Market Commentary

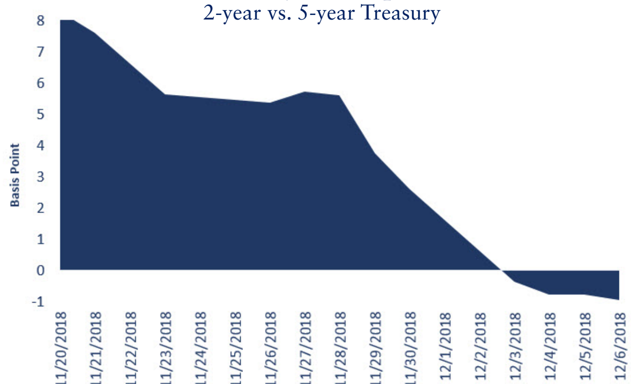
December 2018

It Was Only One Basis Point

When equity markets fall over 3% in a single day – like the carnage seen on December 4th – it is prudent to pay attention and ask a few questions. Two of the more important questions to ask are: 1) has anything fundamentally changed to cause such an outsized and negative reaction, and 2) are key investment assumptions still valid given new market developments?

Addressing the first question, one of the main culprits identified for igniting the December 4th sell-off was the single basis point (bp) inversion of the yield curve between two-year (2Y) and five-year (5Y) U.S. Treasuries. To be honest, I am not sure there are significant economic implications for a one bp inversion vs. the five to eight bp positive spread seen in the prior weeks, but the move did grab a lot of press – none of which was positive.

Treasury Yield Spread
2-year vs. 5-year Treasury



Scrutiny over curve inversions is warranted, as they have proven to be reliable harbingers of future recessions. In and of themselves, curve inversions do not cause a recession, but are a signal of market expectations for slower growth. For its part – and who am I to disagree – the Federal Reserve sees the spread between three-month (3M) and ten-year (10Y) U.S. Treasuries as a better measure of curve inversions. And while the 3M to 10Y spread is trending down from a 2018 peak of +136 bps, the spread is still around +50 bps.

Treasury Yield Spread
3-month vs. 10-year

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Tariffs caught some blame for the sell-off as well. A bit of context first: at the Group of 20 (G20) Summit it was announced the U.S. and China would delay imposing additional tariffs for 90 days, during which new trade talks would try to hammer out broad agreements around key issues such as intellectual property protections and coerced technology transfer. The prospect of cooperation and progress sent the S&P 500 up a healthy 1.9% over November 30th and December 3rd. Investors lost enthusiasm after President Trump professed to being a "Tariff Man," which I take was an endorsement of the Administration's hardline approach and not a proposed Avengers role. It probably didn't help that Larry Kudlow, Director of the National Economic Council, told reporters the tariff moratorium would begin on January 1st, only to have the White House walk the actual start date back to December 1st later that day. Getting everyone on the same page would assuredly improve investor confidence in the trade talks.

But I still have a hard time believing a small inversion in a specific portion of the yield curve or gnawing doubts over hypothetical trade agreements were such fundamental game-changers as to spark a 799-point plunge in the Dow Jones Industrial Average. Here's my best guess: the declines were driven more by technical than fundamental factors. I could envision the yield curve inversion sparking trading algorithms to sell equities. Couple that with illiquidity and distortions caused by the short notice market close on December 5th to honor former President George H. W. Bush and you have a recipe for a major technical sell-off.

So now we are left to decide whether our key investment assumptions are still valid in the face of the dramatic equity market sell-off. On the economy, we remain optimistic the U.S. can maintain steady, but slower, growth going forward. Strong employment, robust Purchasing Managers' Index data and contained inflation all argue for continued expansion, which should support overall investment-grade credit conditions and our strategy of over-weighting credit as a source of additional coupon income. We expect higher interest rates and slower growth will expose more levered, down-in-quality issuers and pressure some of those individual credit spreads. All of which argues for deep fundamental credit research and portfolio diversification, both of which have been and always will be core principals in our investment approach. If anything, market volatility should reduce the need for more aggressive Fed tightening, moving policymakers toward our forecast for one or two 2019 rate hikes rather than the current Dot Plot forecast for three.

Despite the market turmoil and yield curve inversion, we anticipate the Fed will meet market expectations and raise rates at the December 19th meeting. We also anticipate policymakers will use the opportunity to begin dialing back expectations for 2019 and 2020. For our outlook, this is more evolutionary than revolutionary. And absent a clear and unexpected shock to the economy or financial system, fixed-income investment strategies should evolve over time rather than knee-jerk react to the most recent data or events.

Action / Reaction Timeline

November 30 – December 3
S&P 500 gains 1.9%

December 1
G20 Summit

December 3
Tariff delay announcement and revision
2Y – 5Y Treasury yield inversion

December 4
DJIA loses 799 points

December 5
Markets closed for National Day of Remembrance

Sources:

Bloomberg

Business Insider, White House confusion over Trump's promised tariff delay shoes the slapdash nature of the trade deal with Xi Jinping, December 3, 2018.

@realDonaldTrump (Donald Trump). "….I am a Tariff Man. When People or…" *Twitter*, 04 Dec. 2018, twitter.com/realDonaldTrump/status/1069970500535902208

[See next page for important disclosure information.]

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