WILLIAMS MARKET ANALYTICS

Weekly Commentary

For the week ending April 20, 2018

Yields Will Signal The End Of The Bull Market

Over the past two years, numerous exogenous events have been cited as potential threats to the bull market. Brexit, the election of Trump, all of Trump's political "crises", North Korea, a trade war with China – all caused epidemic reactions in the stock market, but the bull has carried on higher. It has become clear that the bull market will end not end due to geopolitical events. Nor will valuations stop the rally. Analysts can continue revising earnings estimates higher to make valuations look palatable (however expensive valuations will later be the fuel to drive selling in the bear market once upward earnings revisions cease). Rather, it is most likely that internal, market-based factors will be the ultimate trigger to trip up the aging bull market. And, as the title to this week's Commentary indicates, we believe that yields will inflict the *coup de grâce* ending the equity bull.

Lots of traditional indicators have become irrelevant in this central bank liquidity-driven market. The Yield Curve, however, will be difficult for gluttonous bulls and trading algo programs to ignore. An inverted Treasurys yield curve has always been an ominous sign for growth and a reliable harbinger for recessions. And with the latest bout of flattening, the reality of sub-zero spreads may soon collide with an otherwise sanguine outlook on the economy.

The yield curve from 5 to 30 years has flattened to about 30 basis points, the narrowest spread since 2007. From 2 to 10 years, shown in our chart below, the gap of 47 basis points is also the smallest in more than a decade. For extending to 10 years from 7 years, investors pick up a mere 3.5 basis points, less than a quarter of what they got a year ago.

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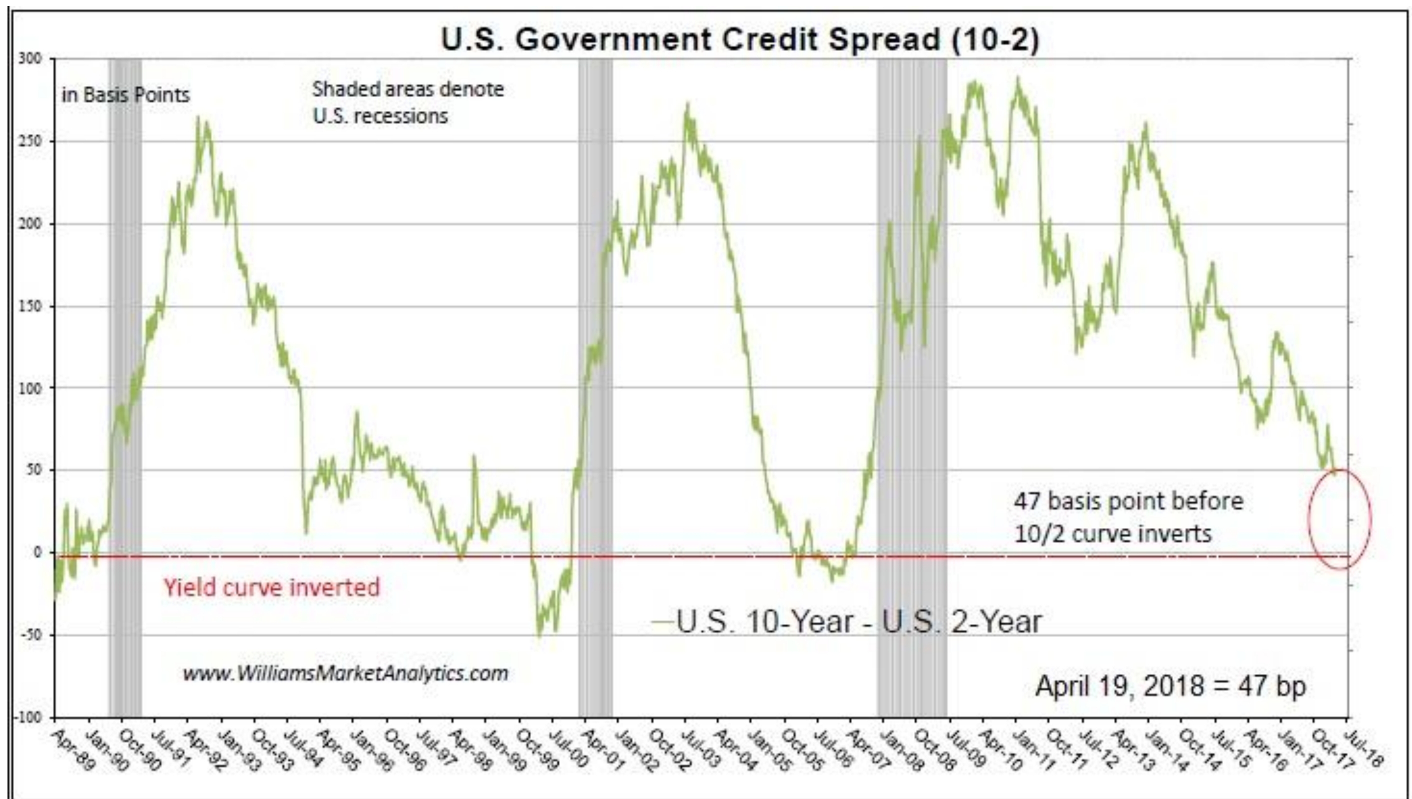

