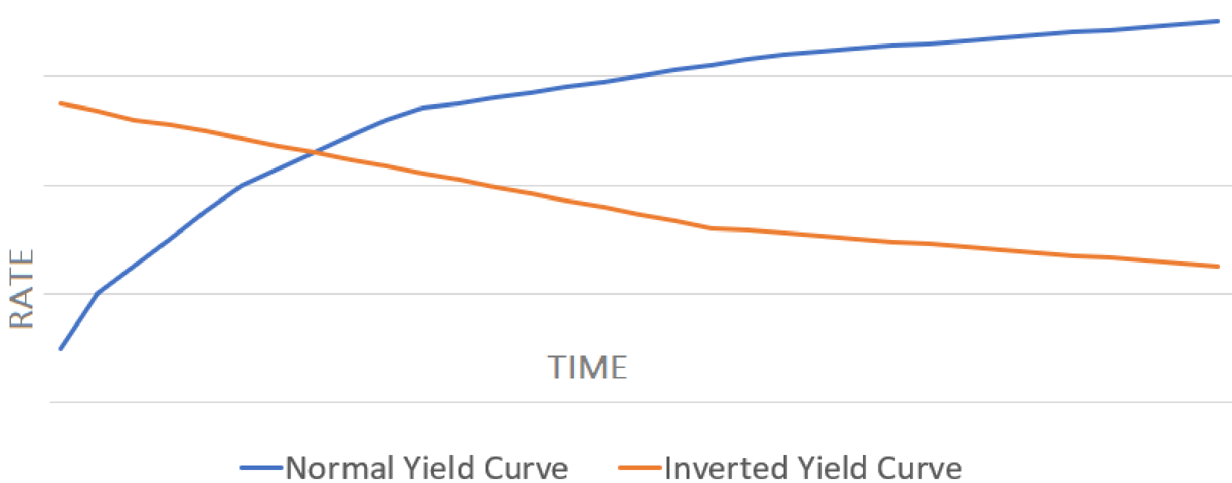
DECEMBER 10, 2018

A DISCUSSION OF THE YIELD CURVE—WHAT IT IS, WHAT IT MEANS TO THE ECONOMY, WHERE WE ARE, AND WHAT COMES NEXT

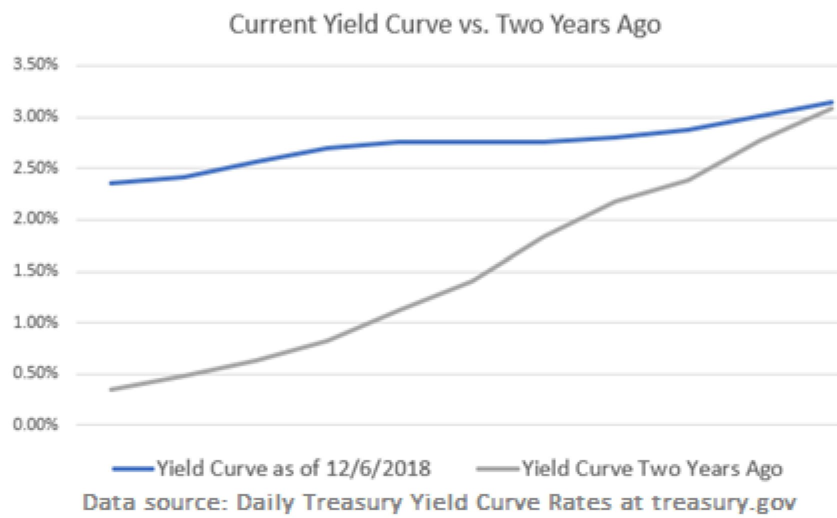
With the heightened market volatility of late, you have likely heard a lot of talk about the yield curve and its hinting a potential recession. Here's why we're not worked up, yet!

A PRIMER--WHAT IS THE YIELD CURVE?

