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Did you hear that?

Concerns about an inverted curve may be cast in a paradigm that no longer exists.

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Crickets. After years of debating with advisors who were certain that inflation would be a problem and long-term yields would rise toward 4%, no one is debating this anymore. Instead, worries about the now-inverted yield curve are proliferating. Evercore ISI says it needs to last 10 weeks or longer and be at least negative 15 basis points to be a real one. It's just been a week since yields on the 10-year Treasury fell *5 basis points* below the 3-month T-bill. During this time, there's been a simultaneous steepening of the 10-year/30-year Treasury curve. And 3-month, 6-month, 1-year and 10-year yields are congregating near the 2.4% level, in line with the federal funds rate, undermining the classic inversion argument. The 10-year yield would need to be about 2% (closer to a 50 basis-point inversion) for that to be the case, Dudack Research says. Long yields have fallen sharply worldwide, driven by slowdown concerns and dovish central bank turns that have global negative-yielding debt back *over $10 trillion*. After a decade of "extraordinary" monetary policy, ISI posits inversion is less about rising recession risks than the deeply negative term premium (the extra yield investors seek above short-term Treasuries to offset the risk of locking money up in longer-term instruments), itself a product of low inflation expectations. Even with unemployment at a 50-year low, job openings at a record high and the economy juiced by fiscal stimulus and easy money, inflation is stuck below 2%. It's running even lower in much of the rest of the world. Chicago Fed President Evans says inflation could run to 2.5% before rate hikes are needed; futures are pricing in a rate cut. Core PCE has not run at 2.5% *for 25 years*. (It was 1.8% this morning.) No more inflation debates. All I'm hearing are crickets.

Worries about inversion have everything to do with the probability of positive S&P 500 returns the next six months. The 3-month/10-year inversion is the 17th since 1962, by Renaissance Macro's count, and nine of those cases produced negative 6-month forward returns while seven posted positive returns. Post-inversion returns three, six and 12 months out generally come in below historic averages, adds Strategas Research. The difficult question to consider, it says, is whether we should expect a "normal" market response to an inverted curve given we're in a cycle that has been anything but normal. We're living in unprecedented low-rate times, and the old rulebook I spent 35 years learning may not be as relevant anymore. While every recession since 1960 was preceded by a curve inversion, not every curve inversion led to a recession. Recent examples include minor inversions in 1986 and 1995. However, inverted curves have stalled stock prices before and this may be a factor in coming months. Indeed, bond market price action is an enormous blaring siren to anyone trying to be optimistic on stocks.

The last time the S&P was around 2,850 in October/November, the consensus 2019 earnings-per-share was $178 vs. about $170 now (and falling), and 10-year yields were much higher (2.9-3.1% vs. around 2.4% now). This suggests that in the absence of a recession on the near horizon, P/E multiples deserve to be above where they stood in Q4. I continue to be concerned about market structure. What was drastically different about Q4's equity sell-off relative to other drawdowns over the past decade was the lack of liquidity—it was about a third to half that of the previous sell-offs, JP Morgan says. This explains how the market could go down and up so much and so quickly on a relatively small change in positioning—and fundamentals—since December. Given this lack of liquidity, it's plausible that just short covering, buybacks, dealers' hedging and some limited re-leveraging drove the entire recovery since Dec. 24. This, in turn, opens the possibility that the current rally can continue during the spring if the broader market participates. While the 3-month/10-year inversion has a phenomenal track record of forecasting future economic malaise, Bernstein notes the magnitude and longevity is significant, as a discrete move can send false signals. A move from positive 5 points to negative 5 points only raised the probability of recession a mere 2 percentage points. For predicting equity market returns, a yield curve inversion often presages explosive moves higher in the final years of a cycle, with defensive names typically outperforming over the next 12 months. There is no evidence of a U.S. recession on the horizon. We think the yield curve steepens again.

POSITIVES

- **Housing green shoots push through February wilt** Trends continue to suggest a pickup in the spring buying season as February new home sales rose a second straight month and elevated January pending sales and upwardly revised starts & permits offset mild February declines. Prices moderated again, according to Case-Shiller and FHFA surveys, and mortgage rates fell to a 14-month low, lifting the National Association of Realtors Housing Affordability Index to an 11-month high.
- **As I have been saying for years, inflation is "just right"** Leuthold Group finds that since 1950, whenever the economy is in the sweet spot (inflation in a 1% to 3% zone), the trailing P/E multiple on the S&P averages about 18.5 (where it is now), the frequency of negative monthly returns is about 30% (vs. 40% outside of the sweet-spot zone), the frequency of negative 12-month forward returns is 15% (vs. 25% when outside the sweet spot), and the spread between stock and bond returns has averaged 10% (to the favor of stocks).
- **Some good trade news** January's trade deficit surprised, sharply narrowing as imports fell and exports rose. If the trend holds, it could lift Q1 GDP growth. The Atlanta Fed raised its post-trade-report Q1 GDP forecast from 1.3% to 1.5%. GDP grew at a downwardly revised 2.2% in 2018's fourth quarter.

NEGATIVES

- **When I'm blue, I go shopping. Works every time.** Conference Board consumer confidence dropped in March to its second-lowest level since December 2017, and the weekly Bloomberg consumer comfort gauge slipped to a 5-week low. But final Michigan sentiment for the month rose above consensus, and the Conference

Board and Bloomberg measures remained consistent with above-trend growth. Perceptions about income turned favorable, boosting plans to buy more durable goods. Plans to buy a car were their highest since July 2012.

- **We need CEOs in a better mood if capex is to revive** Worries about slower global growth caused Business Roundtable CEOs' outlook to deteriorate a fourth straight quarter and by the most in nearly four years to Q3 2017 levels. Expected capital expenditures (capex), employment and sales growth for the next six months all dipped, with business leaders dropping 2019 GDP growth projections to 2.5% from 2.7%.
- **U.S. soft landing watch** Chicago and Dallas Fed regional surveys reflected slowing manufacturing activity in March, with the Chicago gauge posting its slowest growth for a quarter in two years. However, both still reflected healthy expansion; we should get a better read Monday when the Institute of Supply Management's report is released.

WHAT ELSE

Stocks like low yields The correlation between 10-year Treasury yields and P/Es has been negative for the past two years (multiples have risen as bond yields have fallen). Unless the odds of a recession increase meaningfully, market declines based on the decline in yields should prove to be a buying opportunity**.**

Election watch If the traditional 12-18-month lead time between inversion and a downturn materializes, the economy likely will be slowing materially come the 2020 election, creating tougher terrain for Trump to hold onto the presidency. In the meantime, Trump's popularity is higher than it was for Reagan and Obama at the same point in their first terms.

How times have changed! The U.S. bond market today, with 10-year yields bouncing around 2.40%, seems determined to force the Fed's hand, the "opposite" of the "original bond market vigilantes."

TAGS

EQUITY MARKETS/ECONOMY

DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Correlation expresses the strength of relationship between distribution of returns of one data series and its benchmark. The coefficient correlation is always between +1 (perfect positive correlation) and -1 (perfect negative correlation).

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Bloomberg Consumer Comfort Index is based on weekly telephone survey of consumers seeking their views on the economy, personal finances and buying climate.

The Business Roundtable, an association of CEOs from leading U.S. companies, surveys members quarterly.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

The National Association of Realtors' housing affordability index measures whether or not a typical family could qualify for a mortgage loan on a typical home based on median incomes, median home prices and average mortgage rates.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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