Some say that curve is collapsing partly because the Treasury is ramping up issuance of shorter maturities to fund expanding budget deficits. We are not sure if this is a justification to continue to buy risk assets or yet another reason to be concerned as the debt levels grow even larger. In this Commentary, we analyze the yield curve "straight up", and don't consider excuses or justifications for why the move in yields is not as important this time.

Yield Curve Inversion → Stock Market Top → Recession

When the yield curve "inverts" (long-dated Treasurys offer less yield than short-term T-Bills) it implies that the bond market, which more or less controls the long-end of the curve, is anticipating slower growth on the horizon while at the same time the Federal Reserve is raising short rates to cool inflationary pressures. Why is an inversion of the yield curve so important? Simply because going back to 1970s the 10/2 yield curve has inverted 5 times. And in each case a recession ensued within no more than 20-months. That a 5-for-5, 100% track record.

There is a logical sequence that has played out at the end of each economic cycle: an inversion of the Treasury yield curve, followed by a top in the S&P 500, followed by entry into economic recession. Remember that the stock market is a component of the LEIs (Leading Economic Index) and its top generally pre-dates the beginning of the recession. We prepared the helpful table below to better understand the sequence of events at the end of a cycle.

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10/2 Treasury Yield Curve Inverts	Lead Time (months)	S&P 500 Peak	Lead Time (months)	NBER Declares an Economic Recession
August 1978	+18	February 1980	-1	January 1980
September 1980	+3	December 1980	+7	July 1981
December 1988	+19	July 1990	0	July 1990
February 2000	+1	March 2000	+12	March 2001
February 2006	+19	October 2007	+2	December 2007

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To be precise, the 10/2 yield curve did invert several days in June 1998. However the "inversion" only extended to -5 basis points (bp). In the other five cases, the inversion of the 10/2 was relatively deep: -169 bp in 1979, -170 bp in 1980, -44 bp in 1989, -50 bp in 2000, and -20 bp in February 2006.

We mention this caveat as the 1998 "pre-inversion" would have gotten investors out of risk assets well before the expansion ended in March of 2001 – although the S&P 500 did fall -20% in 1998 just after the yield curve inversion. Therefore, if the 10/2 only inverts *briefly* this year (less than 1-month) and does not extend beyond single-digit basis points, the yield curve signal may not be a valid recession signal (while still posing near-term risk for equities).

For equity investors hoping to time the end of the bull, this analysis offers definite implications on the timing of the bull market top, which we flush out in the final section "Key Take-Aways" below.

Two-Year Yield Is On The Move

What has most impressed us, outside the crazy equity volatility after a year of quiet and trending markets, is the move in U.S. short yields. Below is a three-year chart of the U.S. 2-Year Treasury yield. Since last September, the 2-Year yield has jumped 117 basis points! This is a huge move and feels like the bond market is urgently trying to get somewhere after getting a late start.

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What is the bond market telling us with the 2-Year yield doubling since 2017? We believe that the bond market is sniffing out inflation. Or at least bond traders are finally starting to come around to Fed officials' path of hikes, with the unemployment rate the lowest since 2000 and inflation creeping higher. The Fed does not foresee a risk of persistent inflation above its 2% target, however. But then again, the Fed economists are notoriously the worst forecasters of the economy and inflation. We think the bond market has a much better track record of anticipating inflation, which we can see in the break-even Treasury rates (the difference between a conventional Treasury yield and the equivalent maturity TIPS yield). We chart below the 5-year and 10-year break-even inflation rates.

