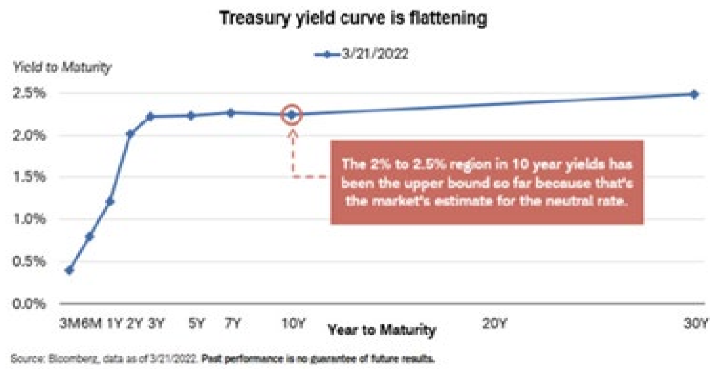
Fixed Income – Flat as a Pancake

After just a single ¼ point hike by the Fed in March, the Treasury yield curve is flashing worrisome signs that trouble awaits the economy. An inverted yield, when the yield on a 2-year note is higher than the yield on the 10-year bond, is a reliable signal that a recession is pending. This has been the case virtually every time the yield curve remains inverted for more than a very short period of time. As this is being written, the 2-year is at 2.13% and the 10-year is at 2.34%, only .21% higher. The 10-year is currently trading at a lower yield than the 5-year Treasury. Banks lend based on long-term rates and pay interest based on short-term rates. At a rudimentary level, when banks pay more on deposits than they can charge on loans they stop lending and the economy shrinks.



Source: *Kathy Jones*

Technical – Falling Knife Trend

Technical analysis pays close attention to correlations between indicators as over longer periods of time they become helpful in forecasting the direction of a chart. Given that the average drop in the broad stock market from peak to trough is approximately 40% during recent recessions (see red arrows), it makes sense for investors to closely track growth in the economy. We highlighted several macroeconomic risks in the Introduction, and the latest ISM data is another troublesome indicator. ISM Manufacturing PMI recently dropped from the upper 50s to mid-40s, a level that suggests contraction in manufacturing. The correlation of these two data series is very high at 65%. More than 90% of the time over the last 25 years, the two data series move in the same direction, suggesting caution.