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TRAHAN MACRO RESEARCH

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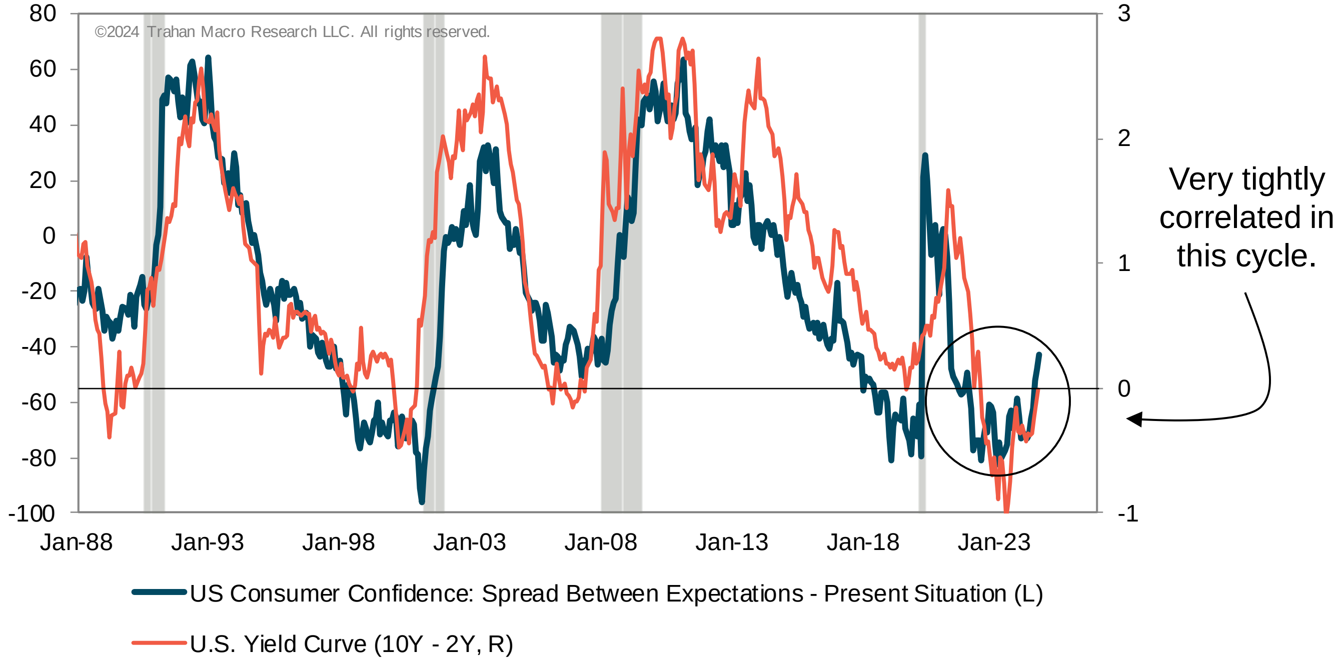
UN-Inversion Of The Yield Curve …Threats & Opportunities!

The yield curve is one of those indicators that gains periodic attention in our industry, usually near the end of a monetary tightening cycle. Its track record as a recession/risk indicator is hard to ignore as we have seen the yield curve invert in the run up to every single recession of the last 50-odd years. Interestingly, this warning sign is often dismissed by investors for one reason or another. There certainly have been plenty of naysayers in the current cycle. In this week's report and next week's conference call (Tuesday October 1st at 10:30am: register here) we will try to demystify the yield curve and its coming UN-Inversion.

Yield Curve Still Strongly Correlated With Economic Indicators



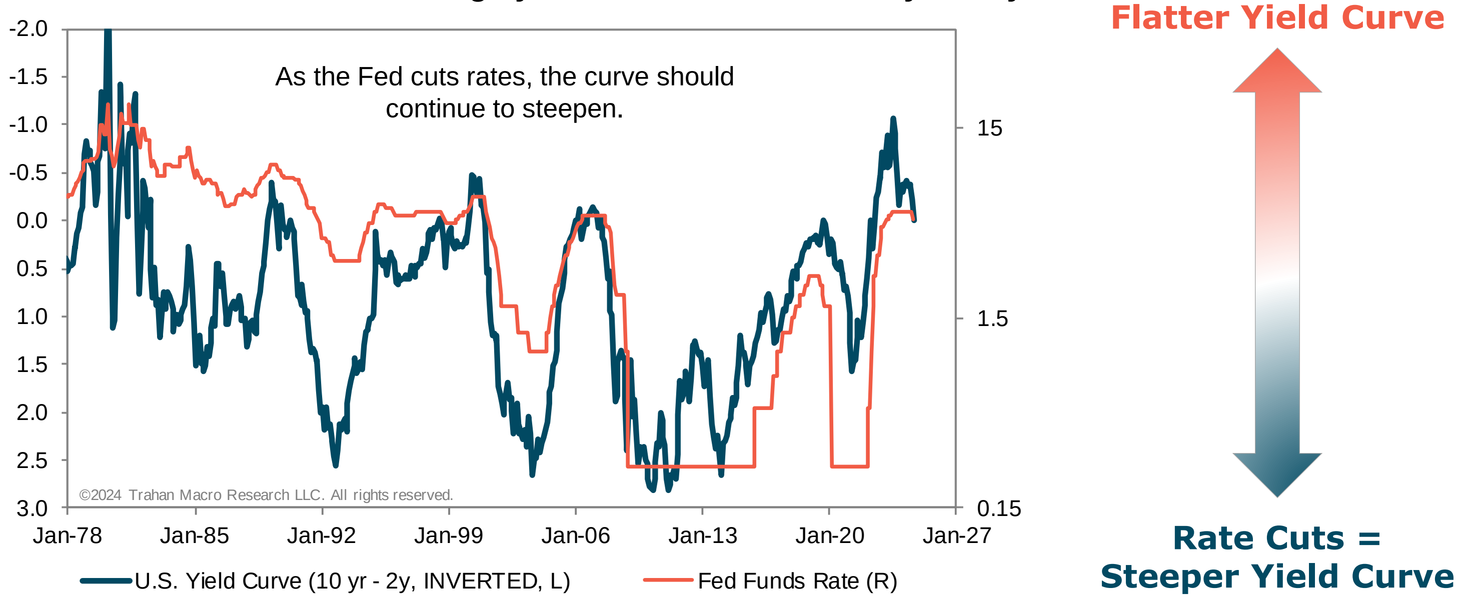
We are not believers that the yield curve is impaired and should be ignored. The chart above – and there are many more like it in our arsenal – shows that it is still correlated with economic data. In the case above, that is consumer sentiment. At the end of the day, an inversion in the yield curve is a sign that monetary policy is binding. In that vein, it correlates well with other proxies of monetary policy like real rates or the neutral rate, all of which are flashing warning signs now. It's not the inversion in the yield curve that is problematic for the economy and markets. In fact, it's when the curve finally UN-inverts that recession risks are truly heightened.

