

Market Volatility, Yield Curve Inversion & Recession Risk

August 15th, 2019

What Happened?

- **Stocks Skittish on Bond Market Signals.** The S&P 500 index closed down nearly 3% on Wednesday and ~6% below all-time highs. A handful of outstanding risks continue to impact the markets over the past few weeks: the ongoing U.S.-China trade war, a slowing global manufacturing economy, earnings weakness, higher odds of a Hard Brexit, and heightened geopolitical tensions. Currently, many are interpreting the yield curve as a signal of imminent recession in the U.S.
- **Bond Market's Traditional Recession Indicator Flashes Warning.** The most recent round of volatility centers on the yield curve, where the spread between 2- and 10-year Treasuries turned negative yesterday. Historically, inverted yield curves have been a harbinger of looming recessions.

What Else Should Investors Know?

- **The Yield Curve Is Not a Perfect or Timely Recession Indicator.** While the yield curve is a reflection of investor growth concerns, it has historically not been a particularly timely indicator of recession. Recessions typically tend to occur, on average, 22 months after inversion, during which equities typically see further gains.
- **The Yield Curve May Be More a Reflection of Expected Fed Funds Rate Cuts.** After cutting rates for the first time last month, the Fed Funds rate sits just below levels of "neutral," or the level that is neither stimulative nor restrictive for economic growth. However, many market participants believe more cuts are coming, with the Fed Funds Futures market pricing in a 55% chance of at least two more cuts by year-end.
- **Global Demand Compresses Longer Yields.** Global bond markets are currently experiencing historic low yields due to record amounts of quantitative easing from central banks on top of strong demand for fixed rate securities. A record amount of bonds across the globe currently trade at negative yields (almost \$16 trillion in aggregate), concentrated to a large degree in sovereign debt. As a result, Treasuries have been the only game in town for investors seeking any yield at all from less risky bonds.
- **Flight to Quality Reflects Recognition of Risks.** U.S. Treasuries often are viewed like a safe-haven asset for investors seeking shelter. In the U.S., the health of the consumer has been driving this now record-long expansion forward, but newly threatened tariffs on Chinese goods may threaten continued expansion. Abroad, recent data has indicated that Germany's export-driven economy has stalled and China's growth appears to be slowing further in the face of a slowdown in global trade and manufacturing activity.

What Should Investors Do?

- **Market Corrections are Normal.** Equity market corrections of 5% to 15% are quite normal, occurring on average about once per year. History has shown the market can survive such a correction and achieve positive returns for full-year periods, particularly in cases of ongoing expansions. The more recent S&P 500 ~6% decline from all-time highs is still well within this normal correction range.
- **A Global Economic Slowdown, but Still Modest Recession Risk.** A review of Glenmede's Leading Economic Indicator and other economic data points reveal a global growth slowdown. However, Glenmede's Recession Model currently estimates a still modest ~20% chance of recession in the U.S. within the next 12 months. While a few components, such as the inverted yield curve, suggest a higher probability of recession, others, such as credit spreads and gauges of economic excess, point to more muted risk levels.
- **Maintain Recent Positioning.** The current economic expansion in the U.S. is now the longest on record. Due to the length of this expansion, signs of modest excesses and the factors mentioned earlier, a recession is more likely than before. However, it appears premature to call for the end of the expansion and bull market at this time. As a result, we continue to recommend a full-weight allocation to equities in diversified portfolios with a bias towards the use of defensive equity strategies within that allocation.
- **Monitor Changes in Information Closely.** Investors should keep a close eye on the recent key drivers of both the ongoing expansion and recent weakness. The late stage of this economic expansion has been supported by the consumer and services side of the economy and should be monitored for signs of weakness and contagion. Similarly, credit markets, which have yet to show significant signs of stress, should be monitored. On the other side, even small incremental improvements in manufacturing or trade policy could quickly change the narrative.

Amid the global economic slowdown, recession risks have risen modestly. Investors should maintain current positioning, but monitor closely.

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