CHART OF THE DAY

February 1, 2018

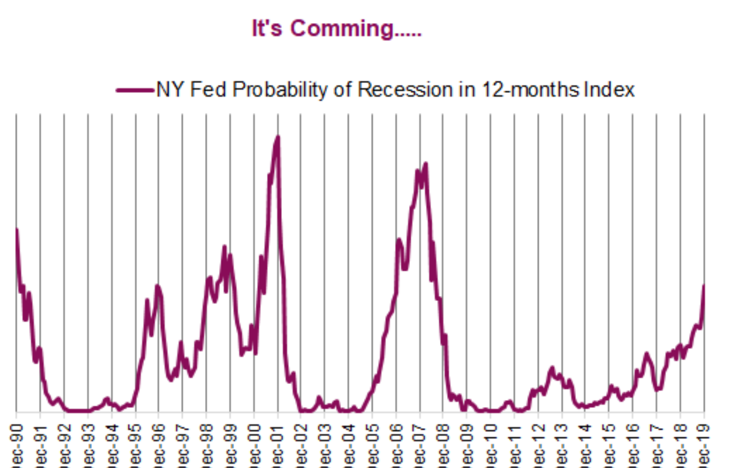
Spotlight on : 10-2 Yield Curve

COMMENT: *Yields in both the USA and Canada trended lower last week. However, the yield "spread" actually increased. Despite the rise, they are still low, but nowhere near inversion.*

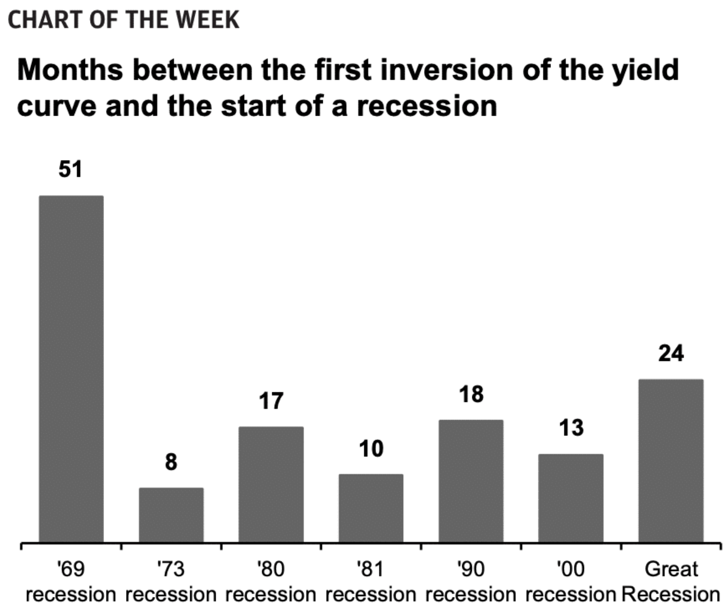
Our "recession barometer" kicks in when the "spread" between the 10-year rate and the 2-year rate for Treasuries in the USA and Government of Canada Bonds in Canada reach 0.00x, which means that the yield on the 10s equals the yield on the 2s. If the 10s yield less than the 2s, an "inversion" occurs and then it is likely that a recession will soon follow.

The yield curve for the 10s/2s is currently quite "narrow" in both the USA and Canada, and more so in Canada. Friday's close has the 10/2 for Treasuries at 0.18x and for Canadas at 0.11x. Both spreads increased this past week. As discussed later in this report, we have shortened our time-line for expecting a recession to occur from 15-20 months to 12-15 months from the time an inversion occurs. Thus, if an inversion occurs in Q1/2019, the recession would occur in Q1/2020-Q2/2020, and so on for each succeeding quarter. This recession expectation will always be a moving target, but we will monitor our prognostication closely.

The following New York Fed chart, which is at the end of December 2018, shows the probability of a recession occurring in the next 12 months, that is, by the end of 2019. The chart shows that probability is rising.



The following chart was produced by J.P. Morgan Asset Management. It shows how long it has taken during each of the last seven recessions from the first yield curve inversion until the actual start of the recession.



The average lag-time for all seven recessions was 20 months, although this was skewed somewhat by the 51-month lag shown by the 1969 recession. Omitting it, the average for the remaining six recessions was 15 months.