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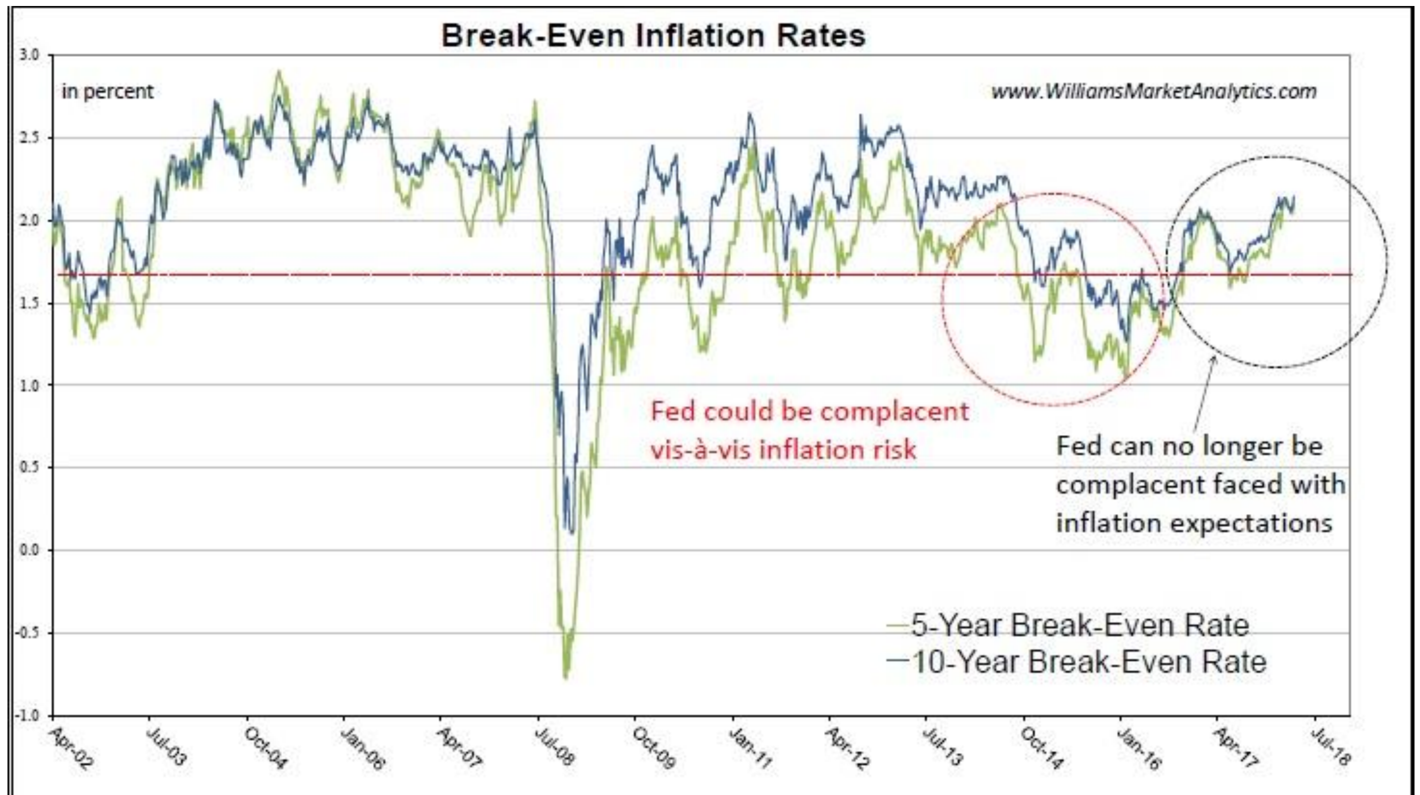

We can see in the chart that in 2014-2016, the bond market was not concerned about inflation. And appropriately enough the Fed kept putting off rate hikes with their "lower for longer" discourse. Now, as the bond market is sniffing out inflation, no doubt due in large part to Trump's fiscal and spending stimulus agenda, the bond market has reversed course and now anticipates inflation rates above 2% year-on-year. The question, as addressed in the next section, is whether the Fed is willing and able to raise Fed Funds to keep up with the surge in 2-Year Treasury rates.

<u>Don't Get Behind The Fed When The Fed Is Behind The Curve</u>

As of today, the Treasury yield curve is still upward sloping and appears normal for an economic expansion (despite the historically low levels of rates across the spectrum). Below is the current on-the-run Treasury curve.

