Is it time to cue the raven? Nevermore?

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The time has come for the annual rite of forecasting. What will 2019 bring? If you believe the stock market, the time has come to price in an economic slowdown. Whether or not what evolves is a "slow patch" or a full recession is up to the Federal Reserve Bank (Fed) in the United States.

In my view, every economic cycle has, at its heart, a credit cycle. Providers of credit (e.g., banks, savers, companies etc.) are willing to finance investment and consumption by both the public and private sectors. Early cycle credit expansion can be quite rapid, much faster than the growth in income. As the cycle matures, demand for credit slows as either the price (interest rate) is too high or the lender begins to doubt the ability of the borrower to service and repay the loan. In investment markets, the key indicators are the interest rate differential between short- and long-term interest rates and the interest spread between risky loans and the "risk free" government bond for the country you are investing in.

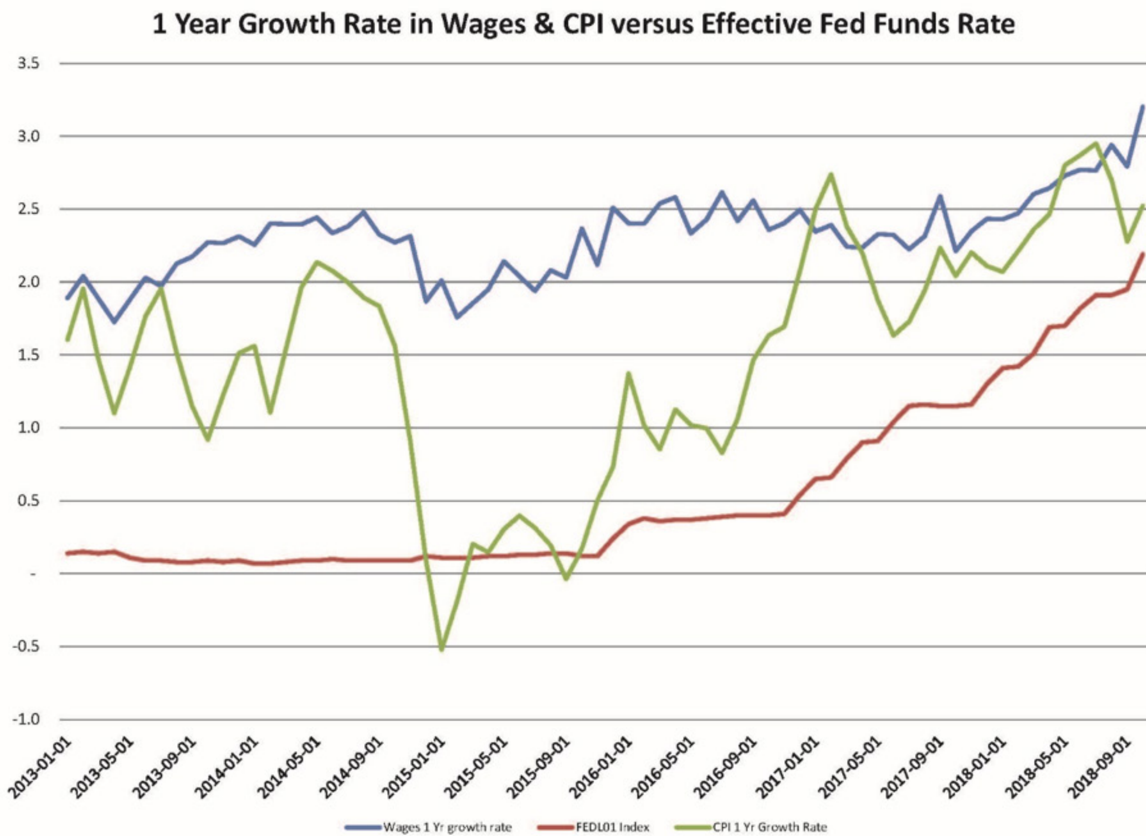
In Edgar Allen Poe's poem, The Raven, it is a bleak December when he is visited by a prophet of doom in the form of a raven. No doubt we will have doom laden forecasts coming our way this month. One of the key indicators of recession is when the yield curve inverts: short-term interest rates become higher than long-term rates. This process is engineered by the Fed to slow the growth of credit through price: essentially making it expensive. The yield curve has been flattening through this tightening cycle and the spread between short-term rates (3-Month Treasury Bills: 2.38%) and long-term rates (10-Year Treasury: 2.84%) is down to 0.48%. If the 10 year stays around 2.75-2.95% the yield curve will be flat with two tightenings of 0.25% and inverted with three.