The yield curve is simply a line that illustrates the relationship between interest rates for securities of the same credit quality and varying maturities. A **normal yield curve** is one in which short-term debt instruments have a lower yield than long-term debt instruments. An **inverted yield curve** is one in which long-term debt instruments have a lower yield than short-term debt instruments. For example, if you were to lend your friend money for one year, you would likely demand less interest than if you were going to lend them money for five, ten, or twenty years.



A **flat yield curve**, as the name suggests, shows parity between rates of varying maturities and generally occurs as an economy is transitioning from either expansion to slower growth (or even recession), or when the economy is transitioning from recession to recovery (or even expansion). As the Federal Reserve has raised short-term rates over the past two years, the longer end of the curve has stubbornly increased, albeit slightly (hence a flattening of the current yield curve).



What does the Yield Curve mean to Markets?

In financial markets there are no sure things—and, as financial advisors, we cannot (and would be foolish to try to) use the word "guarantee." But if advisors and investors ever looked for (or accepted anything as) a sure thing, there is a leading economic indicator with a perfect record. Every modern US recession was preceded by an inversion of the yield curve by anywhere from around 18 to 24 months.

Therefore, it should not be a surprise that last week when the interest rate for 5-year government notes dipped below that of shorter dated securities (an inversion), it sent US equity markets lower on concerns of a looming recession.

Should we be Concerned?

While this leading indicator did trip the alarms last week, we're not concerned—yet!

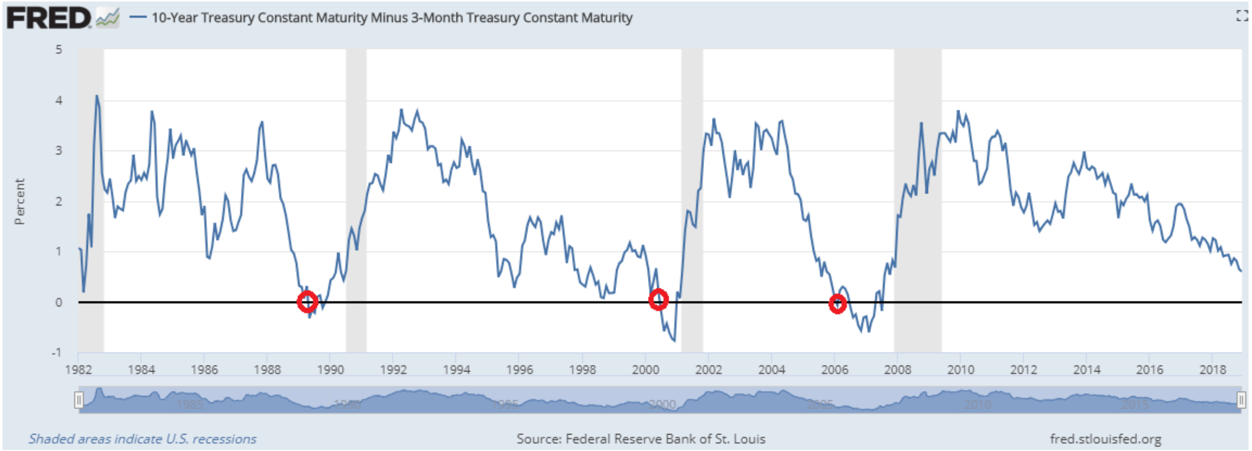
Reason 1: This wasn't the inversion we have all been watching for.

Not to discount that *an inversion* did occur, it is not *the inversion* that we have been bracing for. Widely accepted as the most important relationship is between the 3-month and 10-year rates (also closely watched is the relationship between the 2-year and 10-year rates). These portions of the yield curve, which are more closely watched, are not inverted. While the yield curve has been flattening, as of Thursday there is still a 46 basis-point spread between the 3-month and 10-year yield (the 2-year and 10-year spread is tighter at only 12 basis-points).

Reason 2: It is a leading, not immediate, economic indicator.

When the yield curve inverts, it is not an immediate signal of a recession. A recession is defined as two consecutive quarters of negative GDP growth—not defined as an inversion of the yield curve.

