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Spread is not necessarily destiny

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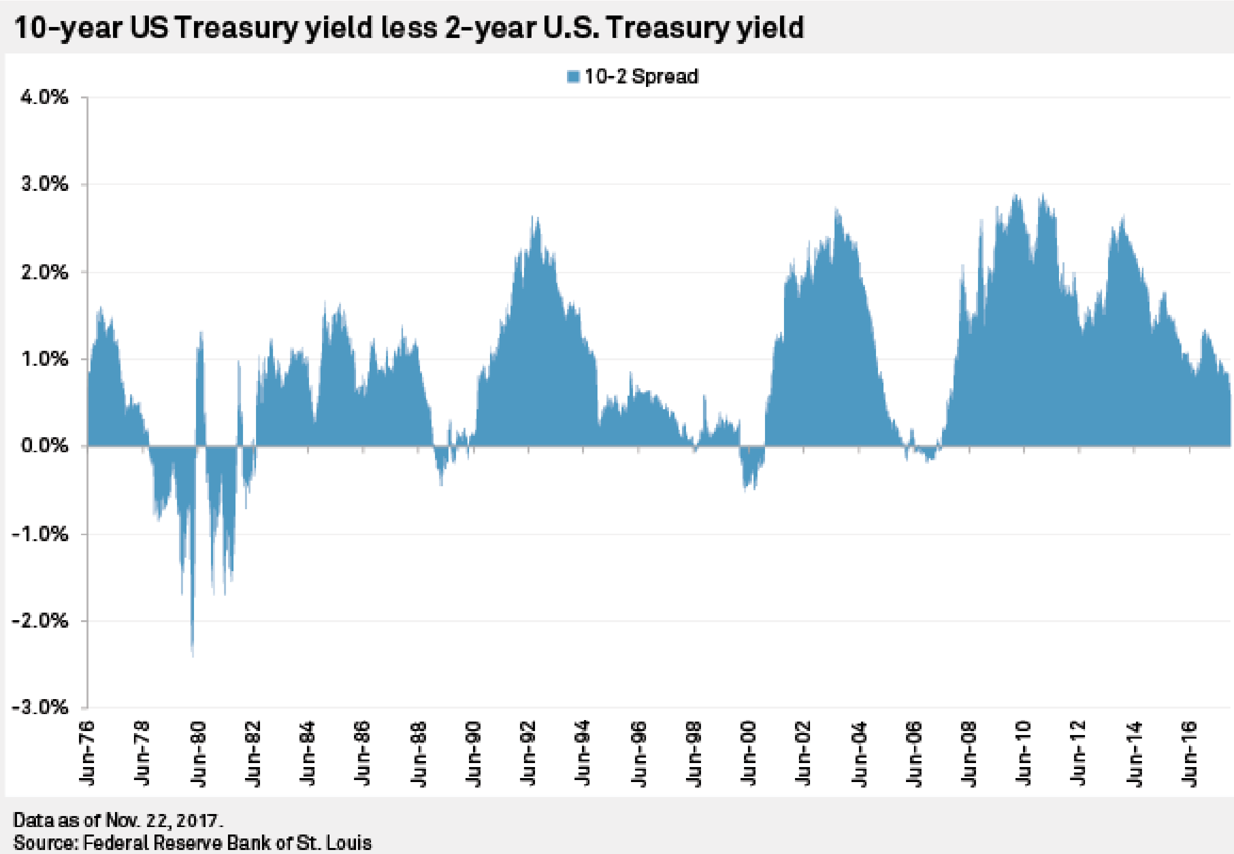
The internet of everything is making once-obscure financial metrics readily accessible to all. One such metric is the shape of the yield curve as measured by the spread between the yield on the 10-year and two-year U.S. Treasurys (10/2). It has been getting a lot of press lately, which I would like to add to with this post.

