REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

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OBSERVATIONS ON THE MARKET

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By Greg Denewiler, CFA

The tea leaves have spoken. They have seen their shadow (or is it they didn't see their shadow)? Anyway, a recession is on the horizon in 12 months, 18 at most. Just what, exactly are these tea leaves? Three-month interest rates on Thursday were 2.49%, on Friday they declined to 2.46%. Ten-year treasury rates declined from 2.53% on Thursday to 2.45% on Friday. It doesn't appear to be newsworthy, but it was good for a 450-point decline on the Dow. This just proves you can't read tea leaves. Readers of financial tea leaves understand that these seemingly insignificant moves in interest rates signal with absolute certainty that a recession is just around the corner. This is also known as the inverted yield curve. Where short-term interest rates are higher than long-term interest rates. It has called the last five recessions, and more importantly, it has had no false signals. We were close in December but didn't quite get there. Close was enough to spook the stock market in December that resulted in a very rough few weeks up to December 24th. On Friday, the yield curve inverted. Since this has been one of the most reliable market indicators, it is probable worth looking at in more detail.

Cam Harvey, professor at Duke University wrote a paper while attending the University of Chicago in 1988 studying the cyclical properties of the slope of the yield curve. Simply put, what happens when short rates are higher than long rates, and why does it predict a recession? His conclusion was that if longer term interest rates fall below three-month rates, it is signaling that the economy will be slower in the future, so investors are willing to except lower interest rates longer term. They expect higher short-term rates to slow economic growth. Cam was asked if he thinks that it will be reliable this time with all the Fed intervention that has influenced interest rates? He suggests that even during the 1960's the Fed was in the market attempting to influence interest rates, so Fed intervention is not new. One interesting point is that Cam says that the yield curve needs to stay inverted for at least one quarter before it is a true signal for slower economic growth. We have experienced two days to date. Any suggestions by the media to this indicator is signaling a recession are premature.

In Japan this indicator has not worked, and in Europe it has been much less reliable. The high yield bond market seems to be unimpressed. Interest rates on CCC rated bonds, lower quality bonds that experience default rates of greater than 10% in recessions, hardly moved in the last few days. They are within a few percent of their 52-week highs. The stock market is worried, but the bond market is not, at least so far. The other issue is that the inverted yield curve indicator can be up to 1 ½ years early. The biggest point to remember as the media most likely runs with this story is that the yield curve needs to stay inverted for three months before it becomes a true indicator. There are also a lot of reasons to think it could be different this time. However, the most dangerous statement in investing is: It's different this time. One big reason to think the inverted yield curve could end up being a false signal would be that 30% of the worlds bonds have negative interest rates.

It is interesting to note that the recession in 1958 saw GDP decline by 10%. In 1980 GDP declined by 8%. Everybody remembers 2009 when the economy declined by 8.7% on a seasonally adjusted annual rate. Even though 1958 and 1980 experienced about the same economic declines, 2009 is the one that is considered the worse recession since the 1930's. Every recession is different, so relying on any one indicator to be the final answer is eventually going to fail. What has been evident in the past is that there is plenty of time to read the tea leaves if history is our guide, at least when it comes to the yield curve.