The below chart shows the spread, or difference, between the 3-month and 10-year yield curve since 1982. The red dots highlight when the yield curve inverted. The grey bands highlight periods of recession. As you can see, the inversion is not an immediate indicator of a recession. On average, there is a period of 18 to 24 months before the next recession after an inversion (and, by the way, the 3-month to 10-year has not inverted - the spread is still positive by 46 basis-points, as mentioned above).



Reason 3: The economy is still currently expanding.

We know that a recession is defined as two consecutive quarters of contraction in GDP growth. In the second quarter of this year, real GDP increased 4.2% and the second estimates of third quarter GDP still show a 3.5% quarterly growth. The economy is still in expansion. By definition, we cannot be any closer than 6 months to the next recession, and that assumes the economy were to begin to contract immediately.

What happens now?

As part of the Federal Reserve's support of the economic recovery, they did two things: they cut short-term rates (the fed funds rate) to near 0% and they made large purchases of longer dated US Treasuries and mortgage-backed securities to keep longer-term interest rates low as well (you have probably heard this referred to as "building their balance sheet"). For the past two years, the Federal Reserve has been systematically raising the short-term fed funds rate to begin weening the economy off its *recovery era morphine drip.*

As the Federal Reserve has raised short-term rates, the market has been clear that investors want rates to stay lower for longer (through the flattening of the yield curve). For obvious reasons, the Federal Reserve and Chairman Jerome Powell do not want to invert the yield curve. This flattening of the yield curve puts a lot of pressure on the Federal Reserve and Chairman Powell—but their options are limited.

As we see it, the Federal Reserve has two options. First, they can slow their aggressive schedule of rate hikes. Second, they can accelerate the unwinding of their balance sheet. Unwinding the balance sheet simply means the selling of the longer-dated Treasury and mortgage-backed securities on their balance sheet. By doing so, they would increase the supply of these longer-dated securities which, in theory, would reduce the price investors are willing to pay for these securities, thereby raising longer-term interest rates. Pushing longer-term interest rates higher would steepen, or at least hold steady, the slope of the yield curve.

We see an acceleration of the unwinding of the balance sheet as a less likely as it is an uncharted territory. No central bank in the world has ever attempted a balance sheet reduction of this scale. With the Fed announcing an emerging "data dependent" plan, we suspect that the Federal Reserve may take a more conciliatory approach in slowing the pace at which they raise rates to quell markets and hold off an inversion.

What are we doing?

Markets come in cycles. While the timing is uncertain, there will inevitably be an inversion of the yield curve and a recession. We do not believe that trying to time the market is a long-term winning strategy. While we cannot positively time the next recession or pullback, we are [fairly] certain that, after a nearly 10-year bull market, we are closer to the next recession and correction than the last. Here’s what we are doing on behalf of clients.

Proactive Management of Fixed Income

You have probably heard in the headlines that bonds are problematic due to low interest rates and the risk that rising interest rates will depress values of bonds in portfolios. There are steps that we have taken on behalf of our clients to mitigate this risk.

First, where appropriate we purchase quality individual bonds instead of funds. By owning an individual bond, we increase the certainty of outcomes. Though the ride (value) from start (purchase) to finish (maturity) may see ups and downs, a fixed coupon payment will be paid to the client along with a fixed payment of principal upon maturity (subject to the credit of the issuer, of course).

Second, we are managing clients’ fixed income portfolios to avoid longer-dated bonds. By holding shorter-dated fixed income securities, we are taking on less interest rate risk (risk that rising rates will hurt bond values). By holding shorter-duration bonds, it also affords us more flexibility to “trade-up” for higher yielding securities when longer-term interest rates finally see meaningful push higher in the years to come.

Rebalancing Portfolios

Over the last few years the equity markets have seen strong returns. While stock values have risen, so have the equity allocations in client portfolios. We are proactively rebalancing client portfolios to ensure that their portfolio equity allocations are in line with their overall risk tolerance and financial plan.