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We predict that Federal Reserve (who made the unfortunate decision after the Financial Crisis to unilaterally add financial market administration to its mandate) will not raise rates in hopes of not provoking an implosion of financial markets. The above yield curve will **not** invert over the whole maturity range prior to the next recession, but rather we expect to see an inversion from 2-years forward.

We put together an interesting chart of the 2-Year Treasury yield less the Fed Funds target rate. The shaded areas are the official NBER recession periods.

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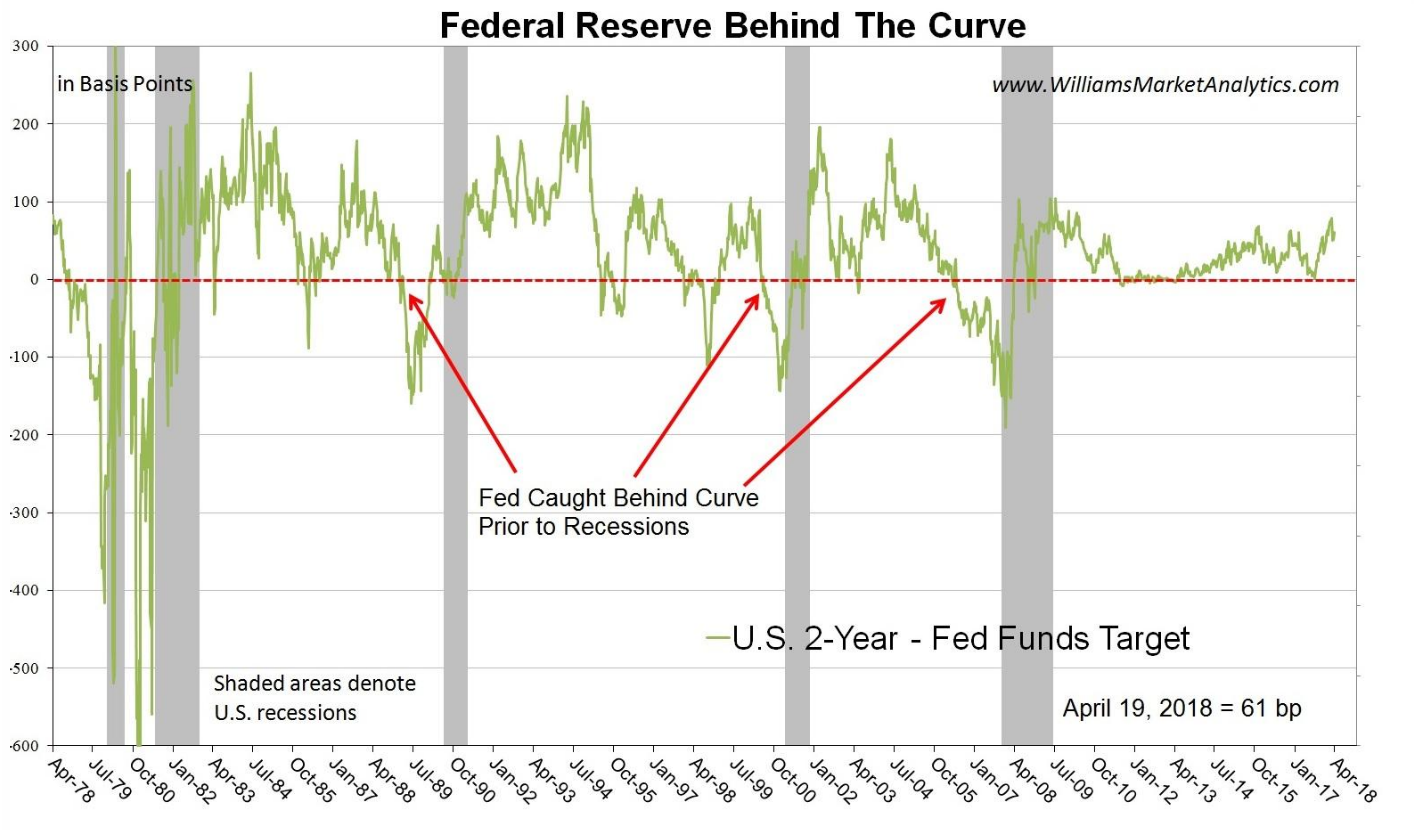

What we see happening prior to past recessions is a relatively late inversion of the 2-Year yield – Fed Funds spread. The Fed leaves Fed Funds too low relative to the 2-Year yield (which does a better job rising in anticipation of inflation as the economy heats up), ends up "behind the curve", then is forced to raise Fed Funds in the months prior to entry into recession, causing the spread to invert.

