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An Equity Manager's Perspective on What the Bond Market is Signaling

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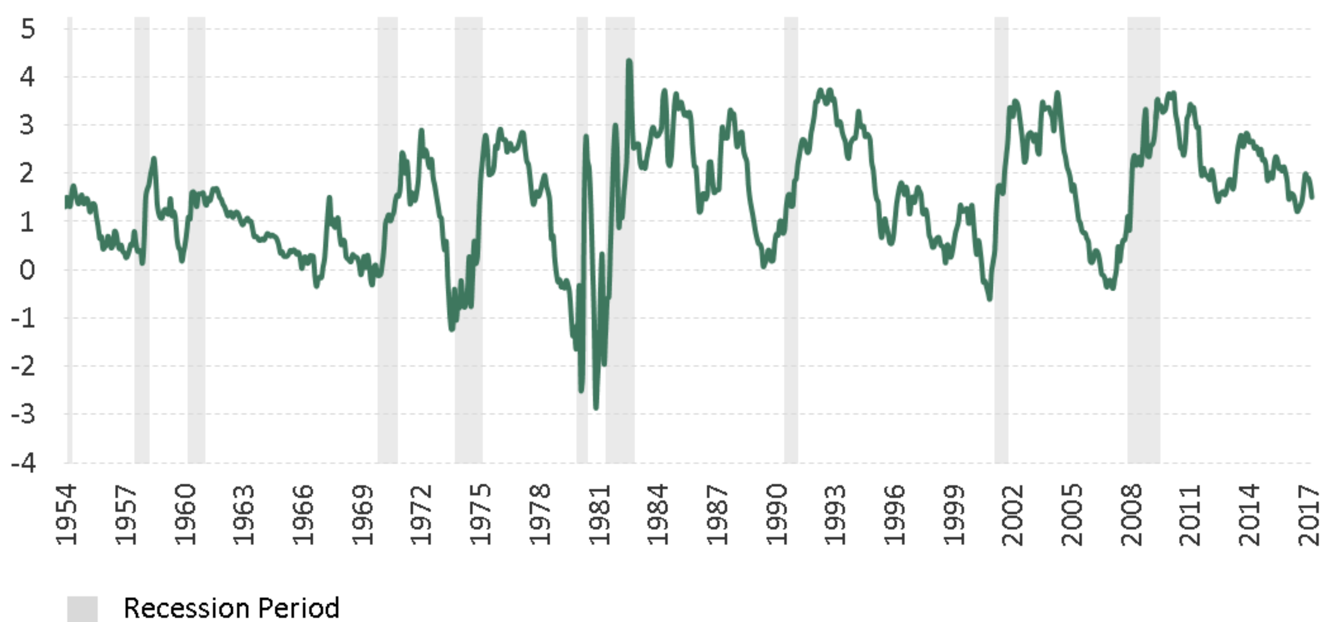
Conventional wisdom says the bond market is much better than the stock market at flashing warning signs of impending trouble in the economy. In recent weeks, investors have been pointing to the Treasury market rally as a signal that the "soft" economic data, such as consumer confidence, is likely to be met with disappointment. Defensive stocks, also known as "bond proxies," have rallied while banks and other more cyclical companies have seen their stock prices fall.
The equity market is drawing the conclusion that growth will disappoint, and that investors should hide. However, we only need to recall last July in 2016 when the 10-year Treasury rallied and sent yields down to record lows. But instead of a warning sign, it marked a bottom, and a tremendous rally for value stocks followed from July through early December.

Is the bond market as good at signaling economic downturns as many people think? What signals are real, and what are misleading?

It is true that the yield curve has inverted ahead of every U.S. recession since World War II (see Chart 1).

Chart 1: Treasury Spread—Ten-Year Bond Rate Minus Three-Month Bill Rate
Monthly Average (%), As of 4/04/2017