What does this mean? In the modern era (post 1954) there have been thirteen periods with flat or inverted yield curves. Unfortunately, they are not consistent, rates move into and out of inversion. Nine of those were followed by recession. On the surface one should treat the possibility of recession as a reason to get defensive in portfolio positioning. Where this gets difficult is in timing. Not all yield curve flattening results in inversions and not all yield curve flattening results in recession. There is a material opportunity cost in reacting too quickly to a flattening curve.

I have gone through the timing of each yield curve flattening since 1954 and measured the time to recession and the time to, or from, an interim market peak. What I have found is there is no market timing signal inherent in this indicator. There are too many false positives. Even in the past two cycles the timing was uncertain. The curve flattened in March 2000, a full year before entering recession. The market peak was coincident with that curve flattening, but had nothing to do with yield curve analytics and everything to do with the blow-off of a speculative bubble in technology stocks. The yield curve flattened again in January 2006; recession and the stock market peak were almost two years away.

What a flattening curve does indicate is that risk is rising. In my client presentations and in my writing throughout 2018 I have been very explicit in recommending investors improve the quality of their portfolios. Participate in the last years of this cycle in high quality companies with good interest and dividend coverage. Own businesses that are structural to everyday life. The best way to accomplish this is to own businesses that generate free cash flow and avoid businesses that are consumers of capital. Each of the portfolio management teams at CI has their own way of analyzing, but one element that they have in common, is they all focus on the ability to grow cash within a business.

I fully expect the Fed to tighten at their meetings on December 18-19. But it is uncertain what they will do in 2019. The U.S. economy is running hot and at long last there is evidence of pricing power for labour. Wage inflation is over 3% after stalling at around 2.5% for years. The consumer is famously 70% of the US economy and consumer sentiment remains strong. Wage growth reinforces the consumers' well-being.