The beginning of a Fed easing cycle is usually synonymous with a steepening yield curve and this often begins from inverted territory. There are many important messages from this dynamic and we expect this UN-inversion in the yield curve to become an important influence/indicator for the rest of 2024 and throughout 2025. This week, we briefly review the likely implications for markets, especially when it comes to asset allocation and positioning portfolios. Hope you can join us next week Tuesday on the conference call (register now). Wishing you a great rest of your week. All the best. Francois

The 1st Inning Of An <u>Extended</u> Monetary Easing Cycle

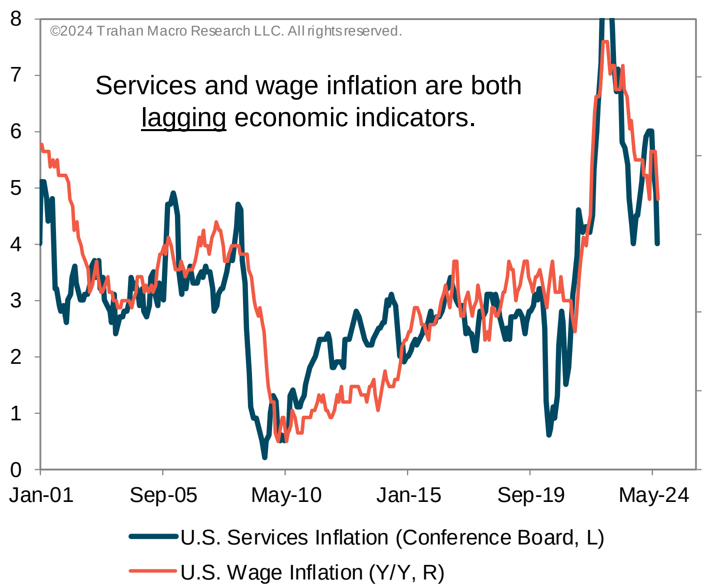
The yield curve is really nothing more than a gauge of monetary policy. A Fed tightening cycle is usually a sign that the yield curve is flattening, and vice versa. In that vein, IF the yield curve is inverted AND the Fed starts to cut rates one should expect the yield curve to steepen and UN-invert at some point soon. History shows there are many repeated patterns associated with this steepening process for both the economy and markets. This is what we will home in on in next week's conference call as we review the portfolio implications of an UN-inversion process.

Trends In The Yield Curve Largely A Reflection Of Monetary Policy

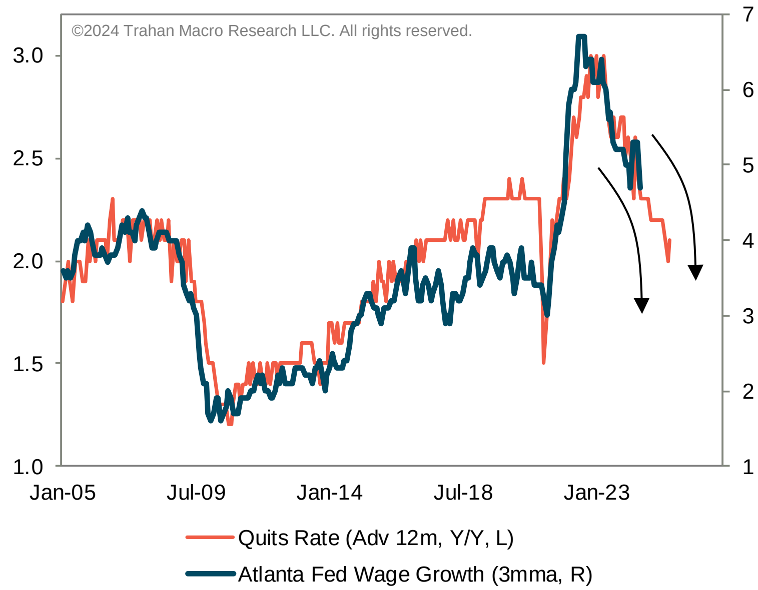


Exactly why do we think that the Fed easing cycle will last for some time? First, the average easing cycle last about 18 months so even a "normal" scenario would take us into 2026. Realistically, however, this is not a typical cycle. What seems clear is that the Fed has given up on forecasting. They simply expect real GDP growth to be 2% for the next three years and now willfully talk about being "data dependent" which should concern all investors. IF they are truly data dependent and set policy based on last quarter's results then there is a lot of easing coming – and probably well into 2026.

