16 trillion dollars and counting

There could be many reasons for the yield-curve inversion. More than $16 trillion of negative-yield global debt is certainly among them.

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If ever a yield-curve inversion *wasn't* going to work as a recession signal, it arguably is now. For one, longer U.S. bond yields are artificially low, clipped a full percentage point by the Fed's quantitative easing (QE). Moreover, we're in a new full-blown global easing cycle—central banks in the past week announced 20 additional rate cuts. There's currently *$16 trillion of negative-yielding sovereign debt globally*, acting as huge anchor on U.S. yields. German 10-year bonds alone at one point traded at -0.70% this week. It's hard to bet against all that easing and, in the U.S., fiscal stimulus that's high for this stage of a cycle. Finally, the curve inverted amid Fed easing; the last five times the curve correctly predicted a recession, the Fed was tightening. The 2-year/10-year Treasury curve has given two false recession signals out of eight since 1978. By comparison, the 3-month/10-year curve, which first inverted in March but has bounced between positive and negative since then, has produced no false positives over the previous six recessions since 1968. Historically, it has taken an inversion of three months or more for the curve's recession signal to work. With inflation undershooting its targets and with its newfound emphasis on the interconnectivity of global growth, the Fed almost certainly will work aggressively to reverse this inversion—markets are now pricing in three more rate cuts this year, and possibly another in 2020.

"This time, it's different" is a rationale Goldman Sachs says it's hearing all over regarding the curve's inversion. It's not so sure. It notes that whatever the cause—and the reasons for the most part have been different each time—the takeaway is the curve has inverted. History shows that, since 1978, a recession occurs 22 months, on average, after a 2/10 inversion, with the S&P 500 up 12% on average in the first 12 months after inversion. This week's inversion had everything to do with the historically low U.S. term premium—the extra return fixed-income investors demand to lock up their money in longer-term instruments. The term premium is low for many reasons—demographics, low inflation risk, global weakness, and the trillions and trillions of negative debt abroad (everyone buys Treasuries because of safety and their higher yield). Yardeni dismisses Wednesday's panic as outright "hysteria," blaming it mostly on computer-driven algorithms programmed to sell stocks on bearish headlines such as "Key indicator sends recession warning!" While computerized quant investing can tease out historical correlations, these correlation exercises aren't designed to distinguish between a "technical" curve inversion (arguably the case this week) and a "fundamental" one driven by economic factors (many of which have been trending up in the U.S.). The machines don't care.

The world may be addicted to QE and all of the consequences that come with that. All this easing comes amid an ongoing if not worsening trade war, a likely hard Brexit, Japan's value-added tax hike in October and an uncertain and potentially disturbing end to the Hong Kong riots. Commodity prices are declining, and *we may be in the grip of significant structural global deflation!* The fact it's August doesn't help as a vacuum of liquidity, volumes and attendance have exaggerated market moves. Stocks have traded poorly month-to-date, and not without reason. But "sell everything" days such as Wednesday often occur near market lows. Short-term technical trading readings on the New York Stock Exchange were their highest since 2015 that day as liquidation dominated market players' preferences. Such high readings can cluster and take time to stabilize, but generally come near interim bottoms. If support around S&P 2,850 holds, we remember that history shows S&P performance after an inversion tends to be positive. The market might like it if Fed Chair Powell or some other Fed head talks

about the need for more QE at Jackson Hole next week. Are we going to get QE that unkinks the yield curve? Bank of Japan-style yield control? We are about to find out.

POSITIVES

- **The consumer is shopping a lot!!!** July retail sales jumped by the most in four months and more than double consensus, bolstered by a surge in online sales due to Amazon Prime Day. On a year-over-year (y/y) basis, sales accelerated, with core discretionary spending rising at its fastest pace in eight months, aided by a strong labor market and rising incomes. Confidence remains strong but has deteriorated somewhat—the first take on August sentiment slipped to its lowest level since the start of the year, according to the bimonthly University of Michigan survey.
- **… even for houses** With mortgage rates plunging, the Mortgage Bankers Association said refinancing applications spiked 37% in the latest week to their highest level since November 2016. Purchase applications posted their first increase in five weeks. Homebuilder confidence for August matched the high for the year, led by the best reading on new home sales since October. July housing starts disappointed, but that was all in multifamily units. Single-family starts were up 1.9% y/y, and permits jumped.
- **Small businesses hire a lot of consumers** Contrary to the global recession narrative, small business optimism is on the rise, up for the fifth time in six months in July, according to the National Federation of Independent Business monthly survey. Respondents said their outlook has improved and their capital spending and hiring plans have picked up. Their largest challenge? Finding qualified workers, a sign of a healthy economy.

NEGATIVES

- **Global recession watch** Germany's economy contracted in the second quarter, and German August ZEW investor expectations fell much more than expected to new lows, reflecting heightened trade tensions, hard-Brexit fears and dollar-driven emerging-market stress. The latest data out of China shows that country's growth

continues to slow, with industrial production in July rising at its slowest pace since February 2009.

- **Why is the Fed cutting rates?** This week's CPI data for July was on the strong side, with core y/y CPI coming in 2.2%. The month-over-month reading of 0.3% contributed to the strongest 2-month rise in inflation since early 2006. If the inflation data is ticking higher and the rate of change is making multiyear highs, why is the Fed be cutting rates? Global concerns.
- **Manufacturing is not so fine** It's not so bad, either, it's just not growing much. In July, for example, industrial production fell but June was revised up, making for a flat 2-month performance. Philadelphia and New York Fed surveys showed manufacturing activity was expanding this month in their respective regions, though at a modest pace and well off cycle highs.

WHAT ELSE

What American Pharoah and the yield curve have in common In 2013, Equine Biomechanics & Exercise Physiology's Jeff Seder recommended race-horse entrepreneur Ahmed Zayat not sell his yearling, saying it was the best of the 151 young thoroughbreds up for auction and possibly the best in a decade. His advice was based solely on data-driven analytics of the horse's physiological characteristics, with his research showing horses with big left ventricles and hearts, as well as spleens, tend to run best. He doesn't know why, they just do. And this yearling had all three. Zayat kept the horse, which he named American Pharoah. It went on to become the first Triple Crown winner since 1978. Goldman Sachs shared this tale to reinforce its argument above that, looking out one year anyway, it doesn't matter why the yield curve inverted, only that it did.

Shout-out to dividends The S&P is offering a trailing 12-month dividend yield that is higher than the 10-year Treasury yield for the first time since October 2016. Goldman Sachs is forecasting healthy continued dividend growth, and believes the market is being overly pessimistic about dividends. It notes stocks with the highest dividend yields are trading at their lowest relative valuation *in nearly 40 years*.

Warren would be a wild card As economic worries potentially threaten Trump's re-election odds, Elizabeth Warren is surging in the Democratic primary, aided by Biden's gaffes and, arguably, his lack of vision to excite Democratic voters. The Chinese have been responsive to U.S. polls, so will Warren's climb change their negotiating equation? It was thought they became less responsive to a trade deal last April when Biden's odds looked better—a Biden presidency might be far more favorable to China than one under either Trump or Warren.

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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).

Consumer Price Index (CPI): A measure of inflation at the retail level.

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.

There are no guarantees that dividend-paying stocks will continue to pay dividends.

The ZEW Indicator of Economic Sentiment polls financial experts to gauge whether they are optimistic or pessimistic about the subsequent six months.

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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