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OBSERVATIONS ON THE MARKET

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Apparently, the Fed likes to read tea leaves too. The Federal Reserve Bank of St. Louis published two short articles this month exploring the inverted yield curve, looking for other economic indicators that help predict the accuracy of the inverted yield curve. They wanted to know if there were indicators that help predict recessions, which also show up before the yield curve inverts.

If you don't recall, an inverted yield curve is when short-term (one year) treasury rates move above longer-term (10 year) treasury rates. There is some debate as to whether a short-term rate is six-months, one-year, or two-years. The Fed uses one-year rates. Cam Harvey, the professor who first researched the topic in 1988, uses three-month rates, but also states the short rate must to stay above longer rates for at least three months. The financial media uses which ever rate moves above the 10-year treasury rate first. Never let the facts get in the way of a good story. So, what did the Fed conclude?

They did suggest that most economic indicators turn negative after the yield curve has already inverted. Indicators like manufacturing employment, and the broader total non-farm employment, weaken after the yield curve flashes its recessionary signal. The two they found that occurred before the yield curve inverts are housing starts and housing permits. These indicators are tied closely to higher interest rates. They are impacted almost immediately as interest rates rise, weakening before the yield curve inverts, which helps predict a recession. It makes sense when you think about a higher interest rate on a mortgage rate can immediately affect your decision whether to buy or not buy. Both these indicators started to weaken in the middle of last year. As mortgage rates moved up to 5% last summer from below 4%, housing starts began to slow down (Denver being one of the few exceptions). Once we see an inverted yield curve, it takes on average 13 months before the recession materializes. That leaves a conundrum because; 1) the yield curve hasn't inverted yet. The one-year treasury rate is 2.46% while the ten-year rate is 2.62%. So, if you follow the three-month rule (it must stay inverted at least three months), and add the 13-month average, we are at least 1½ years away. 2) Some of the best gains in the market occur at the end of an economic expansion. Who wants to miss out on those? 3) If the yield curve does finally invert, the media will relentlessly remind you Armageddon is close at hand - never mind that historically a recession is on average more than a year away. 4) We have never had interest rates invert when interest rates are so low to start with. If a recession is on the horizon, everyone knows that recessions are not good for stock prices, so here is a thought on how to deal with the uncertainty.

The S&P 500 currently trades at a P/E of 19. Two of the larger dividend growth fund ETF's have P/E's of 17. They have dividend yields that are about 10% higher than the market, and the dividends are growing as the name implies. The companies who are dividend growers tend to have less debt and strong cash flows, which is why they pay dividends. This is exactly what you want to own going into a recession. Dividend growers will still decline in a market sell off, but they should give you more confidence that they will emerge on the other side intact. If there is no recession, and the market moves higher, they should participate also. It is always a balancing act, because you must be invested to make money. However, most investors don't like to see their account values decline. Timing is nothing short of impossible.

The Fed realizes that reading tea leaves is challenging. "So, although yield curve inversions are good predictors of recessions, they're not perfectly correlated and the exact relationship isn't completely understood." The Fed knows that the economy is always evolving. However, the media will imply there is no doubt as to the outcome.