ECONOMIC & INVESTMENT PERSPECTIVES

MARCH: MARKETS REMAIN VOLATILE

YIELD CURVE INVERSIONS SIGNAL TROUBLE AHEAD

Figure 1: 3/31/2022 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-2.8%	-5.8%	-4.3%	-8.3%	1.1%
Investment Grade Corp Bonds	LQD	-2.9%	-8.4%	-4.9%	-11.6%	2.1%
U.S. Treasury Bonds	GOVT	-3.2%	-6.5%	-3.9%	-7.9%	0.9%
20+ Year Treasury Bonds	TLT	-5.4%	-10.6%	-1.0%	-14.9%	3.5%
Muni Bonds	MUB	-2.6%	-5.4%	-3.8%	-7.1%	0.4%
High Yield	HYG	-1.3%	-4.7%	-1.7%	-6.7%	3.0%
Non-US Corp Bonds	IBND	-3.0%	-7.7%	-10.7%	-17.1%	1.3%
Emerging Markets Bond LC	EMLC	-0.3%	-4.8%	-7.5%	-16.2%	4.4%
Global Equity						
ACWI Global Equity	ACWI	1.9%	-5.7%	6.7%	-7.1%	9.0%
United States	VTI	3.3%	-5.4%	11.6%	-6.7%	10.0%
International Developed	EFA	0.5%	-6.5%	0.3%	-10.6%	10.6%
Emerging Markets	EEM	-3.4%	-7.6%	-13.7%	-19.6%	10.7%
Global Equity by Region						
United States	VTI	3.3%	-5.4%	11.6%	-6.7%	10.0%
Europe	IEUR	0.4%	-8.2%	1.8%	-11.2%	13.7%
Asia ex-Japan	AAXJ	-4.6%	-9.3%	-17.3%	-22.2%	10.4%
China	MCHI	-9.8%	-15.7%	-34.6%	-37.4%	21.3%
Japan	BBJP	-2.3%	-7.9%	-8.3%	-18.0%	6.3%
Latin America	ILF	13.0%	29.5%	19.1%	-6.5%	34.6%
US Equity						
US S&P 500	IVV	3.8%	-4.6%	15.6%	-5.9%	13.5%
NASDAQ 100 QQQ	QQQ	4.7%	-8.8%	14.2%	-11.3%	14.7%
US Large Growth	IWF	4.0%	-9.0%	14.9%	-11.0%	13.7%
US Large Value	IWD	2.9%	-0.7%	11.4%	-3.2%	9.5%
US Eqwt S&P 500	RSP	2.7%	-2.7%	12.9%	-4.4%	11.2%
US Mid Cap	IJH	1.3%	-4.9%	4.4%	-8.1%	8.3%
US Small Cap	VTWO	1.3%	-7.6%	-6.0%	-16.1%	9.3%

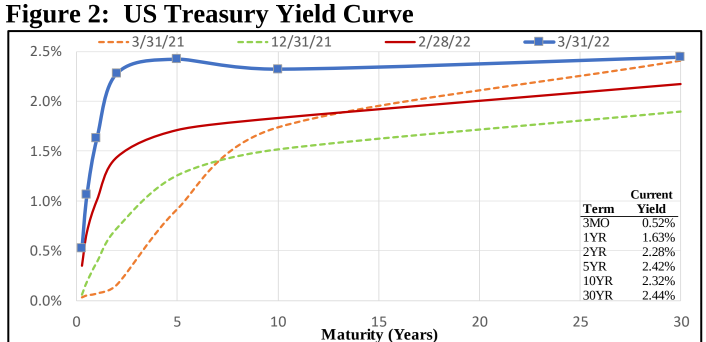
Markets continued to be volatile in March as war raged in Ukraine. Uncertainty is high due to geopolitical tensions, trade and supply disruptions and elevated commodity prices (oil, metals, agriculture). Oil remains near $100 per barrel, exacerbating inflation pressures as the Fed begins to raise rates. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The U.S. Aggregate index (AGG) fell 2.8% (-5.8% YTD) as interest rates rose. Corporate bonds (LQD) were down 2.9% (-8.4% YTD), and high yield bonds (HYG) fell 1.3% (-4.7% YTD) as credit spreads narrowed. Emerging market credit (EMLC) lost just 0.3% for the month (-4.8% YTD).
- Global equity (ACWI): +1.9% in March (-5.7% YTD).
- U.S. Equity: Stocks recovered somewhat in March. The broad market (VTI) gained 3.3% (-5.4% YTD), while the S&P 500 (IVV) rose 3.8% (-4.6% YTD). Large growth stocks (QQQ and IWF) rose more than 4% but remain 11% below previous highs. Small caps gained 1.3% (-7.6% YTD). Commodity-oriented sectors (energy, materials) and defensive issues (utilities, health care) posted solid gains while financials lagged.
- Non-U.S. Equity: Developed markets (EFA) rose 0.5% (-6.5% YTD), led higher by commodity-rich countries like Australia (EWA +9.9%, +6.4% YTD). Emerging markets (EEM) fell 3.4% (-7.6% YTD) despite gains in Latin America (ILF +13.0%, +29.5% YTD); new COVID lockdowns in China (MCHI -9.8%, -15.7% YTD) added to uncertainty in Asia.