Wage Inflation ≅ Services Inflation



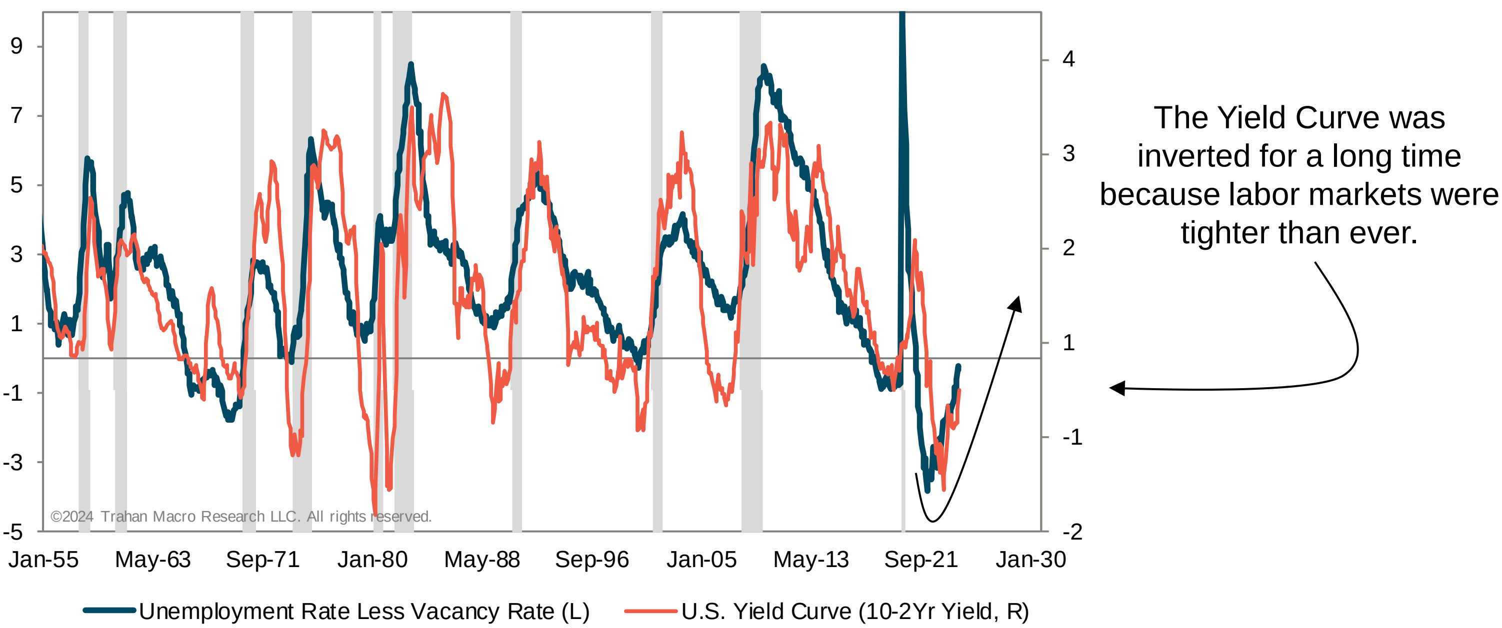
Wage/Core Inflation … An Old Story!



An Unusual Post-Covid Cycle – But With Hindsight, Aren't They All?

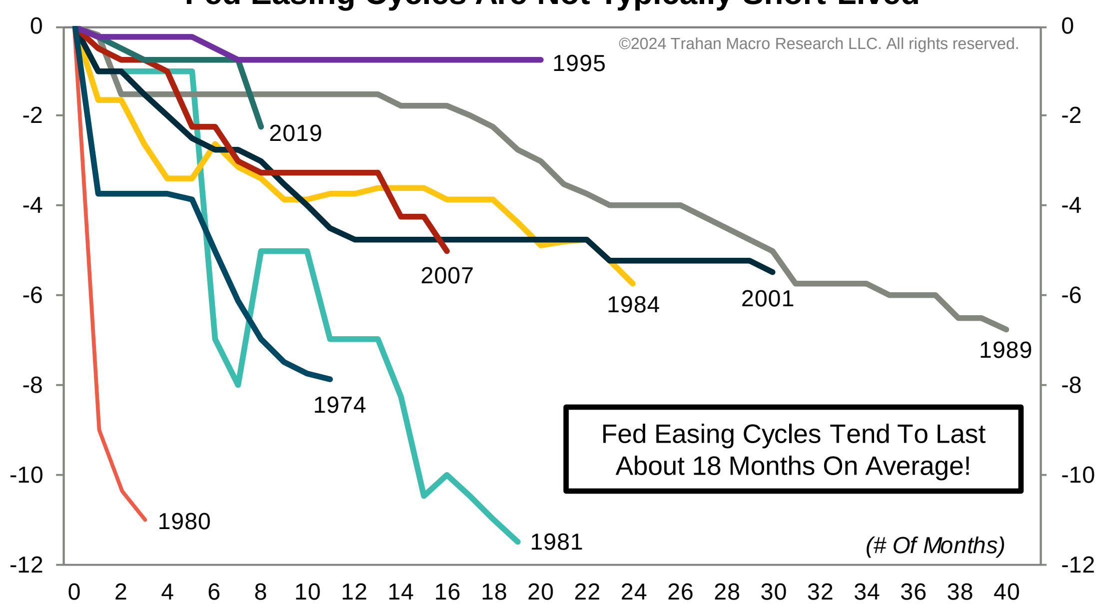
One of the arguments of the "yield curve is broken" crowd is that it was inverted for a long time, and nothing happened. It's pretty easy to see that leads/lags between an inversion in the yield curve and an eventual recession are quite variable. As the chart below illustrates, labor markets tend to dictate trends in policy and the yield curve by extension. We have had the tightest labor markets in 70 years of available data and that is consistent with an extended inversion in the yield curve.

