

Stock market volatility continues on recession fears

Situation analysis

Date: August 14, 2019

Global markets continued their volatility with stocks selling off as U.S. interest rates continued to fall. Headlines on August 14 emphasized the decline in 10-year U.S. Treasuries below the rate for two-year Treasuries, joining company with three-month U.S. Treasury bill rates. This is known as a yield curve inversion. Typically, longer-term interest rates are higher than shorter-term rates, reflecting the value of money over time.

When the yield curve inverts it typically indicates a shortage of money in the near term. In addition, the cost of managing stock market risk, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) has significantly increased, consistent with past periods of stock market drawdowns. Past yield curve inversions of this type have been consistent with recession an average of over 5 or 6 quarters into the future, making inversions a very poor tool for investment timing.

The market decline came after yesterday's surge on news that the U.S. would delay much of its previously announced tariffs on \$300 billion in Chinese goods until December 15. Trade policy remains a meaningful uncertainty for investors. The August 14 decline reflects concern not just about trade uncertainty, but also the path of global economic growth, with key economic data from China pointing to slowing growth. July data for retail sales, industrial production and investments in fixed assets all slowed, and the unemployment rate rose. Also, of concern was the contraction in the German economy in the second quarter, the first since the third quarter of 2018. Germany is a major exporting economy and the contraction is raising fears of a continued decline in global trade activity. Our indicators of global economic data continue to point to a slowing trend in U.S. and global economic growth. However, the absolute levels of economic activity remain more consistent with a mid-cycle slowdown than a recession, despite the recent inversion of key U.S. yield curves.

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[1] Important disclosures provided on page 3.

Yield curve inversion is a poor timing tool

While the 10-year U.S. Treasury yield fell below the two-year yield for the first time since June 2007, it's likely too soon to call this a recession indicator. History tells us there is often a long lag time between this "inversion" and recessions. Inversion indicates short-term rates are likely too high. This creates pressure on the Federal Reserve to continue their campaign of interest rate cuts. Relatively flat to inverted short- to long-term Treasury yields have the potential to suppress economic growth down the road. However, the moment of inversion has proven to be a poor timing tool for both recessions and asset price returns. The table below shows the tenuous relationship between curve inversions, forward price returns on the S&P 500, and the number of months until the next recession.

Initial 10-year/two-year Treasury yield inversions versus forward S&P 500 price returns and time to next recession

Initial 10-year/ 2-year inversion	S&P 500 forward price returns following initial inversion for each time period			Months to recession following initial inversion
	6 months	1 year	2 years	
8/17/1978	-6.0%	3.1%	17.4%	18
9/11/1980	6.0%	-3.2%	-2.7%	11
12/19/1988	15.4%	22.8%	18.4%	20
8/11/1989	-3.2%	-2.7%	12.6%	12
3/8/1990	-5.8%	10.2%	19.1%	5
5/26/1998	8.1%	19.3%	26.3%	35
2/2/2000	2.1%	-2.5%	-20.4%	14
<u>12/27/2005</u>	<u>-1.4%</u>	<u>13.6%</u>	<u>17.5%</u>	<u>24</u>
Average	1.9%	7.6%	11.0%	17

Source: U.S. Bank Wealth Management, National Bureau of Economic Research, Bloomberg. Daily data from 1/31/1977-8/14/2019.

We see weakening economic momentum as a larger concern than speculation around trade policy or the yield curve inversion. We have registered a slowdown across the globe, albeit from a strong base, based on our systematic data checks spanning more than 700 economic variables. Many central banks around the world have begun easing monetary conditions and lowering rates in response to ongoing trade frictions and weakening data. We are carefully monitoring indicators to assess whether the growth picture could weaken further from here. For the time being, stronger than expected second quarter earnings in the United States and a strong labor and consumer market are supportive.

Value of stocks relative to bonds remains fair

We maintain our balanced assessment of risks between stocks and bonds, despite the possibility yield curve inversion may indicate further risk to global stocks and economic growth. Our current view of this as a 'mid-cycle' slowdown in economic activity reflects the still solid level of economic indicators. We believe investors should ensure their bond portfolios act like bonds, rather than chasing income for income's sake. This provides important diversification to their equity investments. Maintaining average maturities just short of benchmark levels and maintaining exposure to high quality bonds is the best approach to ensure bond portfolios are aligned with our current portfolio guidance. We maintain a slight bias toward U.S. equity exposures within equity allocations. We also continue to emphasize opportunities for qualified investors in private market investments to capitalize on the potential benefits of controlling underlying companies.

Our job is to improve the odds of your success, and we think remaining diversified and disciplined within your financial plan is the best path for you. Please do not hesitate if we can answer any questions and we thank you for your trust.

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