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ECONOMIC TALKING POINTS

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Forget the Current Yield Curve; Focus Instead on the Consumer

The drumbeats warning of recession reached a crescendo this week.

The thunderous sound that frightened many into thinking this business cycle will soon screech to a halt was the inversion of the yield curve. The 10 yr / 2 yr spread turned negative for the first time since 2007 and history has shown such an inversion was a precursor to every US economic downturn for more than half a century.

If that's not concerning enough, analysts have also cited the sharp slowdown in both manufacturing and service activities, the listless housing market, a virtual shutdown in business capital spending and finally the plethora of indicators showing Europe is now teetering on recession.

All that economic gloom hammered financial markets. The Dow tumbled 800 points on Wednesday, biggest drop of the year. All 30 Dow stock plummeted. All eleven sector indexes in the S&P 500 fell too. The 30 year treasury yield nose-dived to its lowest in history (2.018%) as investors fled to shelter.

The main culprit for this awful turn of events, if you believe President Trump, is the Federal Reserve. Time and again, he has criticized Jerome Powell in tweets that short-term interest rates were too high and that Fed under his leadership was not moving fast enough to reduce them, thereby endangering the economy and eroding asset values.

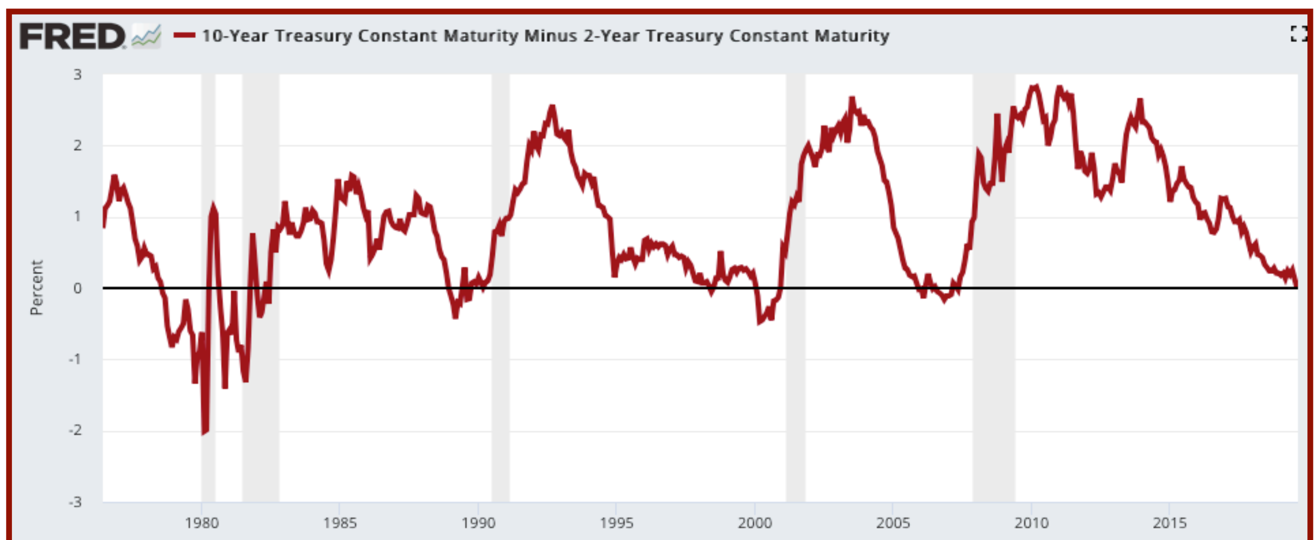
Whether you share Trump's criticism of the Fed or not --- and we do not ---many analysts now see the probability of a US recession in the next 12 to 18 months as being above 50%.

So let's clear the deck. We are definitely not in that pessimistic about the outlook. Missing from all this doom and gloom about the economy is a sense of perspective.

Let's begin with the inversion of the yield curve and why we are dismissing it this time as a reliable predictor of recession.

No one can dispute how well it has foreshadowed every recession since 1955 (Chart 1). This metric has had an extraordinary track record in the past. However, there are some fundamental differences between the latest inversion and those that preceded it. The most significant is the unprecedented degree central banks around the world have intervened in capital markets to devour tens of trillions of dollars in sovereign debt since 2008. Those massive purchases have hugely distorted the government debt market, effectively tilting the scale so that US treasury yields were skewed down.

