Weekly Digest
6 August 2018

Investec
Wealth & Investment

The weekly insight into world stock markets

Is the Flat US Yield Curve Signalling A Recession In the Near Future? Or Was Love Island Better In 2005?

A week ago, a triumphant Donald Trump claimed credit for figures showing the US economy grew at its fastest pace in almost four years in the second quarter of this year. The economy grew at an annualised rate of 4.1% in the three months to June 2018. The president proclaimed business confidence had reached historic highs and that his “America First” policies on trade and manufacturing were delivering rapid jobs growth. He even insisted that the faster growth would be maintained for years to come. So why are market commentators suggesting that the US could enter recession in the next two years?

One reason for suggesting that a US recession is nearing is the current shape of the yield curve. A yield curve is a plot of the interest rates a government must pay to borrow for different time periods. It is accepted that in normal conditions, lenders (buyers of government bonds) require higher rates of interest to provide money for longer time periods for reasons including fears of the borrower becoming less creditworthy or rising inflation eating into returns. As such, an upward-sloping yield curve should be the norm. However, there are periods when long term government borrowing rates can be the same as or even lower than short-term rates. These scenarios give rise to flat or inverted yield curves and, in the past, have been reliable indicators that a recession occurs in the following six to 24 months. Occasions in the past when the US yield curve shape has turned negative (i.e. long rates lower than short rates) include the early 1980s (monetary policy-induced), late 1980’s (ahead of the inflation/interest rate recession of the early 1990s), early 2000s (ahead of the dot.com bust) and 2006-07 (ahead of the Great Financial Crisis). Today, interest rates on 2, 10 and 30 year Treasuries are 2.7%, 3.0% and 3.1% respectively. For many, this signifies a flat yield curve and shows we should be preparing our client portfolios for recession. Is the yield curve likely to be a reliable indicator of recession this time round?

The answer is yes and no! When reviewing the yield curve, it is better to split the segments into the two main constituent parts- short rates and long rates. The short end of the curve is dominated by movements in US base interest rates. Currently, the US Federal Reserve is raising rates by a quarter point every three months to balance against the strength of the US economy. It is expected that the market will see two more US interest rate rises in 2018 and three more in 2019 (to give a base rate of 3.25%). However, the future rate rises are not certainties. First, the current business cycle is one of the longest on record and we are overdue an economic slowdown. Second, the fiscal stimulus introduced by the Trump administration (such as tax cuts for corporates and individuals) may bring forward the timing of the next recession. Next, there are growing concerns about the impact of rapidly rising US interest rates. Finally, higher global trade barriers may slow growth and require lower rates. As a result, it is credible to suggest that the US may experience an economic slowdown over the next few years.

For the long end of the curve, the evidence is less clear. Long-term interest rates are supposed to be governed by long-term inflation expectations as well as forecasts of growth and interest rates. However, there are other forces at play today. The first and most obvious is the Western central bank policy of quantitative easing (QE). QE has reduced the yields in bond markets relative to those expected from market forces. Second, inflation has disappointed on the downside since the financial crisis and investors have, to some extent, stopped worrying about a sustained spike in inflation over the longer term. Next, the introduction of technological solutions to many industries has pushed down prices over the past twenty years and this phenomenon may continue for some time. Last, ageing populations have led to lower inflation as the elderly prefer to save rather than spend. Overall, there are good reasons to suggest that long rates are now determined by factors outside of the normal economic influences and long rates are less reliable indicators of long term interest rates.

In conclusion, we are more concerned about the possibility of a future US recession and its negative implications for our portfolios. However, we do not currently see the market anticipating the slowdown in our investment horizon of 18 months. In addition, long term interest rates have become less helpful indicators of future economic conditions but we are wary of stating that “this time is different”!

So why add Love Island to the title of this article? It may be the only way of drawing in readers to what is, let’s face it, a very dry subject during these wonderful hot summer months….

Darren Ruane
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FTSE 100 Weekly Winners

Rolls-Royce	10.1%
Mondi	7.5%
Smurfit Kappa	4.5%
Admiral Group	3.6%
GVC Holdings	3.4%
Royal Bank of Scotland Group	3.3%
Imperial Brands	3.2%

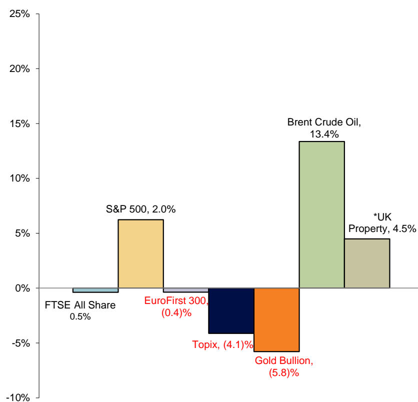
Source: FactSet

FTSE 100 Weekly Losers

Just Eat	-6.4%
Centrica	-5.8%
Micro Focus International	-5.8%
Pearson	-5.2%
Marks and Spencer Group	-4.8%
Rentokil Initial	-4.8%
Kingfisher	-4.6%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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