Interest Rates and the Economy

The US yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Yields rose across the board in February as the Fed raised interest rates for the first time since 2018. The yield curve remains flat at longer maturities and is partially inverted (short-term rates higher than long-term yields), increasing recession concerns as the Fed removes accommodative policy measures (more on page 2). The benchmark 10-year bond yield ended the month at 2.32%.

Figure 2: US Treasury Yield Curve

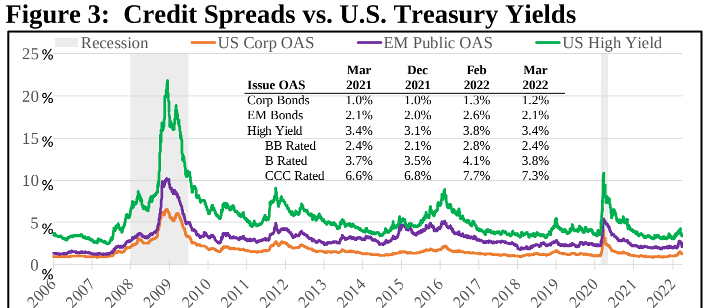


Source: Board of Governors of the Federal Reserve System via FRED

For bonds other than U.S. Treasuries, we track the option-adjusted yield spread (OAS) versus Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. After widening in February, spreads narrowed in March, even as geopolitical tensions remain high.

- Investment grade corporate bond spreads were down to +1.2% this month but remain higher than +1.0% spreads a year ago.
- High yield (non-investment grade) spreads narrowed to +3.4% this month, comparable to year-ago levels. The riskiest bonds (rated CCC & below) yield +7.3% over Treasuries, down this month but still above 2021 levels; this "junk bond" segment has a disproportionately high exposure to energy-related debt.
- Emerging market bond spreads narrowed to +2.1% after spiking to +2.6% last month with geopolitical tensions; these spreads had been stable at around +2.0% for most of 2021.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



Source: Ice Data Indices, LLC via FRED

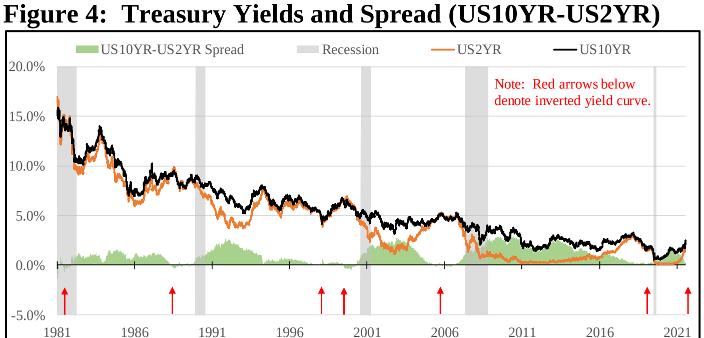
Inverting Yield Curve: Recession Warning

As discussed on page 1, the U.S. yield curve has begun to invert. Figure 2 on the prior page shows that the curve is taking on an odd shape, with the 5-year yield now exceeding the yield on 10-year Treasuries (2.42% vs. 2.32%, respectively). More importantly, the yield on 2-year Treasuries exceeded the 10-year yield briefly last week and is doing so again as we write. As this is gathering quite a lot of attention from investors and pundits, it is important to understand what it means and why it is important.

Normally, interest rates are higher for longer-term maturities, so the yield curve tends to be upward sloping. This this makes sense from a risk perspective: A bond buyer (lender) demands a higher rate of return from the debt issuer (borrower) for longer maturities (payback period) to compensate for time and inflation risk; short term bonds generally carry lower interest rates because they get paid back quickly (less risk). The yield curve is "inverted" when yields on short-term Treasuries are greater than longer-term rates. This is not normal and is a signal that something is wrong.

While inverted yield curves do not cause recessions, they have historically been a good predictor of recessions, as illustrated in Figure 4 below. Specifically, every recession in the past 50 years has been preceded by an inverted yield curve. Figure 4 uses the "term spread" to illustrate how the shape of the yield curve changes over time. (Note: The term spread is the difference between yields on different Treasury maturities; e.g. if the 10-year yields 2.32% and 2-year note yields 2.28%, the 10YR-2YR term spread is +0.04%). In Figure 4, the black line tracks the yield on 10-year Treasuries since 1981 (40+years); the orange line tracks the yield on 2-year Treasuries; and, most importantly, the green area represents the spread or difference between 10-year and 2-year yields. When that spread is negative, the curve is inverted, as indicated by the red arrows at the bottom of the graph.

