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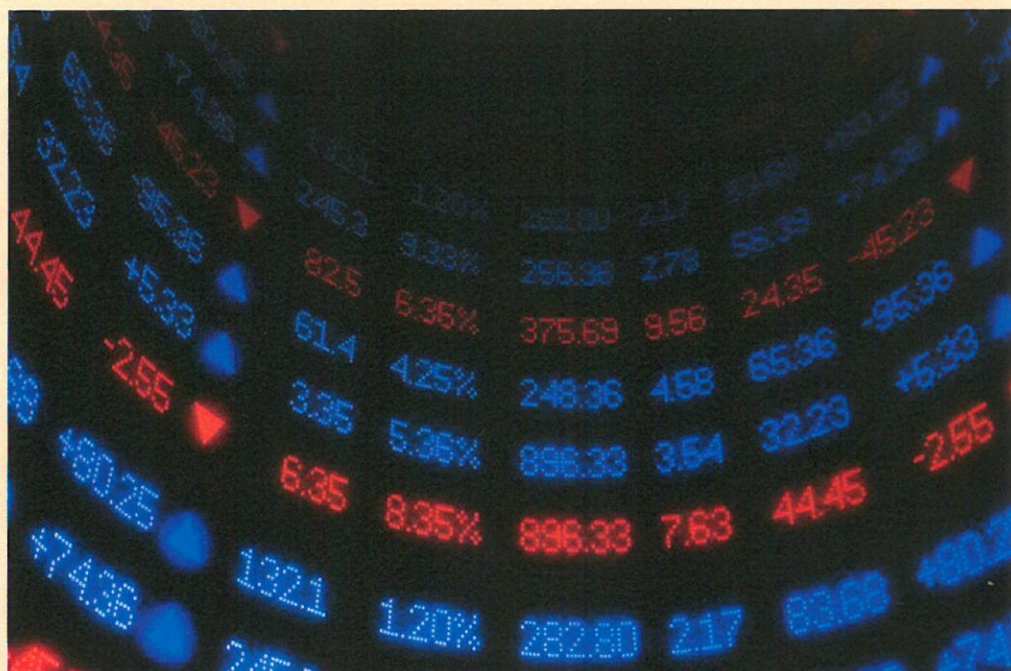
What is an Inverted Curve ... and why should we care?

by Terry E. Nager, CFP®, ChFC®, CLU®

There has been a great deal of discussion recently about the yield curve and if it has inverted. The reason for all of this attention is the historic relationship between recessions and the phenomena of an inversion of the yield curve. But first it is important to define the term.

WHAT IS A YIELD CURVE

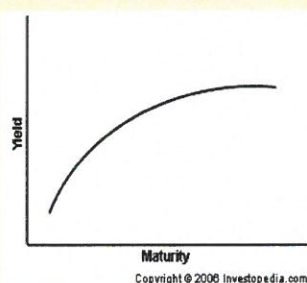
"A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year, 10-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates, and it is used to predict changes in economic output and growth." (*Investopedia*)



There are three basic types of yield curves: Normal, Flat or Humped, & Inverted.

Normal

"In general, short-term bonds carry lower yields to reflect the fact that an investor's money is at less risk. The thinking behind this is that the longer you commit funds, the more you should be rewarded for that commitment, or rewarded for the risk you take that the borrower may not pay you back. This is reflected in the normal yield curve, which slopes upward from left to right on the graph as maturities lengthen and yields rise. You'll generally see this type of yield curve when bond investors expect the economy to grow at a normal pace, without significant changes in the rate of inflation or major interruptions in available credit. There are times, however, when the curve's shape deviates, signaling potential turning points in the economy." (*Fidelity Learning Center*)



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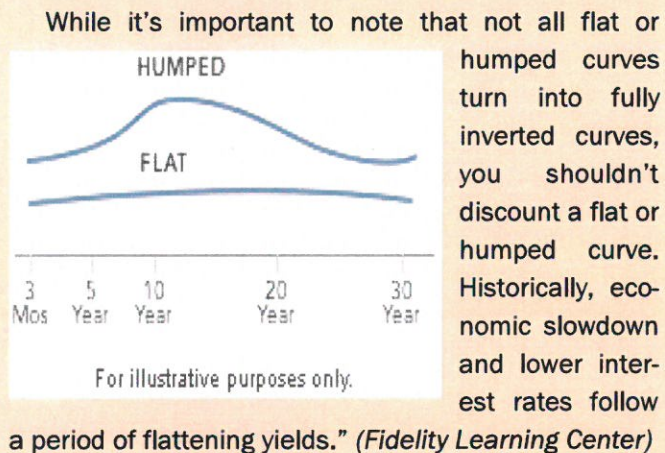
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What is an Inverted Curve? (cont.)

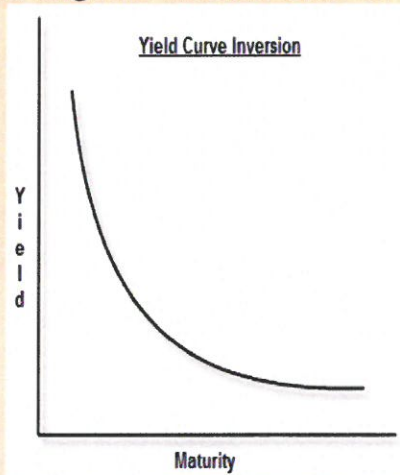
Flat or Humped

"Before a yield curve can become inverted, it must first pass through a period where short-term rates rise to the point they are closer to long-term rates. When this happens the shape of the curve will appear to be flat or, more commonly, slightly elevated in the middle.

