LPL RESEARCH
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YIELDS' MARCH MADNESS

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KEY TAKEAWAYS

Last week, the 10-year Treasury yield fell below the 3-month yield for the first time since 2007.

Long-term yields have been suppressed by the Fed's patient stance and international demand.

We expect solid fundamentals to push the 10-year yield back above 3% before the end of 2019.

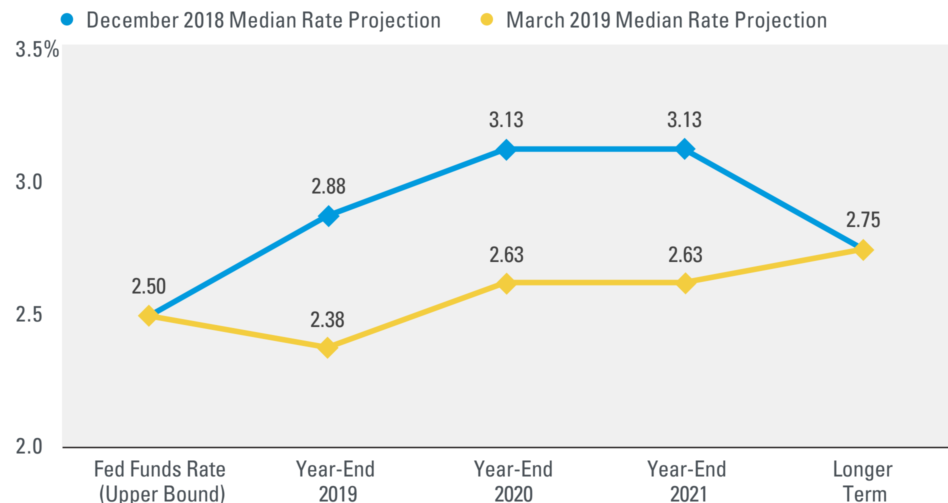
Investors are becoming increasingly impatient, even as the Federal Reserve (Fed) doubled down on patience at its March meeting. Policymakers signaled a complete pause in policy in a nod to slowing growth and global uncertainty, while Fed Chair Jerome Powell's praise of domestic economic fundamentals rang hollow for financial markets. Recession concerns intensified as the 10-year Treasury yield dropped through the end of the week, briefly falling below the 3-month yield on March 22 for the first time since 2007.

Yield curve inversion (or long-term rates falling below short-term rates) can be an ominous signal for the economy, as it's preceded each of the nine recessions going back to 1955. However, we encourage investors to understand the catalysts before bracing for an economic downturn.

A DIMMING OUTLOOK

One catalyst for falling longer-term yields has been the Fed's U-turn in policy since its December 2018 meeting. The Fed left rates unchanged last week for its second straight meeting, and updates to policymakers' projections painted a strikingly different picture of the U.S. economy and future policy than what was seen in the last set of projections three months ago. Taking some pressure off

1 WHAT A DIFFERENCE THREE MONTHS MAKE



Source: LPL Research, Federal Reserve 03/20/19
The economic forecasts may not develop as predicted.

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rates and the tightening financial conditions was part of the Fed's intended effect, but it came at the expense of a gloomier outlook.

In the latest "dot plot," Fed voting members projected slightly lower interest rates this year, with one more rate hike in 2020 or later to lift the long-term rate to 2.75% [Figure 1]. There is a growing consensus among policymakers that this tightening cycle has ended: 11 of 17 voters now forecast unchanged rates at the end of 2019, while six voters expect rates to stay at or below 2.50% (the current fed funds rate) through the longer term.