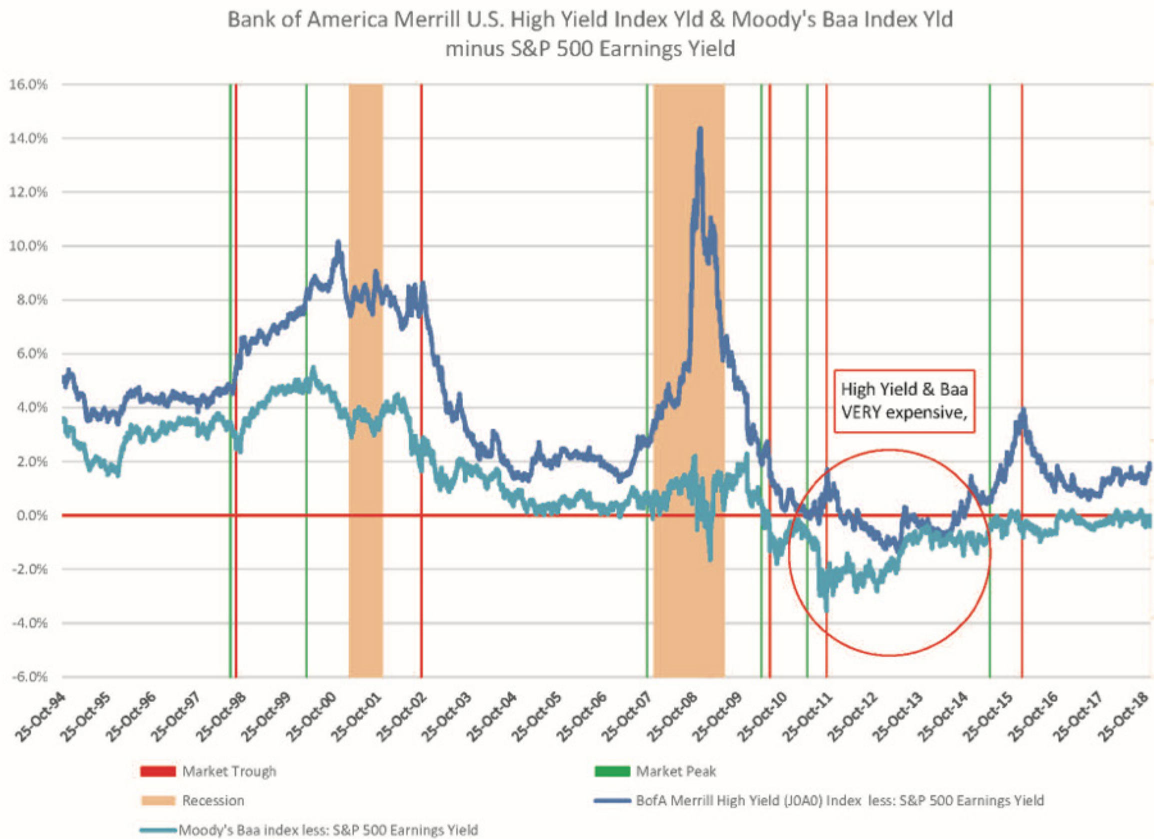


Let's assume that the Fed follows through on its measured process of tightening monetary policy. Cash is finally providing some return and becomes an alternative to stocks. Higher cash yields also put pressure on yields for investment grade and high yield bonds. What we have seen in the fourth quarter of 2018 is a re-evaluation of the price that investors are willing to pay for future growth in equities and a more appropriate risk premium for holding corporate debt.

I watch spreads closely. The yield premium for the ICE BofA Merrill Lynch US Pay High Yield Index has widened from 3.15% at the peak of the stock market in September, to 4.46% currently. The absolute yield is now 7.31%. With the timing of recession very uncertain, the default rate on high yield should remain very low. Our specialist bond managers at both Marret and Signature are taking advantage of the opportunities developing in this market. They are reversing some of the more aggressive defensive positioning that was put in place when spreads did not adequately compensate you for risk.

When you get into investment grade bonds, the benchmark Moody's Baa Index spread over treasuries has widened by 22 bps to 5.16%. This index is for long-term corporate bonds. I use it to judge whether stocks are expensive or cheap relative to debt of equivalent duration. Think about it: with the debt you have a fixed coupon for the next 20 to 30 years. With the equity you have an option on income growth over that 20 to 30 years. How expensive is the option?

In the following chart I compare the earnings yield of the S&P 500 Index to the yield on high yield and investment grade bonds. Which part of the corporate balance sheet is expensive or cheap?



Source: ICE Bank of America Merrill Lynch J0A0 High Yield Index; Moody's Baa Corporate Bond Index; Bloomberg L.P.; CI Investments