Sometimes, a negative yield curve gives a false positive (see the long-term chart on page 6).

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.

Here is a recent quote from JP Morgan on the yield curve:

> 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.

COMMENT: *Notwithstanding the above quote from JP Morgan, the anticipated slow-down in the North American economy in 2019 has likely been exacerbated by the recent U.S. Government shut-down, which may be reinstated in mid-February if a petulant U.S. President does not see things going his way. In addition, GDP growth in China has slowed to the lowest since the 1990s. Europe is also questionable: Italy is officially in recession; France is in turmoil; and Britain is reeling with Brexit worries. As a result, we believe that the time-line for a recession occurring in North America likely has shortened. Consequently, our estimate for when a recession will occur has fallen from 15-20 months to 12-15 months. Thus, if the yield inversion occurs in Q1/2019, then the recession is estimated to occur, using 12-15 months as the time-line, in Q1-Q2/2020. Similarly, if the inversion occurs in Q2/2019, the recession would be expected in Q2-Q3/2020. And so on.*

1. U.S. Treasuries

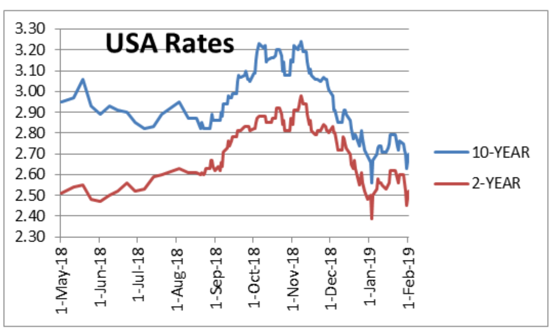
- The 10-year U.S. Treasuries yield dropped last week, closing at 2.70%, down from 2.76%.

- The 2-year U.S. Treasuries yield did likewise, closing at 2.52%, down from 2.60%.

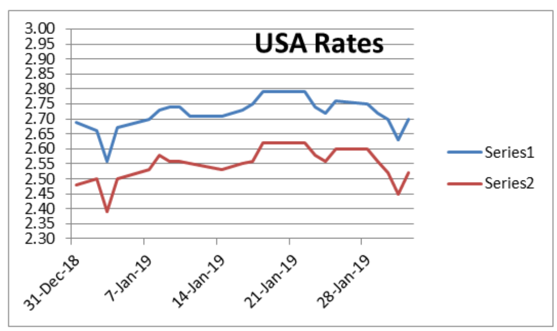
- The 10/2 yield spread actually rose over the week and ended at 0.18x compared to 0.16x at the end of the previous week.

- The first two charts below show the trend in rates since May 1, 2018 and January 1, 2019. The longer-term chart shows that rates rose beginning in September and peaked in November. The subsequent decline went through the September low to a nadir in early January. Rates have since recovered slightly. The short-term chart on the top right, for the month of January, is fairly flat.

May 1, 2018 – February 1, 2019

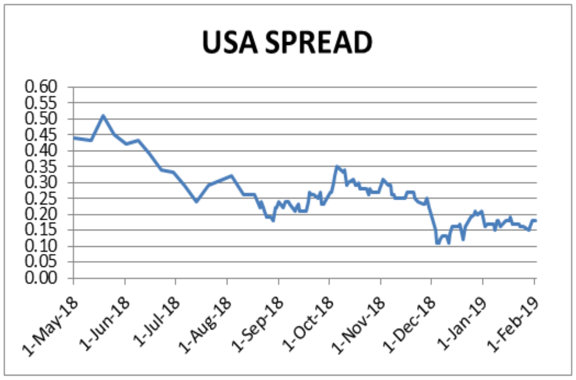


December 31, 2018 – February 1, 2019



- The next two charts show the "spread" between the 10-year and the 2-year yields. The longer-term chart shows a distinct down-turn in the spread. The short-term chart shows a fairly stable yield spread. When the spread gets to "zero", an inversion is imminent.