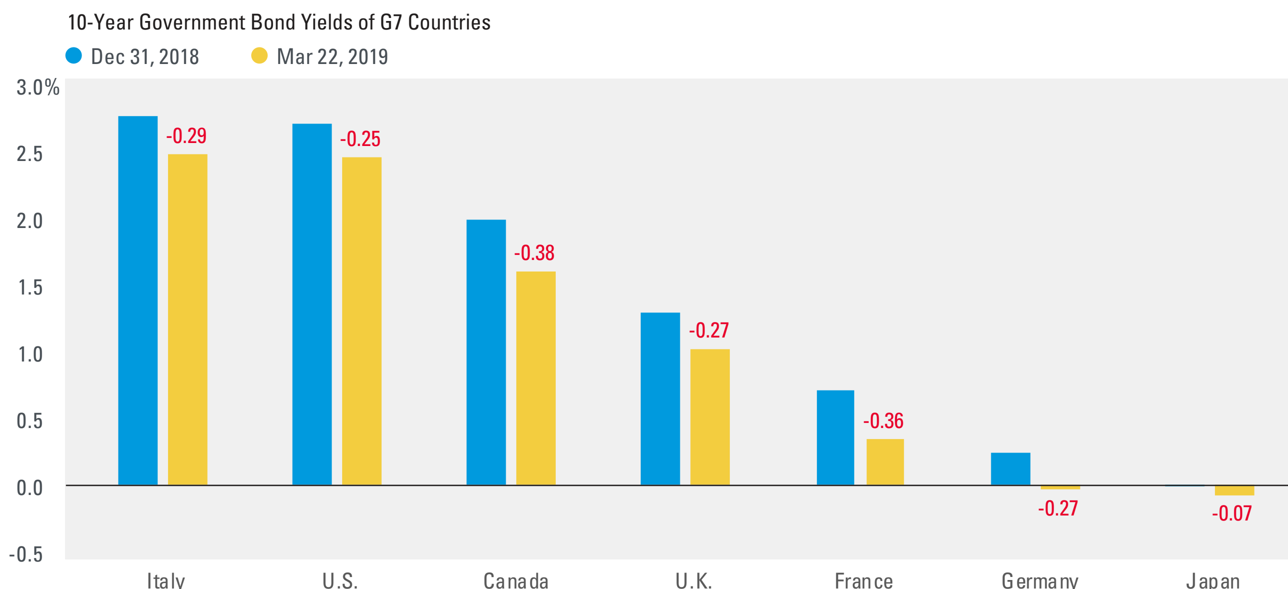
Policymakers also lowered their gross domestic product (GDP) growth projections to 2.1% for 2019 (below our estimate of 2.5% growth) and 1.9% for 2020. Overall, Fed policymakers expect lower growth this year and next, even amid rates at or lower than current levels. That was a tough pill to swallow for fixed income investors, especially in an expansion nearing its 10th anniversary. The 10-year Treasury yield fell 9 basis points (.09%) March 20, its biggest slide on a Fed announcement day since March 2017.

Global developments further complicated matters. The 10-year Treasury yield closed the week at a 14-month low as European manufacturing data continued to slide, and yields on 10-year German bunds, the debt of the Eurozone's largest economy, fell into negative territory. Negative bund yields were a shock to bondholders, and deteriorating global conditions have fueled intense buying in U.S. Treasuries as investors search for attractive sovereign debt yields. [Figure 2].

AN OVERREACTION

While economic conditions are becoming more tenuous, fixed income's reaction to recent events has been overblown, in our view. In his post-meeting press conference, Powell still conveyed significant conviction in U.S. economic fundamentals, noting that "it's a great time to be patient," as the labor market remains strong, economic confidence has been improving, and the outlook remains positive. Powell did acknowledge that global weakness could be a notable headwind

2 A ROUGH START TO 2019 FOR GLOBAL YIELDS



Source: LPL Research, Bloomberg 03/22/19

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to the U.S. economy, but added that it's difficult to estimate that impact on domestic growth. We believe Powell's balanced assessment was appropriate, and adequately summarizes the economic environment. The bulk of economic signals we watch points to low odds of a recession, and inflation remains at healthy levels.

To us, the Fed's dots are more of a reflection of the lack of clarity than a judgment on the economic outlook. The Fed is data dependent, and economic data, while sound overall, have noticeably weakened this quarter. Economists surveyed by Bloomberg have cut their first quarter GDP growth forecasts by 80 basis points (.80%) since the end of December in response to tepid data. It's tough to predict growth given complicated headwinds, and policymakers chose flexibility over optimism in rate projections.

The Fed must also consider global stability in its policy decisions, and Powell mentioned several times that global economic weakness is concerning. With a U.S.-China trade resolution likely being pushed out to the middle of this year, it could take several months before we see global stabilization. However, U.S. economic data have rebounded in the past month, and there has been evidence of the United States and China finding common ground in negotiations. Once trade risk is reduced, global demand should pick up and help support yields worldwide, easing buying pressure that has weighed on U.S. rates.

CONCLUSION

Even though the inversion between the 3-month and 10-year Treasury yields gives us pause, we would become more concerned if that negative spread were to widen significantly. Historically, the spread between the 3-month and 10-year yields has become much more predictive of a recession at -50 bps (-.50%). The recent inversion has been shallow and brief, and another closely watched segment of the yield curve, the spread between the 2-year and 10-year yield, remains positive. On average, the U.S. economy has taken about 21 months after the 2-year and 10-year yields invert to enter a recession.

The bond market is sending cautious signals, but we see plenty of evidence that solid U.S. fundamentals are intact even as the global economy struggles with intensifying trade and political risks. We see these risks as near-term headwinds, but we expect U.S. growth to stabilize and inflation to creep higher as the risks subside, which together would likely begin pushing 10-year yields back up toward 3%. Stabilization could also bring modest Fed tightening back into play before the end of the cycle, but accompanied by careful communication to minimize the shock to investors and the economy. ■

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