As of December 7, 2018

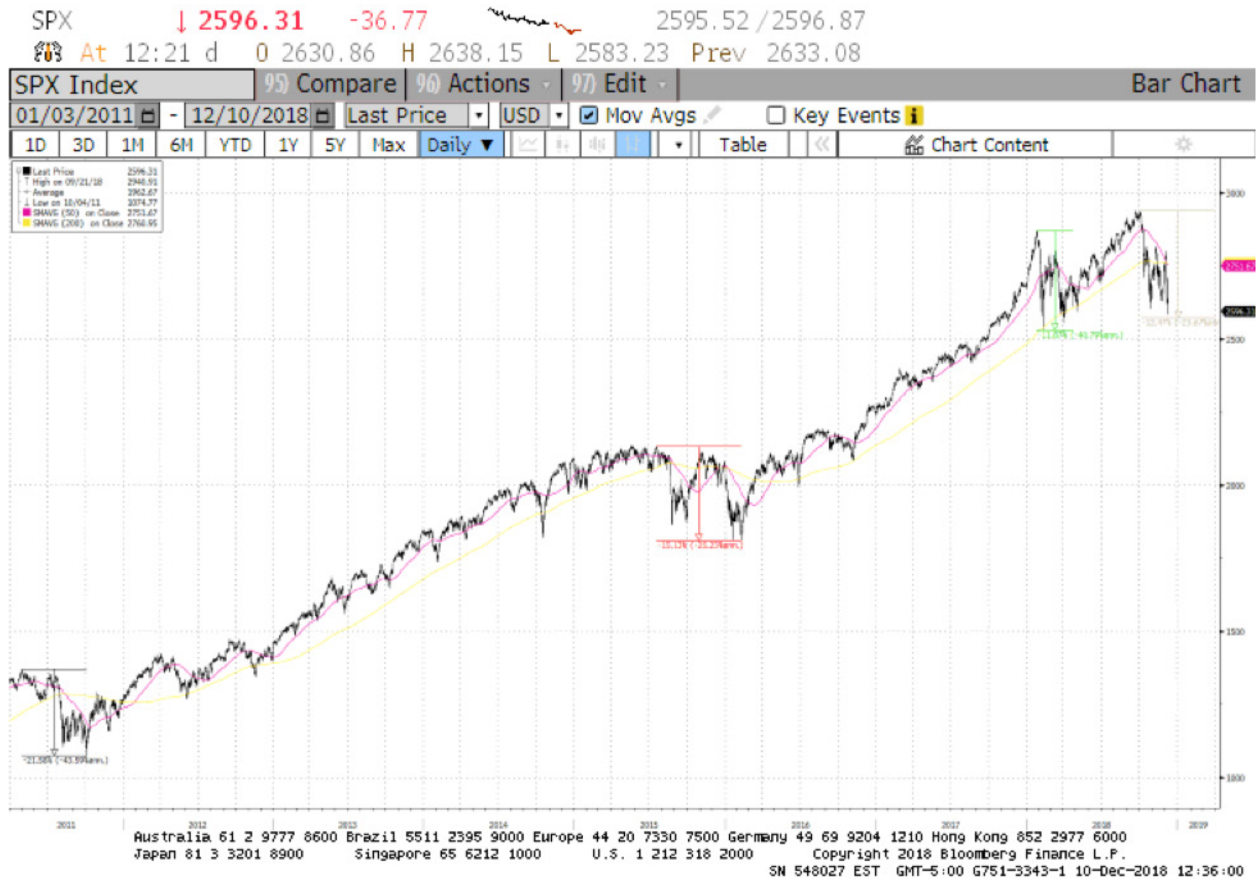
When the earnings yield for the S&P 500 is higher than the equivalent bond yield, the spread will be below the zero line. Since the financial crisis, investors have more highly valued the predictable coupons of investment grade debt instruments over the growth qualities of common stocks. During 2012 and 2013, high yield even traded at a valuation premium to equities.

Today, the S&P 500 is trading at 17.9x trailing earnings. This is an earnings yield of 5.6%. The equity has a yield premium of 40 basis points over the long-term bond equivalent; in effect you are getting a free option on a generation's worth of earnings growth. We do not know what 2019 will bring and we do not know if the yield curve will invert. If it does, we do not know the time line to a potential recession. It could be years away.

What we do know, is the Federal Reserve is well aware of a modestly slowing global economy and representatives, including Chairman Powell, have clearly stated that they intend to extend this business cycle as long as possible. From a purely practical point of view the cure for the deficits created by the 2018 tax cuts is taxes on income. A little wage push inflation would go a long way in helping to fix the U.S. balance sheet.

For those investors who indulge in technical analysis I can make a few additional comments.

SPX Index



Source: Bloomberg Finance L.P. As at December 10, 2018

The above is a chart of the S&P 500 from the start of 2011 to December 10, 2018. There are four meaningful corrections over the past seven years. In 2011, 2015 and again in 2018 (two corrections), there are classic “dark crosses” where the 50-day moving average trades down through the 200-day moving average. These crosses can be harbingers of a more meaningful bear market. In both 2011 and 2015 they were false signals. If you sold as result of the cross, you were locking-in price close to market lows.

The 2018 dark cross occurred last week. Signal or noise? We will only know in the months to come. The market is in a corrective phase after making new cyclical highs. Valuations have corrected for the index and in many cases individual stocks are offering excellent value. Long-term investors, long-term savers should welcome cheap markets as an opportunity to buy good businesses at fair to cheap prices. I am still in a “buy the dips” point of view.

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