Many investors credit the bond market with a better forecasting record than the stock market, perhaps because bond investors are focused only on being repaid with interest. Unless a bond is purchased at a sizable discount to par or the coupon is unusually high, the return potential has been modest, or less than modest since the financial crisis. Equity investors on the other hand spend most of their time thinking about the potential upside over a particular time frame. The bond market speaks to reality while the equity market is about what is possible if not a dream (think Tesla).

Sometimes the bond market speaks especially clearly. Aside from the spread between corporate bond yields over comparable maturity U.S. Treasurys, the 10/2 spread is probably the most widely tracked bond market indicator in the U.S. When it is widening the economy is expected to perform well enough over the coming year or two. When it is narrowing the economy is expected to slow. Of course, “how much” is open to debate. If the spread turns negative then history says the bond market is shouting the odds of a recession are pretty good.

The accompanying chart tracks the 10/2 spread since 1976, a period which encompasses two deep back-to-back recessions in the early 1980s, the mild recessions of 1991 and 2001 and the off-the-chart 2008-2009 recession. In all instances the 10/2 spread turned negative before the economic recession occurred, which is not surprising because financial markets usually lead economic activity.



As of Nov. 22, the 10/2 spread was 58 basis points, which is below the 97 basis-point average since 1976. It is also well below the approximate 250 basis-point spread in mid-2013 following the selloff in longer dated bonds in 2013 when then Federal Reserve Chairman Ben Bernanke broached the subject of "tapering" bond buying at the Fed. Narrowing today reflects a "bear flattening" where prices for two-year notes have dropped and yields have risen in anticipation of Fed rate hikes. The yield on the 10-year has moved up since Brexit and the 2016 election but is range bound when viewed over the past few years.

One interpretation is the Fed has or will make a policy mistake by hiking rates too many times. The more the Fed hikes the more likely economic growth and future inflation will be restrained in the future. One too many hikes and the 10-year will rally in price, pushing the yield lower and potentially creating an inverted yield curve. The last inversion occurred in early 2007 when smallish subprime originators started to blow-up. The inverted yield curve then was a classic warning sign that trouble was brewing even though Bernanke would state a few months later that the subprime implosion was "contained." By the third quarter of 2007, the Fed was cutting short rates a little over a year after the last rate hike had occurred in the last tightening cycle.

Of course none of us know for certain what the future holds, including whether the curve will invert, which is a relatively rare occurrence. Once the Fed accelerates the pace of unwinding its balance sheet next year, long rates may trend higher and offset any additional tightening the Fed may undertake beyond a December hike that seems to be a given.

What is known is that the economic expansion that got underway in 2009 is mature by historical standards. Corporate and personal tax cuts, if enacted, probably will extend the expansion. At some point, however, we know the expansion will end. Before it does, an issue or two likely will develop in the credit and maybe currency markets based upon history.

What should we be watching besides commercial real estate? Private credit funds, which have raised vast sums of capital since the financial crisis as investors have accepted riskier ways to generate yield, are one asset class investors should track. These funds may be the equivalent of what structured investment vehicles (SIV) were in the last downturn. SIVs, which received little coverage in the financial media prior to 2008, were thrust into view when the assets that were financed began to drop in value, which in turn caused commercial paper investors to refuse to roll short-term financings. Given the edgier nature of the borrowers, business development companies (BDCs) also are a sector to watch. A number of BDCs have reported declining net asset values as a result of investments that are falling in value even though the economy is performing reasonably well.

Maybe the eventual turn in the credit cycle will not be too bad for commercial banks given the build-up in capital and what amounts to survival by today's lenders of what was worse than a 100-year flood. Credit losses as a result of the 2001 recession were modest for banks, in part because real estate did not crack then as was the case in the late 1980s and early 1990s. Nevertheless, I think the margin of safety for bank stock investors today is thin given elevated price-to-earnings ratios at a time when credit costs are very low. Whenever the cycle begins to turn stock prices could contract 20% or more as credit markets sort through “how bad” credit losses will be.

Usually the equity markets are the last one to get the memo.

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