The Fed is systemically wrong on the yield curve. It is uncanny. In 2006, then-Chairman Ben Bernanke said he didn't see inversion as portending an economic slowdown. New Fed Chair Jerome Powell said that "inflation will stabilize around the 2% target". Further, he said in testimony before Congress that "at this point, the Fed does not see these [renewed financial market volatility] as weighing heavily on the outlook for economic activity, the labor market and inflation". Are you reassured? Neither are we.

What seems clear is that the Fed is going to be very sensitive to the shape of the yield curve. If we get to the point where inversion might begin to happen, the Fed may put on the brakes on dialing back monetary stimulus. Stubbornly low long-term yields could also eventually force the Fed to slow down. The barrage of Fedspeak this past week is revealing that the persistent yield curve flattening of late is creating a dilemma for officials, who appear intent on gradually tightening policy. We can be sure that the Fed will continue to try to manage financial markets until the bitter end.

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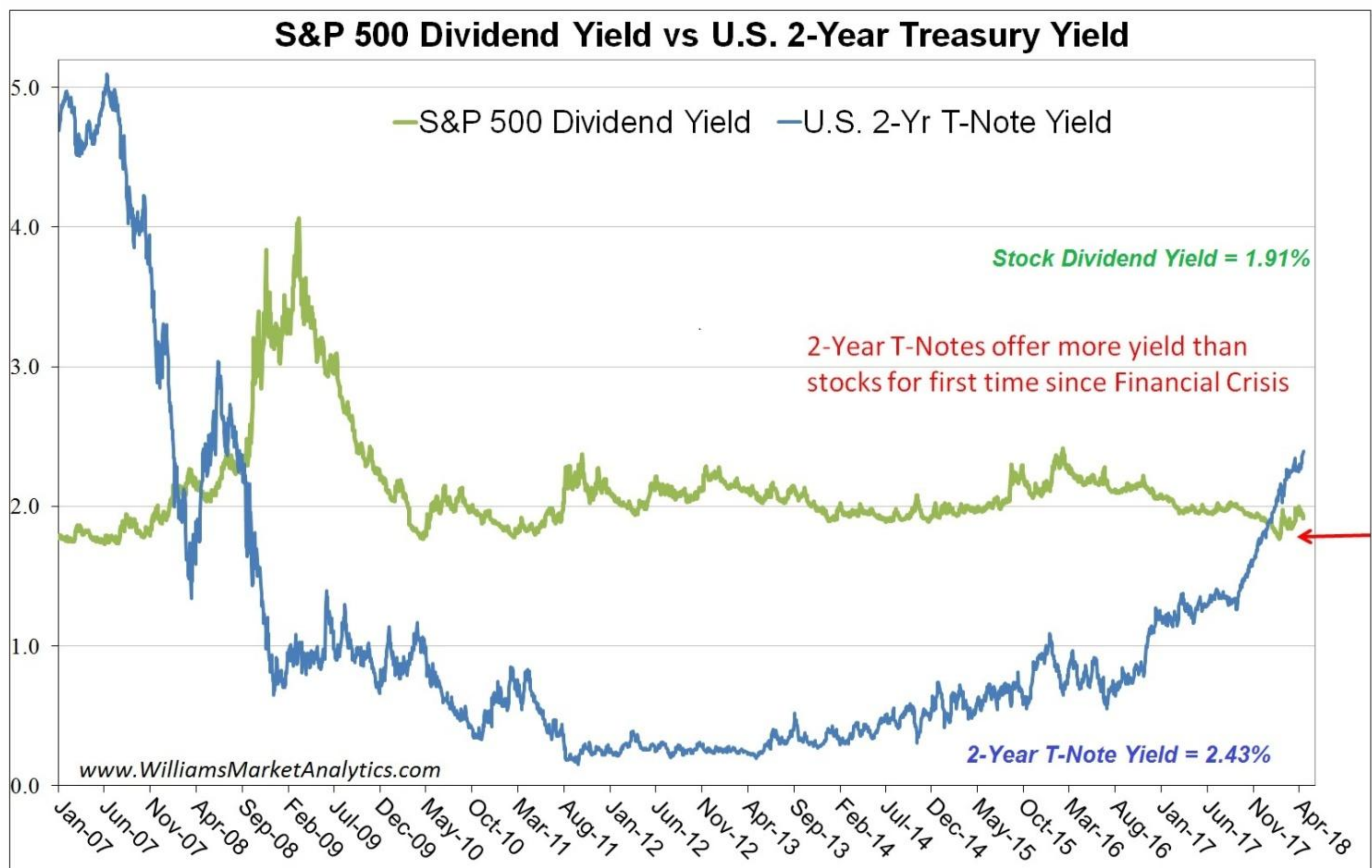
Another Ominous Sign Presented By 2-Year Yields