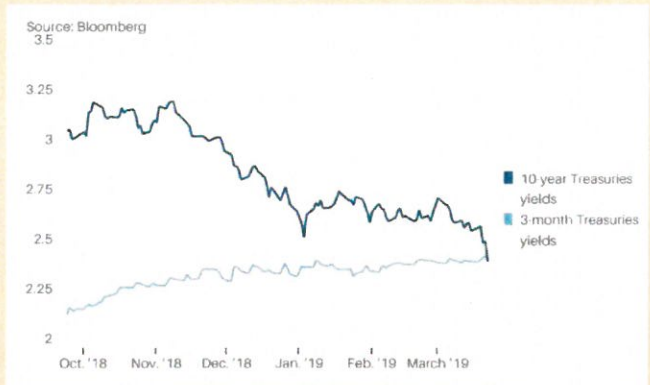


Inverted

"At first glance, an inverted yield curve seems counterintuitive. Why would long-term investors settle for lower rewards than short-term investors, who are assuming less risk? The answer: When long-term investors believe that this is their last chance to lock in current rates before they fall even lower, they become slightly less demanding of lenders. As you might expect, since lower interest rates generally mean slower economic growth, an inverted yield curve is often taken as a sign that the economy may soon stagnate." (The Fidelity Learning Center)



Now that we know what the yield curve is all about, let's look at what has been happening recently. On Friday, March 22 the yield curve did invert (the ten-year treasury fell below the three-month treasury rate).



Implications of an Inversion

"While a yield curve inversion has preceded recent recessions, it doesn't happen immediately, and the lead time has been very inconsistent. Historically, a recession can come anywhere from one to two years after the curve flips upside-down, and the stock market usually continues to gain from the day of the inversion until the cycle peak." (Barron's)

Significance of this Inversion

"The yield curve has merely inverted by a handful of basis points thus far. This fact doesn't invalidate the signal altogether, but it means the signal is at the faint end of the spectrum and could well vanish with only a slight recalibration of the bond market.

"Most econometric models of the yield curve require that the curve be inverted for a full quarter before formally triggering a recession signal. That has not yet happened, and there is a chance that it doesn't happen at all given the limited extent of the inversion." (The Hill)

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CONCLUSION

It is just too premature to draw any meaningful conclusion at this time. The 10-year Treasury (2.50%) is now slightly higher than the 3-month Treasury (2.44%); therefore, the yield curve is no longer inverted. Another aspect that calls this inversion into question is the fact that the US 10-year rate was dragged down by sharply falling 10-year rates around the world (both Germany's and Japan's 10-year rates actually went negative) rather than a reaction to a negative event in the US economy. We will have to patiently watch and see what unfolds.

OUTLOOK

The first quarter of 2019 was very strong. Beginning the day after Christmas, the market recovery began which followed the sharp sell-off that took place the last quarter of 2018. As of the writing of this newsletter, the market has almost recovered the entire decline since 9/30/2018. The reasons for this great market move were: first, the Federal Reserve changed its policy from one of steadily increasing interest rates and monthly reducing the FED balance sheet by selling off some of its bonds and mortgages (called QT - Qualified Tightening). The FED's new policy is "data dependent" meaning that they are no longer going to operate on an automatic timetable but, instead, to study the current information and make decisions accordingly. This approach has been beneficial to the economy and the market because a big negative factor has been removed.

Second, the other big reason was the uncertainty surrounding the US - China trade negotiations. During the early months of this year, the reports concerning the state of the negotiations have been generally positive thereby, being a positive influence on the market. No one can know for sure what is going on, and in the words of the great philosopher, Yogi Berra "It ain't over till its over!" So, it seems favorable but we won't know until there is a final deal, but it has helped the market during this first quarter. These two large factors along with the extremely oversold condition of the market at the end of 2018 provided us a great start to 2019.

Looking ahead to the rest of the year, there are, as always, pluses and minuses to consider. On the plus side we have (as mentioned) a neutral FED, a seemingly favorable US - China trade negotiation, central

banks around the world injecting money into the system (QE - Quantitative Easing to combat sluggishness in their economies), a strong US labor market, a growing US economy (although less than last year's strong pace), a global economy that is showing signs of bottoming and beginning to recover and the continuing effects of the tax cuts and deregulation in the US.

On the minus side, we have

- Brexit (the British break-up with the European Union which could be disruptive to the global economy),
- the trouble with illegal immigration on the US-Mexico border which could disrupt trade (in 2018 trade between the two countries was over \$612 billion),
- the brief yield-curve inversion,
- the decline in the rate of US corporate earnings from the torrid pace in 2018, although at this time the decline seems to be moderating,
- the sluggish global economy although it seems to be bottoming, and
- the large move in the stock market.

We believe that the pluses still outweigh the minuses. However, the market is very unlikely to maintain its current pace throughout the year. We think that there will be more volatility, but if the US-China trade deal continues favorably and concludes, the market can still make more progress in 2019. As always there can be unforeseen events that can dramatically change the perspective.