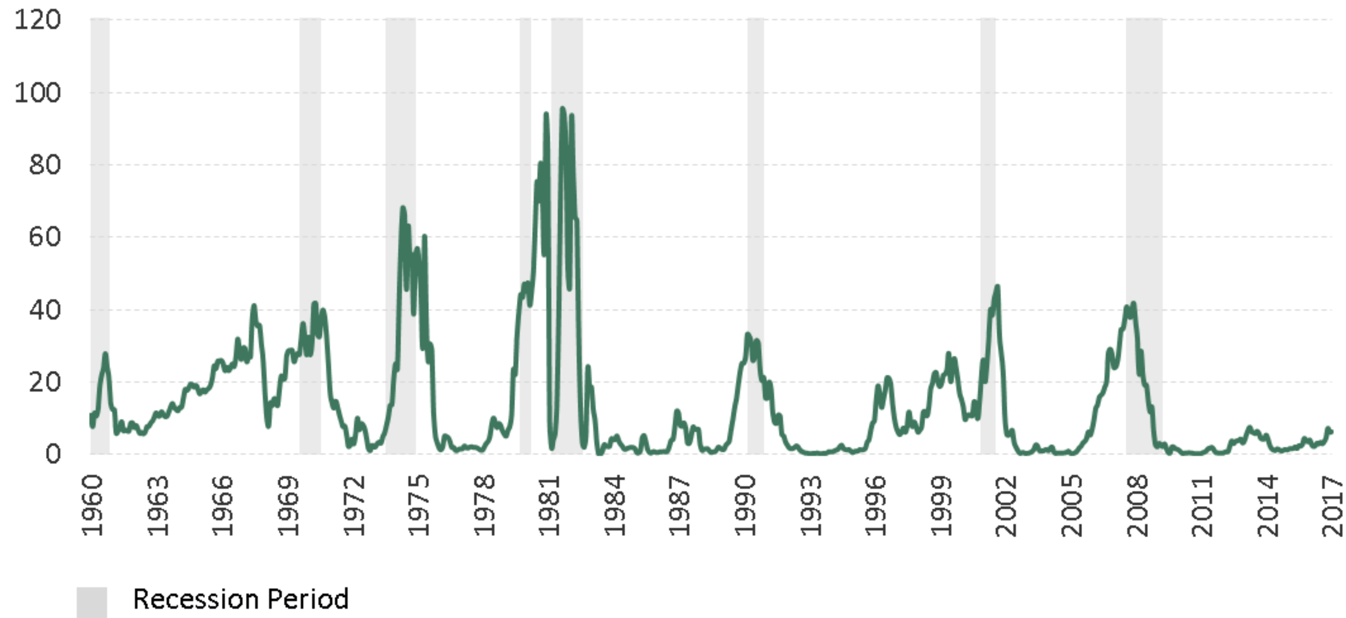
Source: Thomson Datastream, Haver Analytics

However, a flattening curve—which is what we are seeing currently—does not send the same signal as an inversion. For example, the estimated recession risk based on the level of the 10-year/3-month Treasury spread was above 10% numerous times from 1996 to 2000 and above 20% briefly in the 1996-1997 period,

while the spread was below 100 basis points frequently during that period. One thing worth noting from that same period is the flatter curve said nothing about the rate of growth, as the late 1990s saw very fast gross domestic product (GDP) growth. The Federal Reserve of New York currently shows a 5% risk of a recession based on March 2017 yield curve levels, which is not an unusual level (see Chart 2).

Chart 2: Probability of U.S. Recession Predicted by Treasury Spread

Twelve Months Ahead (%), As of 4/04/2017



Source: Thomson Datastream

Other signals from the bond market also can be misleading. High yield spreads widened to 2001 recession levels in 2011 and again late in 2015, leading to many headlines that default rates would rise and recession was an elevated risk. As we know now, the recessions of 2012 and 2016 did not happen.

A flattening yield curve also brings out the bears. In February of 2016, articles started popping up indicating rising recession odds in the next 12 months. By July 2016, *The New York Times* had posted a column titled "Can We Ignore the Alarm Bells the Bond Market Is Ringing?" In the article, the author reported that Deutsche Bank stated the yield curve implied a 60% chance of recession in the next 12 months—a much higher probability than indicated by the Fed's measure at the time. Since we are now only a few months shy of the period ending, we can say with near certainty the prediction was wrong.

What is causing the bond market to have lower-than-consensus value as a signaling mechanism? Part of the problem may be that because of the low absolute level of rates, traditional guidelines cannot be followed, with the "predictive" relationship between the Treasury yield curve and the underlying economy becoming either distorted or losing its efficacy. We recently received a chart from one firm indicating the percentage move in Treasuries signaled trouble ahead. However, the chart was on a logarithmic scale, which distorted the relationship. For example, a move in yields from 2.60% to 2.20% is a 15% move but only 40 basis points; on a chart using a logarithmic scale, a move from 1% to 2% looks to have the same magnitude as a move from 4% to 8%, but clearly in the real world a 100 basis point move has to mean less than a 400 basis point move. The low level of rates may have also introduced another problem with signaling: Japan, which introduced negative interest rates in January 2016, has managed to have four recessions since 1990 without the yield curve there inverting once.

The bottom line is the bond market really only sends a strong signal, historically, when the yield curve inverts, and even then it is usually 12 months ahead of a recession. Most other "signals" are just noise. Therefore, the next time someone notes that the "bond market is signaling" something, take it with a grain of salt. For equity investors, focusing on economic data—which continues to suggest further moderate growth—is likely a much better path to success. Following that course, we believe stocks that trade with bonds should likely be avoided, and pro-cyclical stocks may offer better value right now.

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