Fourth Quarter 2018 Commentary

Happy new year! We hope that your 2019 is off to a healthy and prosperous start.

Doing its best Dr. Jekyll and Mr. Hyde impersonation, the stock market went from euphoria in the third quarter to downright depression in the fourth quarter. From not worrying about much of anything, investors suddenly started worrying about everything, from rising interest rates, to slower growth in China, to an inverted yield curve and an imminent recession (more on this below). After reaching an all-time high toward the end of the third quarter, the S&P 500 went on a downward spiral that took the index into bear market territory, at one point dropping 20% from the peak.

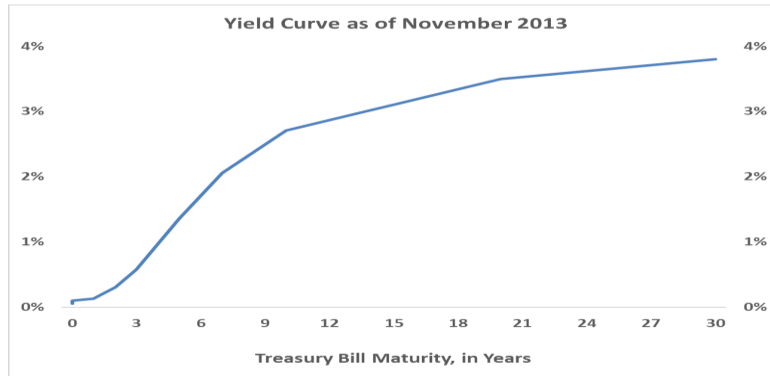
The drop gained steam in the last month of the year, with the S&P posting its worst December since 1931. Not even Santa Claus could lift the market's spirit, as the market had its worst Christmas Eve ever. After all was said and done, the S&P 500 was down 13.5% in the fourth quarter. The Dow Jones Industrial Average did somewhat better, but still dropped a substantial 11.3%.

The big fourth quarter decline wiped out all the gains for the year. For 2018 the S&P 500 posted a drop of 4.4%, with the Dow not far behind, falling 3.5%—the first negative year for U.S. stocks since 2008. The losses for the year were widespread and not limited to the U.S., as virtually every major international market suffered losses. At the end of the day, it seemed there was nowhere to hide in 2018.

Inverted Yield Curves, Recessions, and Bear Markets (Oh My)

Last quarter we wrote about how interest rates are finally starting to rise, when the yield on 10-year Treasury securities reached a multi-year high of 3.25%. Since then, the stock market has found a new interest rate-related wrinkle to worry about: an inverted yield curve.

Just what is an inverted yield curve, and why should we be concerned about it? Perhaps we should first explain what a yield curve is. The U.S. Treasury issues debt instruments in various lengths from one month up to thirty years. Usually the rate the government pays holders of its one-year bills is lower than the rate it pays holders of its two-year bills, and so on up to thirty. If you graph that relationship, it looks like a curve. Here is what the treasury curve looked like in November 2013, when the one-year treasury bill was yielding close to zero, the five-year around 1.5%, and the thirty-year nearly 4.0%:



source: www.exploreanalytics.com

As you can see, as you go out longer and longer in terms of treasury bill maturity, the rate you would earn as a holder of those bills goes higher and higher. Sometimes the slope of the curve is steeper, sometimes flatter, but this is all pretty normal. The short-hand metric that most people use to gauge the tone of the curve, and therefore what bond investors are predicting for the economy, is the difference between the yield on the ten-year treasury and the two-year treasury. This difference is usually referred to as the "treasury spread." Here are some examples of various treasury spreads from the recent past:

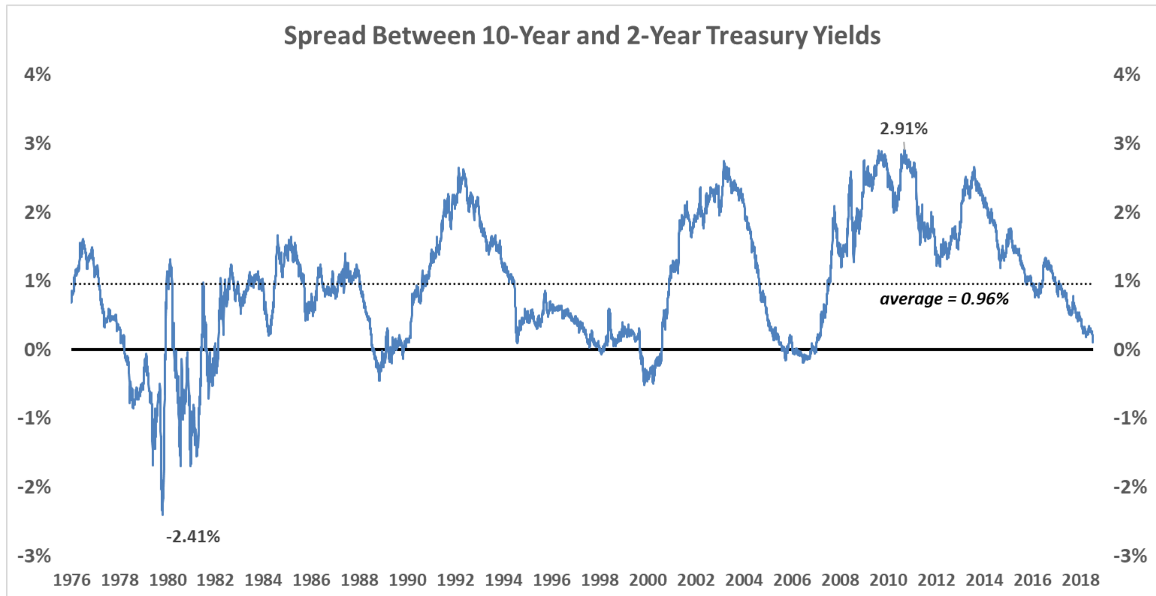
Month	10-Year Yield	2-Year Yield	Spread	Notes
March 1980	12.62%	15.03%	-2.41%	lowest spread
February 2011	3.68	0.77	2.91	highest spread
November 2013	2.69	0.29	2.40	example above
May 2017	2.23	1.27	0.96	average spread
January 2019	2.73	2.58	0.15	latest spread

source: St. Louis Fed, Inkwell analysis

To over-simplify things, the higher the spread, the greater people's confidence in how much the U.S. economy will be able to expand in years 3 through 10. Higher spreads imply higher expectations for economic expansion.

As the first row in the table above shows, sometimes you would earn a higher yield by buying a shorter-duration instrument. For instance, in March 1980 you would be better off buying a 15.03% two-year treasury bill than a 12.62% ten-year. When this occurs, the yield curve is said to be inverted. The most recent time this happened was in 2007, just before the Global Financial Crisis began.

Here is a graph showing how the spread between the 10-year and 2-year treasuries has trended over time:



source: St. Louis Fed, Inkwell analysis

In fact, there is an interesting relationship between yield curve inversions and recessions. Every single time the treasury spread has gone below zero, a recession has followed soon thereafter. So now you can see why, since the spread is just barely above zero and trending downward, everyone is freaking out.

If you look again at the previous chart, specifically noting each time the blue line goes below zero, you can see what we mean. Perhaps you are too young to remember the recessions of 1980 or 1989, but surely you have a sense for the economic turmoil that followed the most recent two inversions in 2000 and 2007.

So will the spread invert again now? Will a recession follow soon thereafter? And how will the stock market react?

Economic Zig Zags

As we have written before, the stock market often zigs when the economy zags. So just because the economy is in a recession is not necessarily a bad thing for owners of stocks. Just consider a few examples…. in 2009 U.S. GDP contracted by 3.1%, which was its worst-ever recession. The stock market, though, had one of its best years in 2009, with the S&P 500 advancing by 26%. That's even more than the 24% the market returned in 1951, when U.S. GDP had its best-ever growth of 7.7%.

Or take 2002 and 2007, when GDP advanced by a normal 1.8% and 1.9%, respectively. In 2002 the S&P 500 experienced a bear market and sank 22%, but in 2007 it actually returned a positive 6%.

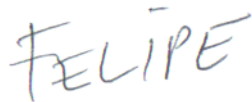
Conclusion

The point is that yes, inverted yield curves do usually lead to economic recessions. But no, economic recessions do not usually lead to stock market declines. They certainly can, but they don't always.

So the lesson to heed is what we wrote in our recent memo entitled Bear Market: "Money you have committed to the stock market is money that you have no need of in the short-term… We believe in the fundamental long-term strength of the American economy, and we believe that our country's businesses in general, and specifically the companies of which we are part-owners, will be more valuable five and ten years from now. So it's just a matter of keeping our heads about us and holding on for the wild ride between now and then."

By the way, there is no higher compliment you can pay us than referring us to your family and friends. We greatly appreciate the times you have done that in the past year, and we look forward to reporting to you again in three months.

Sincerely,



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