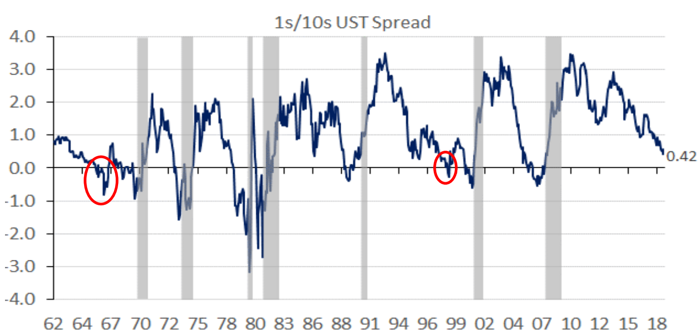
QV UPDATE

Weekly Commentary | August 17, 2018

Clement Chiang, CFA

The Long and Short of It

With the Bank of Canada and the U.S. Federal Reserve well underway in their rate hiking cycles, the investment community has been fixated on the increasingly flatter shape of both government yield curves. Recall, the yield curve is an imaginary line of best fit that is drawn across all bond maturities typically from a single sovereign issuer. It is the difference in yields of short and long maturity bonds that helps explain the shape of this curve, otherwise known as a term spread. Under generally positive economic conditions, the term spread is typically a positive value and indicates that longer bonds are offering higher yields than shorter bonds. Historically, the term spread narrows as the economic cycle ages and briefly turns negative closer towards the cyclical peak. A negative spread, or an inverted curve, results in short bonds offering higher yields than long bonds and is a sign that investors see slower growth ahead. An inverted curve has been a good leading indicator for past economic recessions and is a popular barometer in the investment community. As shown below, the term spread between 1yr and 10yr U.S. treasury notes (1s/10s UST) has been in steady decline and is 42bps away from inversion. No wonder Wall Street is so concerned.



Source: Haver Analytics, Bloomberg, QV Investors

The recent curve flattening has simply been the result of short maturity bond yields rising faster than long maturity bond yields. Short maturity bond yields are highly influenced by changes in the target interest rate of central bank policy and have historically traded in line with each other. Long maturity bond yields, on the other hand, are influenced by a wide host of factors that are seemingly in constant flux. Factors include changes in inflation expectations, long bond issuance, global central bank purchases and strong demand from institutional buyers, to name a few. Many of these factors, and perhaps others we are unaware of, have kept a lid on long yields, leading to the flattening effect that we see today.

It's very difficult for us to refute the validity of this indicator (and we're not) as its track record is near perfect. But by definition, still imperfect, as there have been two instances (circled in red) where the 1s/10s UST spread inversion was not immediately followed by a recession. These past head fakes are important to keep in mind, especially after a decade of unprecedented global central bank liquidity that has manipulated and compressed bond yields to historic lows. As bonds are still under the influence of monetary policy largess, how can we trust that the yield curve is accurately signalling a recession? Further, RBC's U.S. economist Tom Porcelli shared that since 1953, it has taken on average 18 months between curve inversion and the commencement of the next recession. And while the curve has yet to invert, an economic slowdown could still be a few years away. Can we even assume that inversion is near? Take a look at the mid to late 1990s, the term spread was range bound at similar levels for five years until the 2000 recession. Lastly, long bond yields remain bifurcated from otherwise healthy economic fundamentals, and a rising long end could delay inversion further if they finally normalize.

Rather than overreacting to the implications of this indicator, our rational thinking hats are checking back our emotions and keeping us focused on finding quality investments that are on sale. Our teams are still uncovering opportunities that can earn attractive risk-adjusted returns across our strategies. Although, we admit blatantly obvious deals are more difficult to spot than they were nine years ago. More to the point, the narrower opportunity sets and above average valuations have a larger influence on our conservative balanced asset mix than the shape of the yield curve. Currently, we believe we are adequately positioned for a market correction. And so, we need to control our emotions brought on by these fear gauges. They risk weakening our focus on finding investments that will have a larger impact in growing our clients' wealth. Similar to trading costs, distractions can add up and be costly over time.