Recessions Arise As The YC Un-Inverts And The Labor Market Softens



If the Fed is going to react to instead of forecast data, then we are in for an extended period of dovish policy. We already know that changes in the fed funds rate take about two to two-and-a-half years to impact series like the unemployment rate. The implication is that the unemployment rate may be trending higher through 2026 if the historical relationship holds. How in the world will we not see the unemployment rate top the Fed's official forecasted peak of 4.4%? We were almost there just a month ago. The bottom line – expect increasingly dovish revised forecasts.

Fed Easing Cycles Are Not Typically Short-Lived



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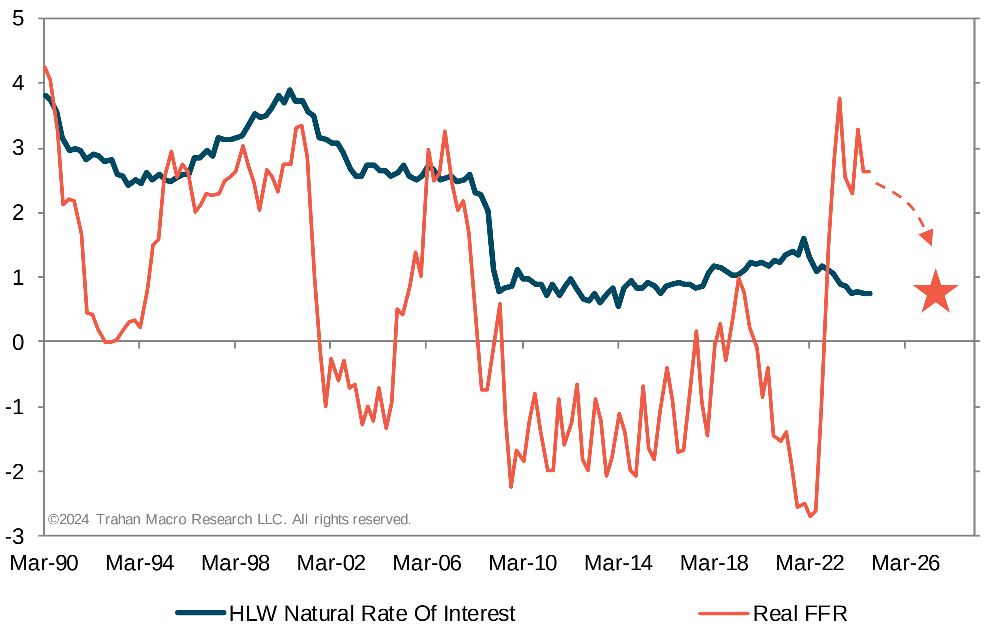
LEIs More Helpful Than Fed's Forecasts … For Forecasting The Fed!

This is one of the times when the neutral rate (also know as r-star) comes into focus in a cycle. The Fed is clearly using it, consciously or not, in their forecasts. Friendly reminder that this is the rate at which the economy is stable between inflation and growth. The New York Fed estimates that it is roughly a 1% real rate. Unsurprisingly, perhaps, the Fed's forecast for inflation and their own dot plot would leave real rates at about 1% by the end of 2026. Not a whole lot of science here.

Fed's Official "Target" Clearly Influenced By R-Star

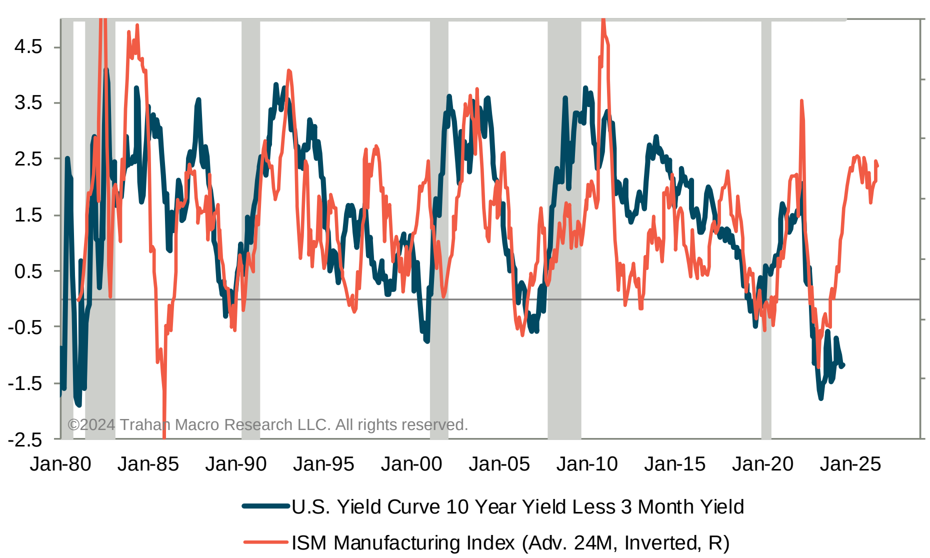


FOMC 2026 Estimates

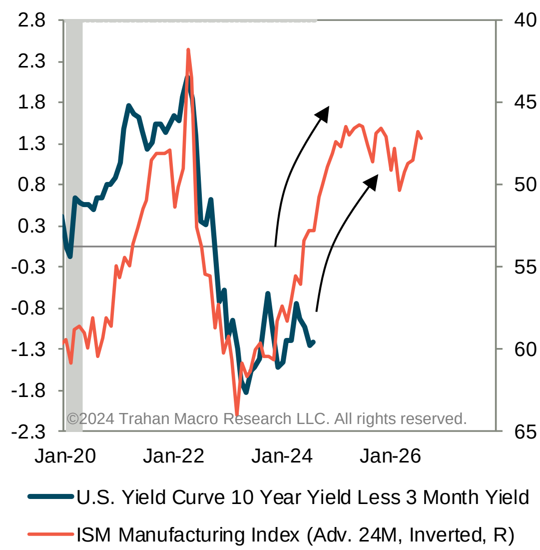
Fed Funds:	2.9%
Inflation Target:	2.0%
Real FFR:	**~ 1%**

