Caron's Corner Transcript – 7.17.2023

You're In Good Shape for the Shape You Are In? Yield Curve vs. Recession

- The *shape* of the yield curve is a long-time coincident indicator with the *shape* of the economy, whether growing, slowing or recessionary.
- A year ago the slope of the U.S. Treasury 2-year/10-year curve inverted, where the yield on the 10-year fell below that of the 2-year.
- This was used as a signal for a recession 6, 9 or 12 months later, as an inversion of that yield curve is a often used as a lagging indicator.
- But a year since the inversion, the heated debate over what the yield curve is telling us about the future economy continues.
- I'd like to weigh in on the debate.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. We are a week before the Fed meeting and there's going to be a lot of talk about the yield curve, recession, whether the Fed is done hiking and what comes next for the economy? What I want to focus on today is the yield curve versus recession. I like to say that "you're in good shape for the shape you are in" because the shape of the yield curve is a long-time coincident indicator with the shape of the economy, whether growing, slowing or in a recession. A year ago, the slope of the U.S. 2-year/10-year Treasury curve went negative, aka inverted, with the yield on the 10-year falling below that of the 2-year. This was used as a signal for recession either 6, 9 or 12 months later, as yield curve inversion is often used as a lagging indicator. But here we are a year since the inversion and the debate over what the yield curve is telling us about the future of the economy still rages on. I'd like to weigh in further on the debate, so let's get into it.

We also like to say "dangerous curves ahead" but now add a question mark and ask "dangerous curves ahead?" because are they really dangerous? Like most things related to the market, it's not just about the level, but about the change. Both provide information, but the rate of change sends a stronger signal and it's no different for the yield curve. Yes, it's true that the curve is inverted and that is a coincident indicator with recession ahead. But let's look a little deeper for what it means for asset prices. An inverted curve is the outcome of policy tightening to slow the economy. But initial conditions matter. In this case the initial conditions were that the economy was running hot, which is why Fed policy tightening resulted in a flattening, and possibly inversion, of the yield curve slope.

The longer the curve stays flat or inverted, the more likely it is that there is a material slowing of economic conditions. So the level of the curve matters, but it's actually when the curve slope starts to dis-invert or steepen that it sends a stronger signal for an imminent economic slowdown. In other words, the change in the slope of the curve may matter more and sends a stronger signal. This nuance matters greatly and is often overlooked because when the front-end starts outperforming the longer-end of the curve after a rate-hiking cycle, that's when the market starts to price more of an economic slowdown that will be followed by rate cuts. I think this is what will be focused on with respect to the

treasury market and the curve shape. We'll use this relationship to help inform us about how to manage risk across assets we hold in our portfolios.

One of the things we always like to think about is leading indicators and so far, leading indicators haven't given us such a strong signal for economic conditions. So I'd like to say “in search of followers” for leading indicators. Now leading indicators told us the recession should have started actually in the first half of 2023. Well, so much for that. But let's make a brief comment on the recent inflation data. It came in weaker than expected, but I see that as more of a relief than a surprise. Year-over-year base effects have been well advertised to bring inflation lower. The market is just relieved that it's happening on schedule and this reduces the odds of rate hikes after the July meeting. Yes, slowing inflation usually comes along with slowing growth and this raises the voice of the recession cries. Once again, when the recession occurs matters less to us than how deep.

Now we think a recession that comes sooner will be shallower than a recession that comes later, which may be deeper when we put it all together. But not until we see the start of a trend steepening of the yield curve will we be willing to reduce our risky asset positions, i.e. equities or high yield or emerging market exposures. It could be the Fed remains higher in terms of policy rates for longer, but when it does cut, it may cut by less than what long-term bond yields already have priced in. This is contrary to market pricing of longer-date bond yields that are already yielding 100 to 125 basis points below the Fed funds rate. Said differently, holding longer-duration assets may not be as safe as some think.

As we sit a week ahead of the Fed meeting and contemplate what may come next, let's keep in mind that the changing shape of the yield curve - not just the level - sends the strongest signal once the hiking cycle is over. If we ascribe any significance to next week’s Fed meeting it's likely to be this: in terms of how economic conditions are evolving relative to the shape of the curve, it's “in pretty good shape for the shape that it's in.” Not until this changes, will we change our views. Many of you will recognize this phrase as the title of a Dr. Seuss book, and the market can learn a lot from the logic of Dr. Seuss. Perhaps the good doctor would have liked our tagline “better to be balanced than defensive” as well. This seems logical to us, still to this day, even at this point in the cycle. I'll be back next week with another Caron’s Corner and also with a special Fed comment from Caron’s Corner July 26th.

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