As readers know, asset allocation is to a large extent the choice between equities and bonds. When economy is running well, investors have a greater appetite for risk and allocate money to the former. In times of incertitude investors allocate new money to the latter. One metric that often helps in determining the flow of funds is the relative yield of stocks compared to fixed income interest rates. Our next chart illustrates that, following the jump in 2-Year yields, an important level was breached. Since the Financial Crisis, yield-seeking investors were pushed into the stock market, with the S&P 500 dividend yield exceeding Treasury yields. Today, an investor earns 2.43% on two-year U.S. paper well above (especially on a risk-adjusted basis) the 1.91% S&P 500 dividend yield. This could be a watershed moment in the bull market. Traditional bond investors, who fled their preferred fixed income space over the past years due to the Federal Reserve depriving savers of yield, will now start considering rotating out of stocks back into bonds.



Key Take-Aways

Astute investors looking at our table above showing the typical progression of yield curve inversion to stock market tops to recession will be asking, since the 10-2 curve has yet to invert, is the S&P 500 top in? And this brings us to **our first take-away**: the equity bull market has not likely topped out. This assumes that the current cycle will proceed in a similar fashion to the prior five economic cycles in the U.S. The mean historical lead time from the moment the 10/2 yield curve inverts to the date the S&P 500 hits its ultimate high is 12 months. On one hand, we could say don't worry about being fully invested in equities until the yield curve inverts and remains inverted for a couple months. On the other hand (don't you wish that we were

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one-handed economists!) the extreme interest rate market manipulation this cycle by central banks may screw up the traditional sequence of events (yield curve inversion – stock market top – recession).

Our second take-away is that the equity market is defying all naysayers and aiming to set as many records as possible. The current bull has already seen the longest period without a -3% pull-back in history, the longest period without a -5% pull-back in history, and the strongest gains in history relative to paltry company earnings. Two more records are in sight with odds that may interest a gambler. As shown in the table, the duration of the current bull market has hit 110 months. The record length for a bull market is 114 months. While the record gain of +418% on the S&P 500 seems out-of-reach, you have to believe that traders will try to keep this market aloft until August 2018 to see the prior duration record broken.

THIS IS THE SECOND LONGEST AND SECOND LARGEST BULL MARKET

Bull Markets Since World War II

Bear Market Bottom	Bull Market Peak	Months	S&P 500 Return	Annualized Return
06/13/1949	08/02/1956	86	267%	20.0%
10/22/1957	12/12/1961	50	86%	16.2%
06/26/1962	02/09/1966	44	80%	17.6%
10/07/1966	11/29/1968	26	48%	20.0%
05/26/1970	01/11/1973	32	74%	23.3%
10/03/1974	11/28/1980	74	126%	14.1%
08/12/1982	08/25/1987	60	229%	26.7%
12/04/1987	07/16/1990	31	64%	20.9%
10/11/1990	03/24/2000	114	418%	19.0%
10/09/2002	10/09/2007	60	101%	15.0%
03/09/2009	03/05/2018*	109	302%	16.7%

Source: LPL Research, FactSet 03/06/18
*Bull market is still active

The other objective traders are eyeing is the 3000 level on the S&P 500. From current levels, this only represents an +11% gain on the S&P 500 – very feasible given that U.S. equities are on track for breaking the longevity record. Not to mention that we still have not seen an inversion of the yield curve. We are quick to add that chasing after the final percentage gains of this bull market is not attractive from a risk/reward perspective – you don't want to be left holding the equity bag when the market begins its ultimate descent.

Our third and final take-away is that the bond market is not going to crash and burn. Sorry Bill Gross. Too many bond investors were forced into equities seeking relatively higher dividend yields since 2009. These investor profiles do not correspond to the level of risk inherent in equities. If the U.S. 10-Year T-Note gets above 3% there will be demand for Treasurys from savers. Savers who will be selling equity positions to take advantage of the higher bond yields.

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