The message that seems loud and clear from the chart above is that policy is currently very binding. Hence, the Fed *should* be dovish. One interesting way to forecast the yield curve – and Fed policy trends – is to look at LEIs like the ISM Manufacturing PMI. They tend to lead the yield curve by about two years. Tell me WHEN the ISM will be at its lowest and about two years later, we should then see the most dovish Fed and the steepest yield curve of the cycle. Since we are writing this with the ISM sitting near cycle lows, we are talking about dovish policy for at least two years?!

LEIs Provide Tremendous Insights On YC And Policy



Hmmmm!



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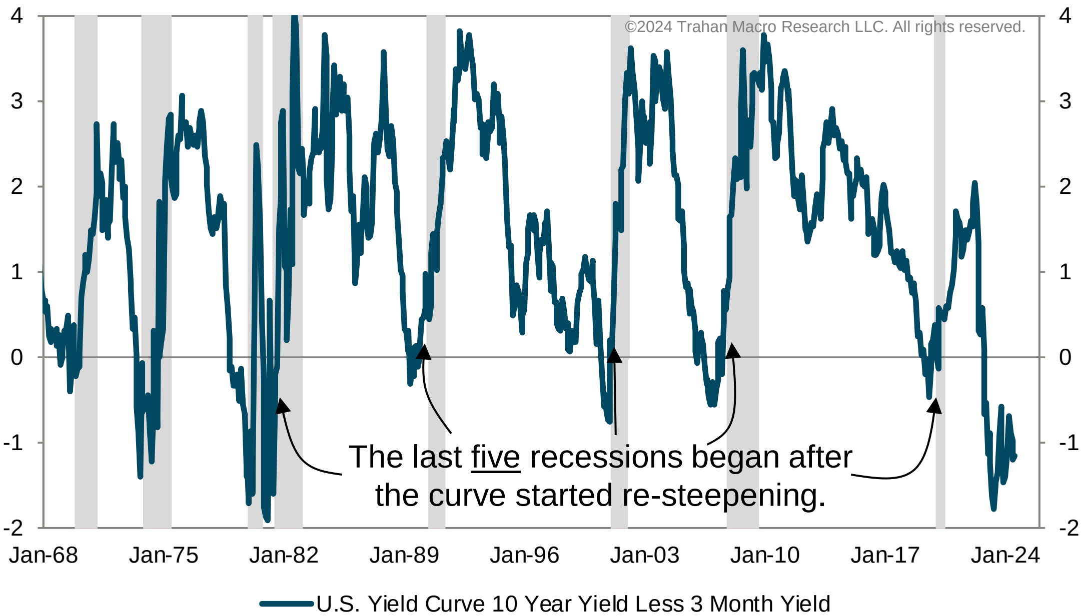
It's The UN-Inversion In The Yield Curve That Is Typically Problematic

We have already covered the historical track record of the yield curve and the economy. Given that the yield curve is a proxy of policy, and an inverted YC means policy is tight or binding, it tells us that recession risks rise in the wake of Fed tightening. However, it is fashionable for some to dismiss the risks from an inverted yield curve. The Richmond Fed famously said in the spring of 2007 that the inversion had no implications for banking and the economic future.

Softer Labor Markets Trigger An Un-Inversion In The Yield Curve



In the last 55 years the 10Y - 3M YC, the Fed's preferred measure, has had a perfect hit rate. In other words, the curve has accurately warned of each of the last eight recessions.

An inverted yield curve is a sign that policy is tight. This by itself does not guarantee a recession, but it does reveal that it is a significant risk. The UN-Inversion in the yield curve is a sign that a recession is likely to start in the coming quarters or months. The UN-Inversion is more significant than the curve being inverted as we already know an inversion can last for an extended period. What we want to cover in this report and elaborate on in next week's conference call is what "typically" takes place when the yield curve is un-inverting, and there are many consistent patterns historically.

