield curve going back to January 1999. 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 0.16x, up from 0.13x two weeks ago.



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.

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

THE EQUITY MARKET

● Everyone is well aware of the recent pull-back in the market averages. A "correction" is denoted by a decline of 10%. A "bear market" represents a decline of 20%. The NASDAQ is now in bear market territory, being down 22.13% from its August high. The FAANG stocks have not done well. The Dow Jones Industrial Average has declined 16.72% and the S&P 500 Index is down 17.83%. We are getting close to experiencing the end of the longest stock market up-trend in history. Even though the U.S. economy is still humming along, there are a few signs cropping up to suggest that overall growth in 2019 will slow. In addition, 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 long-term chart above, it can give a false positive.

● Here is a recent quote from JP Morgan: Investors tend to fear yield curve inversion, looking at it as a signal that a recession is looming. However, we believe investors should not over-react to these recent moves for a few reasons. First, a flattening of the yield curve is common during rate hiking cycles, which is where we are today. Second, this time around, the shape of the curve has been distorted by central bank asset purchases around the world, making it a less trustworthy predictor of a recession. Lastly, the curve can stay flat for a long time before inverting and, even then, a recession can take a while to arrive. Over the last 7 recessions, it has taken an average of 20 months between the first inversion of the curve and the start of a recession.

CONCLUSION

● 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. However, using the JP Morgan 20-month statistic as a yard-stick, a recession could occur in the USA sometime in the middle of 2020.

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