Essential Economics

A Tench, L'Heureux & Fortier Wealth Management Team Newsletter September 2019

Economic Direction

Several factors, including inversion of the yield curve, zero/negative interest rates, the age of the current economic expansion and global trade negotiations present a number of challenges to the economy and investing. We thought it might be helpful for us to share our thoughts on these matters.

Yield Curve Inversion as a Predictor of Recessions

The 10-year US Treasury bond yield dropped below the 2-year US Treasury bond yield recently. A yield curve inversion of this nature has preceded each of the nine recessions since 1955, so it is a pretty reliable warning sign of a recession ahead. Those previous recessions started between 8 and 24 months (an average of 15 months) following the yield curve inversion. Following a yield curve inversion there is usually a pretty good run up in the stock market. Results have ranged from a decline of over 7% to a gain of over 25%, averaging a 9.5% upswing. It should also be noted that the yield curve has also inverted twice during that period without being followed by a recession. Furthermore, yield curve inversions generally occur when central bank overnight rates are driven up meaningfully to cool an overheated economy. While short term rates have risen modestly in the past year or so, neither those increases nor the rate of economic growth can be described as exuberant. This current yield curve inversion has been driven by a somewhat atypical decline in 10-year rates. Another reason to perhaps take this inversion with a grain of salt is that central bankers around the world are actively manipulating bond yields for both economic stimulus reasons and to manage the gobs of debt their governments are issuing, begging the question, “With the huge supply of government debt out there, would yields really be as low as they are if this interference was not taking place?”. The point of all this being that yield curve inversion, while a reliable economic/market indicator, is not 100% accurate in projecting a recession and when it does get it right the recession is rarely imminent. Just to complicate this issue further, at this writing the US 10-year yields are back slightly above the 2-year yields.

Near 0% Interest Rates

Since the great recession of 2008-09, central bankers around the world, most notably in Europe and Japan, have regularly pursued a policy of having interest rates in various segments of the government bond market at or below 0%. The object of the exercise is to help encourage economic activity. While

1602-50 O'Connor Street, Ottawa, ON K1P 6L2
Ottawa (613) 236-0103 Toll Free (800) 267-6586 Fax (613) 236-5916
Graham.Tench@nbc.ca Denis.L'Heureux@nbc.ca Chad.Fortier@nbc.ca
Visit our website www.TLFWealthManagement.com

this may have avoided a worse economic contraction a decade ago than might otherwise have occurred, it is also clear that it has not lead to truly robust economic expansion. There are a number of reasons for this. Central banks push down interest rates in order to encourage borrowing by businesses and consumers. However, commercial banks which generally do the lending, favour an environment where longer term interest rates are higher than short term rates. The zero/negative rate policy has led to a considerable flattening of the yield curve – in turn a disincentive to lending. This is taking place at a time when the large baby boomer demographic cohort is moving into and through retirement. While this group tends to buy less merchandise, they do spend extensively on services (e.g. travel, healthcare). With their savings earning less in a zero/negative rate environment, there becomes a temptation, and perhaps necessity, to cut back on spending in an effort not to run out of money in retirement. The idea of zero/negative interest rate is counter-intuitive to most consumers. Many have been left wondering how bad things really are to necessitate such apparently drastic action. All of these considerations may help explain the limited success in enhancing economic activity that has been the goal of zero/negative rate policies.

Even relatively stronger economies such as the US and Canada have seen interest rates kept below what their economic growth might otherwise call for. The Bank of Canada rate at 1.75% is only 0.75% above its post-2008/09 recession low, despite a decade of economic growth. Government bond yields in North America have been constrained, in part, by an influx of capital from overseas in search of actually earning a return on their bond investments.

The Later Stages of Economic Expansion

We are in a period where the rate of global economic expansion is slowing. That is to say, the economy is growing, just not as quickly as in the past few years. There could be a recession coming, possibly somewhere between 6 months and 3 years down the road depending on which economic scenario takes place. Because of the direct or indirect impact of tariffs related to the USA-China trade spat, some manufacturing sectors are in what would best be described as a recession. However, the service sectors and consumer spending (which account for the vast majority of economic activity in developed countries) are growing at a reasonable clip. The financial condition of consumers in the US is the best it has been in 50 years, as is the unemployment rate. The biggest factors which could upset that apple cart are the USA-China trade negotiations, Brexit and the disruptive aspects of ultra-low interest rates.

Global Trade Negotiations

The USA-China trade war/negotiations is the giant wild card in the global economic outlook. The uncertainty created by the prolonged hostilities has acted as a drag on manufacturing of goods and business investment. The final outcome of the trade negotiations is binary. Either they terminate negotiations and ramp up tariffs and boycotts to their mutual detriment (with an adverse impact on the global economy), driving equity prices down and bond prices up, or they reach a deal they can both live with, each going home and declaring victory. The latter remains the most likely outcome, as both countries are suffering economically from the spat and need a resolution to give their economies a boost. President Trump cannot afford to go into the 2020 election campaign with the US in, or entering, a recession. Both sides need a deal. Necessity being the mother of invention, we expect they will reach one. This is playing out a lot like the NAFTA/USMCA negotiations which took way longer than necessary, did not change a whole lot, but got rid of the tit for tat tariffs that got imposed during the negotiations and let everyone go home relieved and knowing what the rules are going forward. A similar outcome in the USA-China negotiations would likely push back the onset of a recession by up to a couple of years, giving a boost to equities, moving interest rates back up a little and thus causing longer term bond prices (especially government ones) to decline somewhat.

Brexit

Brexit is currently not likely to find a financially happy ending. The effect of the UK leaving the European Union without a trade agreement is likely to be a drag on both UK and European economic activity for a year or two, as both sides adapt.

Low Interest Rates

If low interest rates persist for too long, that could lead to some financial bubbles that do not currently exist, although the prices of medium to long term government bonds do look expensive.

The drop in yields has so far enhanced the performance of bonds that are elements of the investment portfolios of pension plans and insurance companies. Should zero/negative interest rates persist, insurance companies will need to raise premiums to make up for the absence of future returns on their bond portfolios. Similarly, pension plans will require greater contributions from its members to be able to fund the intended retirement benefits. Both of these actions would serve to draw economic resources away from more productive pursuits. It remains to be seen when, and indeed if, central bankers will do a turnabout on their enthusiasm of zero/negative interest rates. It will be a change of direction that will need to be handled delicately given the abundance of government debt outstanding.

Interest rates below the rate of inflation act as a sort of tax on savers and retirees who tend to have a greater portion of their investment portfolios invested in bond-type investments. In due course it might be reasonable to expect that the very large baby boomer generation may bring their considerable political weight to having this issue addressed from their perspective.

Investment Approach

Our viewpoint therefore, is to maintain an appropriately balanced investment portfolio, being prepared to reduce or possibly increase equity exposure dependent upon the outcome of the USA-China trade negotiations.