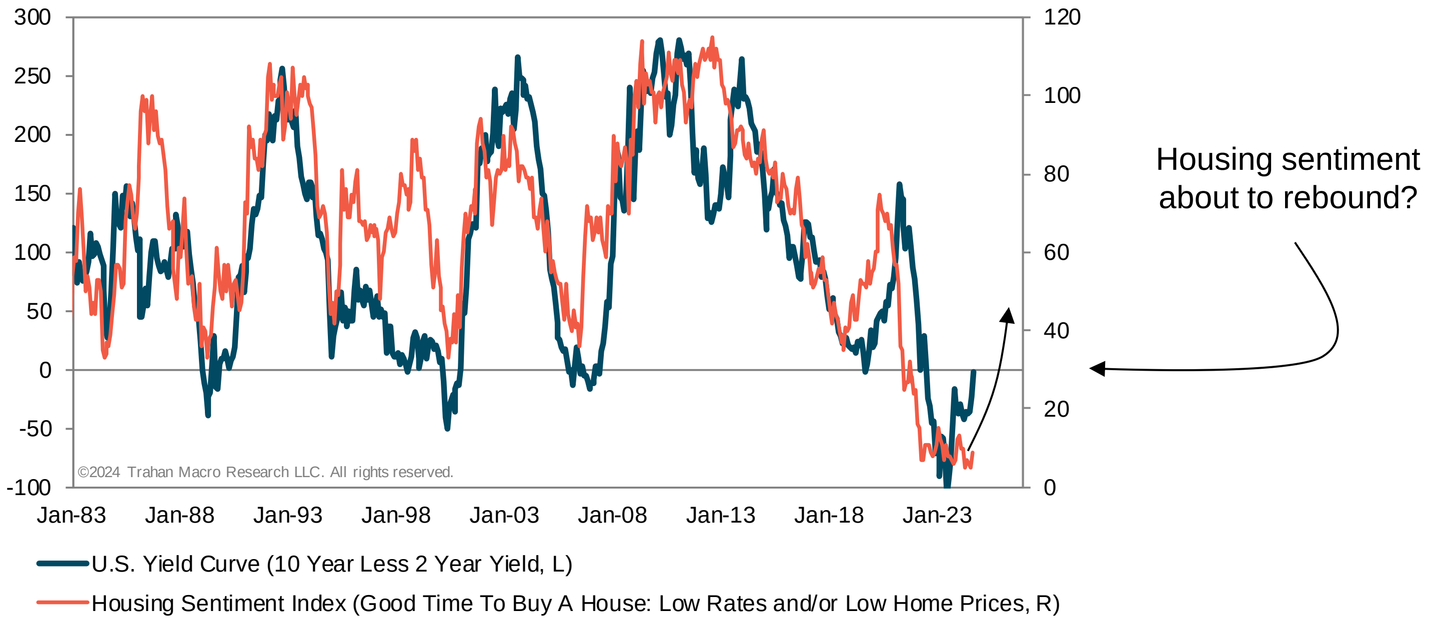
A High-Level Overview Of An Un-inversion In The Yield Curve

History's Take	1982	1989	2001	2008	2019
Housing Recovery	✓	✓	✓	✗	✓
Labor Market Deterioration	✓	✓	✓	✓	✓
EPS Growth Contraction	✓	✓	✓	✓	✓
Industrial Prod. Growth Decline	✓	✓	✓	✓	✓
S&P 500 Decline	✓	✓	✓	✓	✗

The UN-Inversion Good News Is Mostly About Housing!

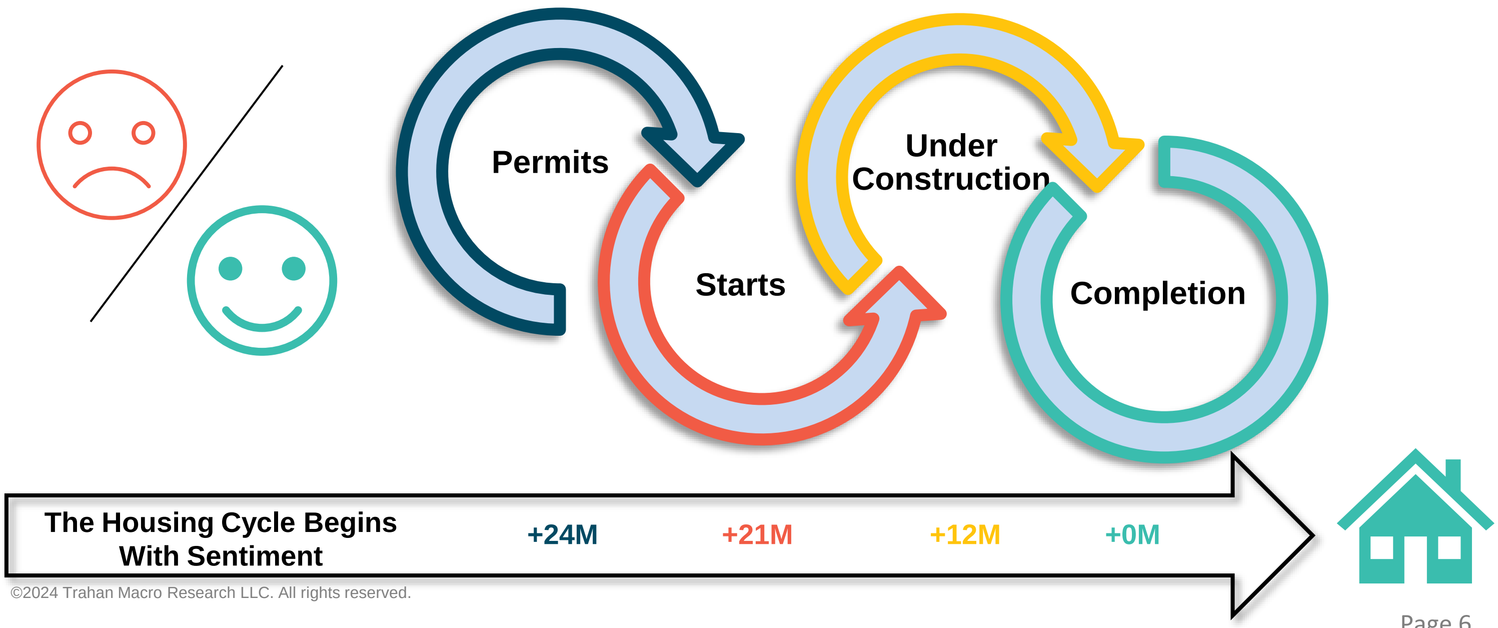
One positive event we can point to when the yield curve is steepening from inversion has to do with housing. We are not talking about an imminent rebound in housing, but this is the time when housing sentiment tends to trough. That sets in motion a chain of mostly positive developments for the industry. The chart below highlights just how tightly correlated the yield curve is with housing sentiment (Michigan survey in red). This is a series we would expect (hope?!?) to see improve in the coming months.