May 1, 2018 – February 1, 2019



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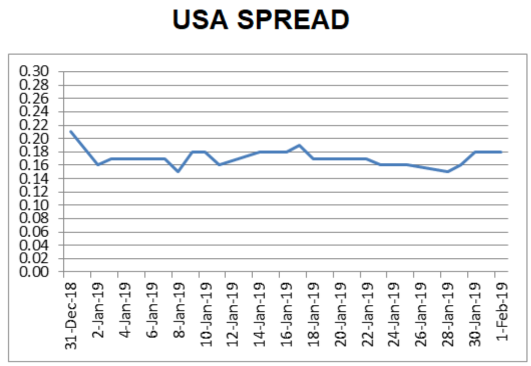
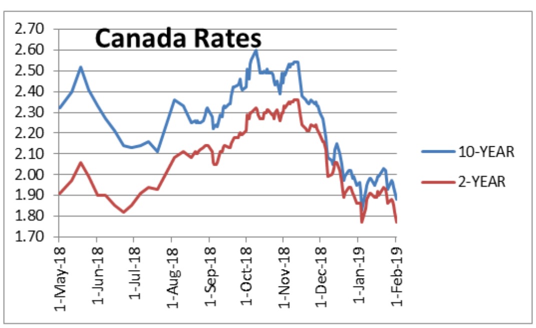


2. Government of Canadas

- The first two charts for Canadas mirror the U.S. Treasuries experience. Rates through January have been fairly stable, although they fell off a bit this past week.
- As shown on the second set of charts the "spread" on Canadas is much less than for Treasuries. Nevertheless, the Canadas' spread has been very stable throughout January, until this week when it rose from 0.07x to 0.11x, but still well above recession levels of 0.00x.

May 1, 2018 – February 1, 2019



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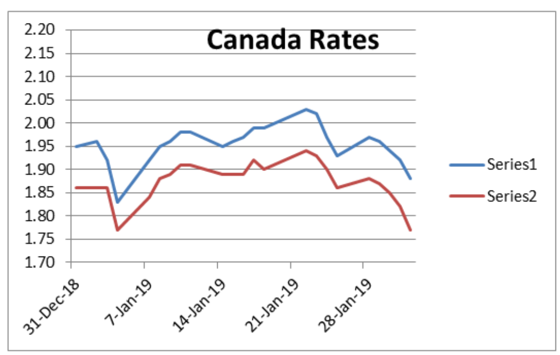
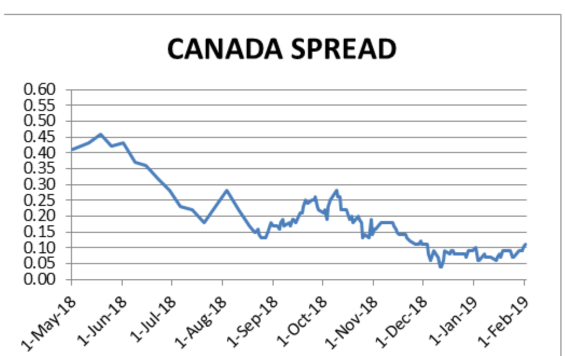
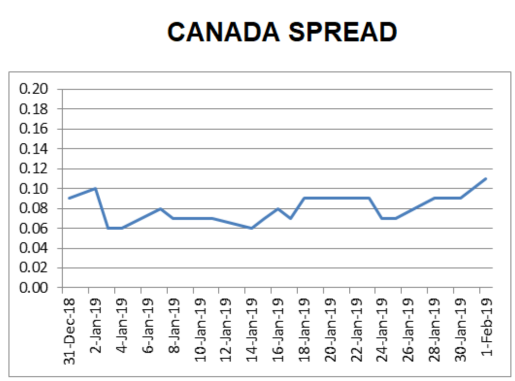


May 1, 2018 – February 1, 2019



December 31, 2018 – February 1, 2019



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 next chart and comment on the following page and the long-term chart on page 6).

<continued>

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 20 years 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 0.18x, up from 0.16x one week ago.

CONCLUSION

- Despite the discouraging down-trend that is currently occurring, U.S. economic growth still continues positively, although signs of global slowing could start to impact the USA as well as slower growth from its own making. The 34-day partial government shut-down is likely to impact Q1 GDP growth considerably. Still, at this point, the possibility of a near-term recession in the United States seems remote. However, our concerns for global economic growth, North American economic growth, the possibility of dysfunctional government in the USA from time to time, and the negative effects of trade wars and ignoble tariffs, cause us to consider the possibility of a recession hitting U.S. shores in Q1/2020 (at the earliest).

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