Figure 4: Treasury Yields and Spread (US10YR-US2YR)

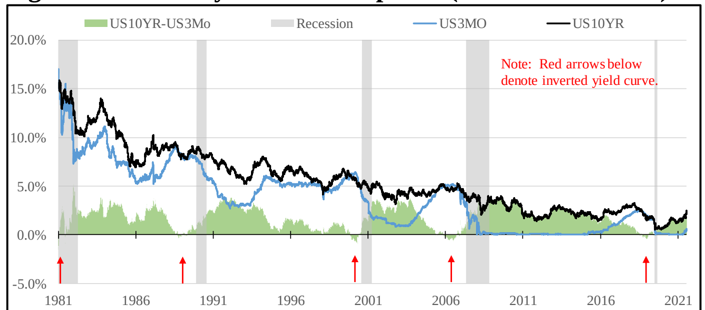


Source: Board of Governers of the Federal Reserve System via FRED; National Bureau of Economic Research (NBER)

The inversion of the spread between 10-year and 2-year U.S. Treasuries has clearly been a signal that the economic cycle is aging and that the likelihood of recession (gray bars) is rising. In the last 50 years, this signal has predicted recession within 19 months on average (ranging from six to 34 months lead time). This spread gave an early signal in 1998 in the middle of the emerging market debt crisis, but a recession did occur in 2001.

There is no clear causal relationship between inverted yield curves and recessions. The Fed has strong influence over short-term rates through their monetary policy, but longer-term yields are more influenced by investor and market expectations regarding future economic growth. In expansionary periods, short and long rates tend to move higher with growth and inflation; when investors turn pessimistic, they tend to reduce risk, buying long-term Treasuries, driving yields lower in anticipation of declining growth and interest rates. Inverted yield curves occur late in the cycle when the Fed is raising short term interest rates in order to fight inflation (like now), juxtaposed with growing pessimism about future economic growth, pushing long-term rates lower. Because the Fed most directly influences short-term interest rates, the spread between the 10-year yield versus 3-month T-bills is an even better indicator of recession risk. In Figure 5, the black line tracks the yield on 10-year Treasuries; the blue line tracks the yield on 3-month T-bills; and the green area graphs the spread or difference between 10-year and 3-month yields.

Figure 5: Treasury Yields and Spread (US10YR-US3MO)



Source: Board of Governers of the Federal Reserve System via FRED; National Bureau of Economic Research (NBER)

This spread has not yet inverted, but with the Fed raising rates aggressively to fight inflation, it is probably just a matter of time. The "normal" sequence of events is that the 10YR-2YR spread inverts first, then the 10YR-3MO spread inverts, and recession follows within 12-24 months. Figure 6 lists the inversion-to-recession lead times over the past 50 years.

Figure 6: Yield Curve Inversions and Recessions
(source: St. Louis Fed – FRED, NBER)

10YR-2YR Inversion	10YR-3MO Inversion	Recession Start	10YR-2YR Inversion Lead	10YR-3MO Inversion Lead
Aug-1978	Jan-1979	Feb-1980	17 months	12 months
Sep-1980	Nov-1980	Aug-1981	10 months	8 months
Dec-1988	Mar-1989	Aug-1990	20 months	16 months
May-1998	Sep-1998	Apr-2001	34 months	31 months
Dec-2005	Jan-2006	Jan-2008	24 months	23 months
Aug-2019	Mar-2019	Mar-2020	6 months	11 months
Mar-2022	?	?	?	?

Bottom Line

Global markets are volatile due to a myriad of concerns and rising uncertainty: war and geopolitics; on-going supply disruptions (especially energy); significantly elevated inflation in the U.S. and around the world; and the removal of accommodative monetary policy in the U.S. (Fed raising rates) and, eventually, around the world. The inverting yield curve is an early warning regarding economic concerns. This is not just happening in the U.S.; yield curves in other developed economies are beginning to invert as well, especially in Europe. With inflation running hot, the Fed (and other central banks) have no choice but to tighten monetary policy by raising interest rates from the historic lows implemented to avoid economic calamity in the wake of the pandemic.

We continue to hope for a resolution of the Russia-Ukraine crisis to end the suffering of the Ukrainian people as well as to stabilize global markets. We expect the Fed to continue raising rates for the foreseeable future and are watching the yield curve inversion closely. Diversification is critical in this volatile environment.

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