UN-Inversion In The YC Typically Marks A Recovery In Housing Sentiment



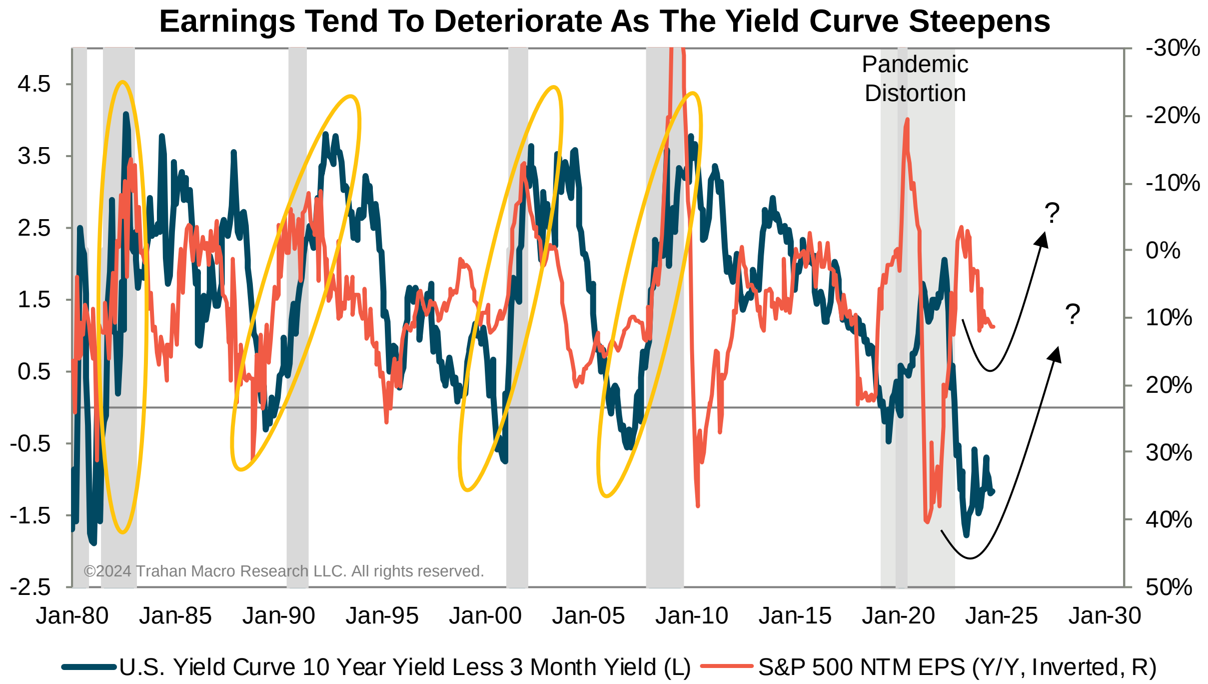
Housing is the earliest industry of the early-cyclical complex, so if there is going to be a recovery in motion anywhere, this is where it should start. Remember, housing has been in shambles for two years now despite a pretty good economy. Said differently, it leads by a long time! Still, this is where we see the earliest green shoots of an economic recovery, and it all begins with better housing sentiment. It will take time before better sentiment makes its way through to housing starts and home sales, but this is what we will be on the lookout for in the coming months.

Shifts In Housing Activity Begin With Sentiment

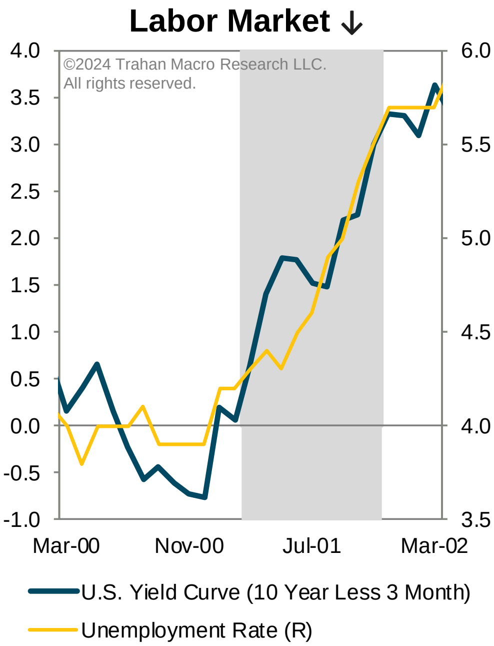


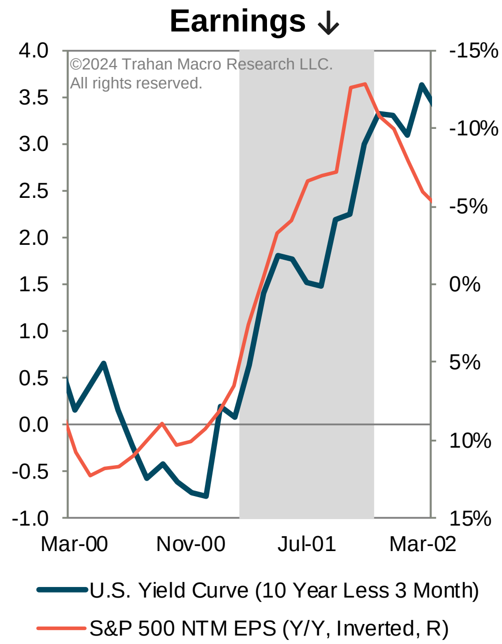
The UN-Inversion Bad News Is A Broad-Based Slowdown In GDP!