Chart 1



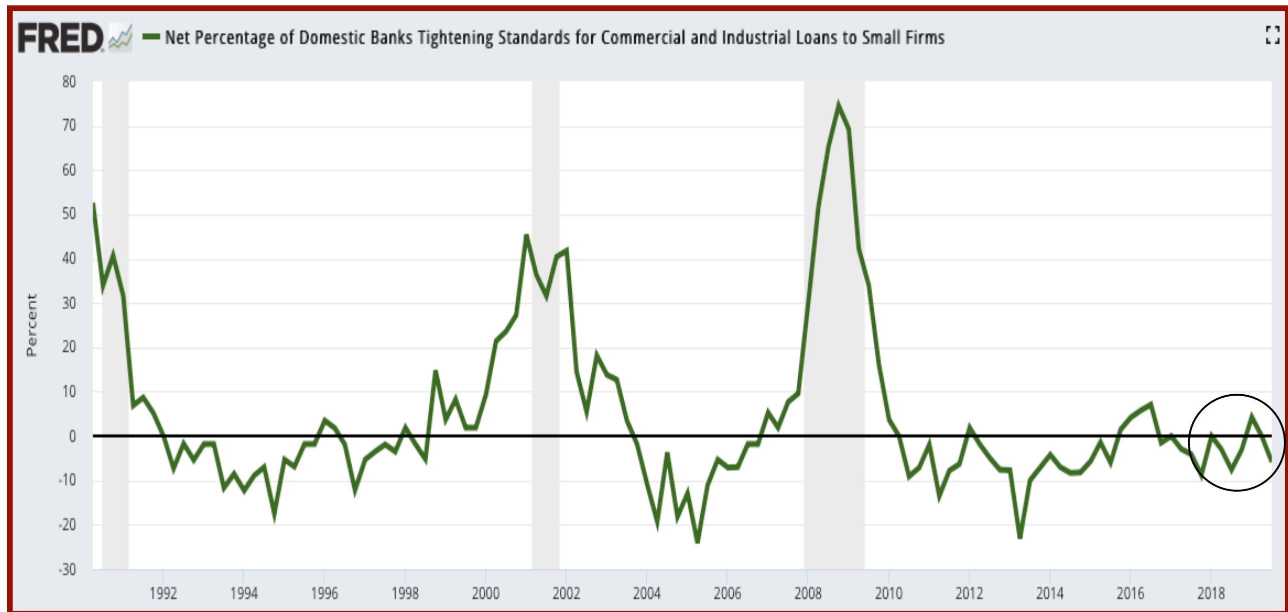
The point here is that unlike the past, when actions by individuals and institutional investors largely shaped the yield curve, this time those yields were forcefully pulled down by central banks to a degree we have never witnessed before.

The result? The world now has about $16 trillion in government debt with negative yields. It has gotten so bizarre that even junk bonds in Europe are being traded with negative yields!!

Simply put, this is not your father or grandfather's inverted yield curve. The current inversion does not possess the same predictive value as those in the past.

By the way, there have been other fairly good indicators that have reliably preceded recessions. Take, for example, the Fed's Senior Loan officer survey. Bankers, worried about credit risk in a weakening economy, tended to tighten lending standards about 12 to 24 months before a recession occurs (Chart 2). These days, however, credit conditions to businesses are anything but tight.

Chart 2



Let's also cast aside the criticism from the White House that interest rates are too high and urgently need to be cut.

It's a disingenuous complaint. The reason many worry the economy could slip into recession is not because rates are excessively high. The real fed funds rate is just half of 1%. And the benchmark 10 year yield is 1.5%, which means mortgage rates will be locked into a 3% handle for the foreseeable future. The cost of borrowing is not too high; it's among the lowest we have seen in modern economic history.

What's really depressing economic activity and evoking fears of recession is actually quite simple. There's a massive foot on the neck of the economy now, which is the escalating trade war with China and the collateral damage it has done to global supply chains and world economic growth. That foot continues to deprive the economy of oxygen. Trump and Xi Jinping have blundered into a dangerous minefield of tariffs, retaliation and other provocations, and no one has a clue what the end game will be in this conflict.

With the business outlook so murky, it's not a surprise that companies have put capital investments on hold. New orders coming in to manufacturers, for example, is close to contracting, according to the last two ISM surveys. And not a single one of the respondents whose comments were published in those surveys complained interest rates were too high.

Cutting interest rates by another 25 or 50 basis point will do nothing to offset the depressive effects of this prolonged trade war with China and the scatter shot threats of yet more US tariffs against Europe, India, Vietnam and others.

What then is the risk of recession in the next year or two?

We believe the probability of a downturn remains at 30% under current circumstances (by which mean in the absence of a major geopolitical eruption).

What will keep the economy out of any serious harm will be the consumer. American households remain financially healthy. Low unemployment, rising real wages, moderate energy prices, the surge in mortgage refinancings and the 7.3 million job openings firms are still desperate to fill --- all suggest that consumers will continue to spend enough to contribute to GDP growth even as businesses retrench.

For these reasons we believe all the worries about recession are overdone. The key determinant that will shape the path of the economy this time won't be the yield curve or the direction of the fed funds rate. It's the extent to which American consumers will offset the damage done by policies that impede world trade and reverse globalization.

All eyes should therefore be laser focused on what households are thinking and doing in the coming months--- and not on some tampered yield curve.

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