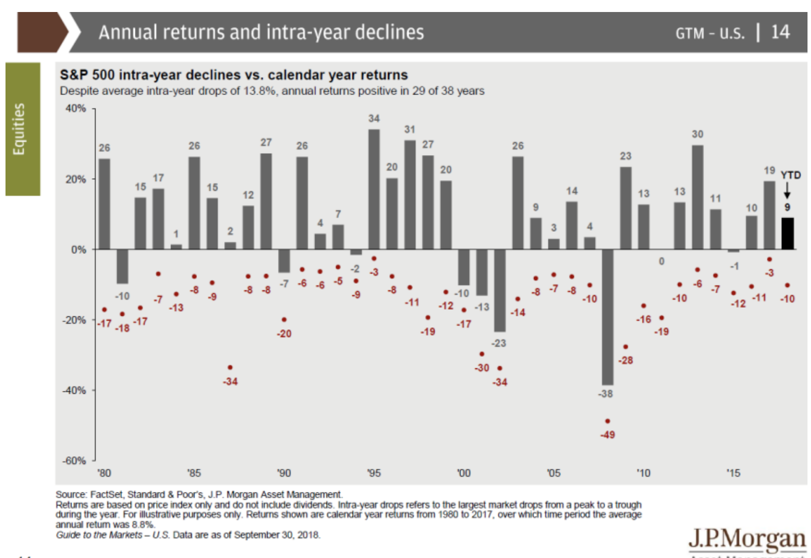
Focusing on the Long-Term Plan

Markets see ups, and markets see downs. While we do adjust portfolios along the way to try to smooth the ride for our clients, investing is for the long-term. Don’t let reactions to short-term movements in the market derail a long-term financial plan.

Looking to Alternatives

While we do see volatility on the horizon, we do not see an economic recession on the horizon until potentially the later half of 2020 (or even 2021). Even with a potential recession, there is nothing at this time to suggest it will have meaningful length or severity. As part of our ongoing relationships with clients, we continue to seek out and implement alternatives to the traditional equity and fixed income investments (of which there are many) to manage volatility and pursue better risk-adjusted returns.

While times may seem uncertain and markets are volatile, we remind clients that there is nothing abnormal about the markets at this time. It may feel unnerving, but market pullbacks are a reminder of what are defined as more "normal" markets. It has been several years since markets have seen historically "normal" volatility. Since 1980, the Standard and Poor's 500 Index has had an average intra-year decline of 13.8% while posting positive returns in 29 of those 38 years. Despite these averages, the Standard and Poor's 500 Index has had markedly little volatility over the last several years, not experiencing an "average" intra-year decline since 2011.



As always, should you have any questions, please do not hesitate to contact the office.

Bradley H. Bofford, CLU®, ChFC®, CFP®
Managing Director, Partner
973-582-1002
bbofford@hightoweradvisors.com

Michael Flower, CFP®
Managing Director, Partner
973-582-1004
mflower@hightoweradvisors.com

Daniel Trout
Partner
973-582-1006
dtrout@hightoweradvisors.com

Steven Gelber, AIF®
Associate Wealth Advisor
973-582-1015
sgelber@hightoweradvisors.com

Andrew Olivier, CFP®
Associate Wealth Advisor
973-582-1005
aolivier@hightoweradvisors.com

HIGHTOWER
FINANCIAL PRINCIPLES, LLC

FINANCIAL PRINCIPLES, LLC
A HIGHTOWER WEALTH MANAGEMENT PRACTICE

310 PASSAIC AVENUE, SUITE 203, FAIRFIELD, NJ 07004
505 FIFTH AVENUE, 4TH FLOOR, NEW YORK, NY 10017
973-582-1000
WWW.FINANCIALPRINCIPLES.COM

FOCUSED ON YOUR FINANCIAL INDEPENDENCE

Data sources: U.S. Department of the Treasury (treasury.gov), Economic Research-Federal Reserve Bank of St. Louis (fred.stlouisfed.org), CNBC (cnbc.com), Forbes (Forbes.com), GuruFocus (gurufocus.com), Reuters (reuters.com)