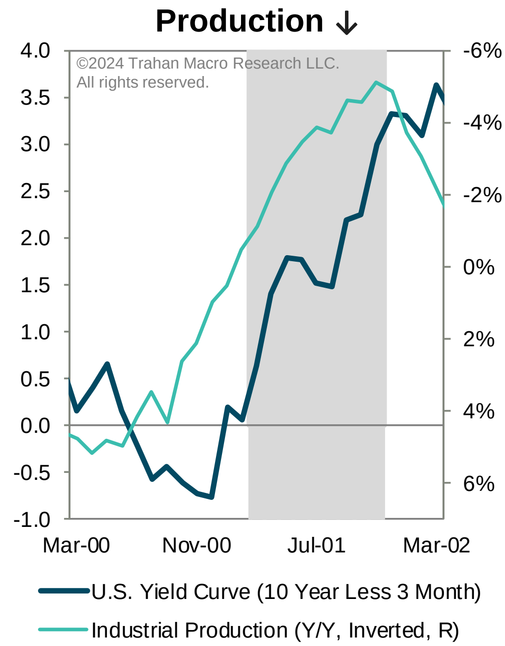
The table at the bottom of page 5 was meant to show that not all UN-Inversions in the yield curve work out exactly the same. As always, context is key. In the typical process, however, we see housing sentiment recover as the yield curve re-steepens. This usually occurs alongside a deteriorating labor market and a general slowdown in economic activity. This is when risks are greatest for equities as earnings are also typically under pressure as this unfolds.



There are plenty of similarities between today's market and what occurred in the late 1990s/early 2000s. We have covered this comparison in many reports, but it is a fairly typical example of what an UN-Inversion of the yield curve looks like. The unemployment rate began to rise, which inevitably weighed on the economy and S&P 500 earnings. Cycles have not been as "textbook," if there is such a thing, but that does not change the fact that this is the risky part of the yield curve arc. Keep a close eye on employment … it holds the key to the earnings outlook.







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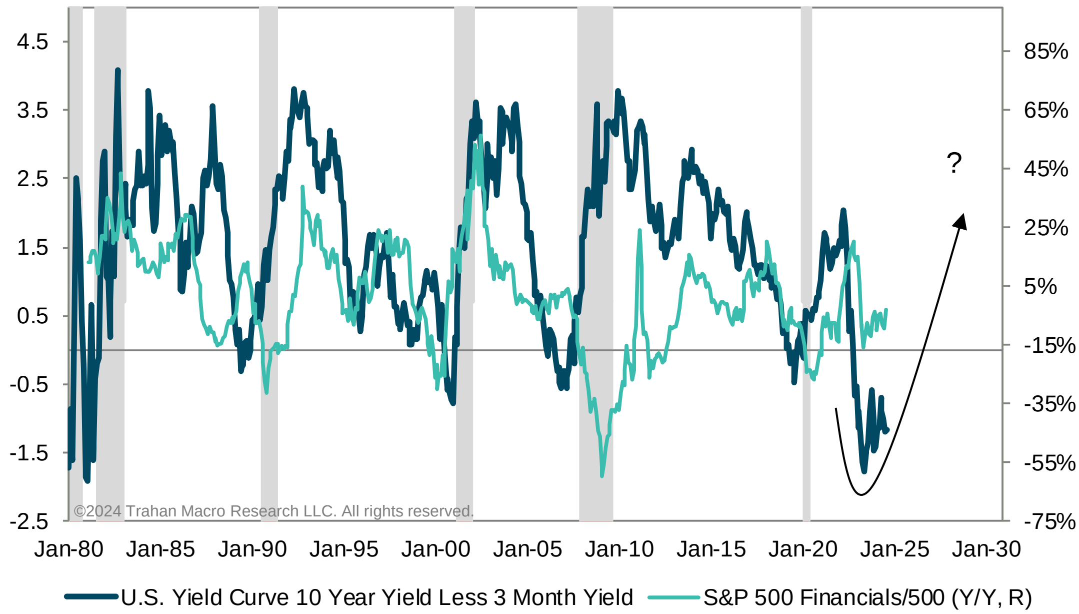
The UN-Inversion Opportunities … Mostly About Defense/Early Cyclicals

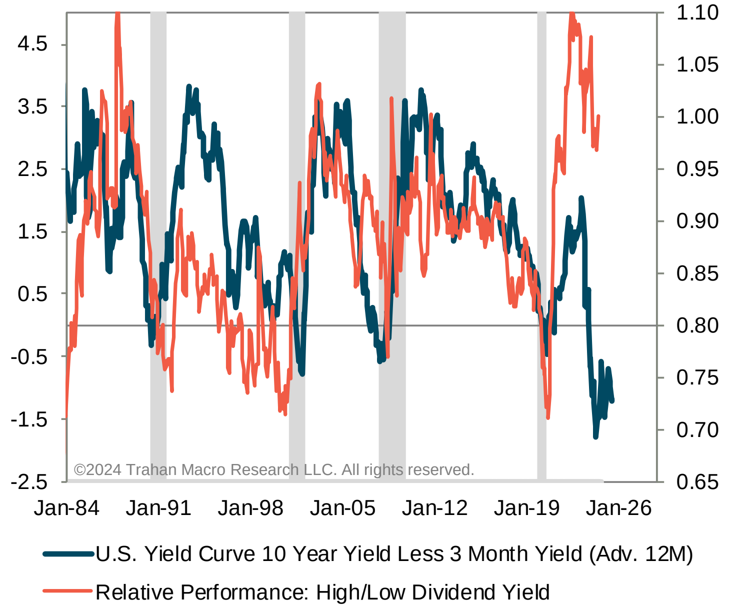
There are plenty of financial market implications of an UN-Inversion in the yield curve. The most obvious one is for bonds. A Fed easing cycle is usually a good entry point for Treasuries. Unsurprisingly, perhaps, this is also the time when defensives like Utilities and Consumer Staples tend to do well – and they are both already outperforming. It also typically marks the beginning of a better world for early cyclicals including segments of the Financials and Consumer Discretionary sectors.

Financials Tend To Benefit From A Steepening Curve

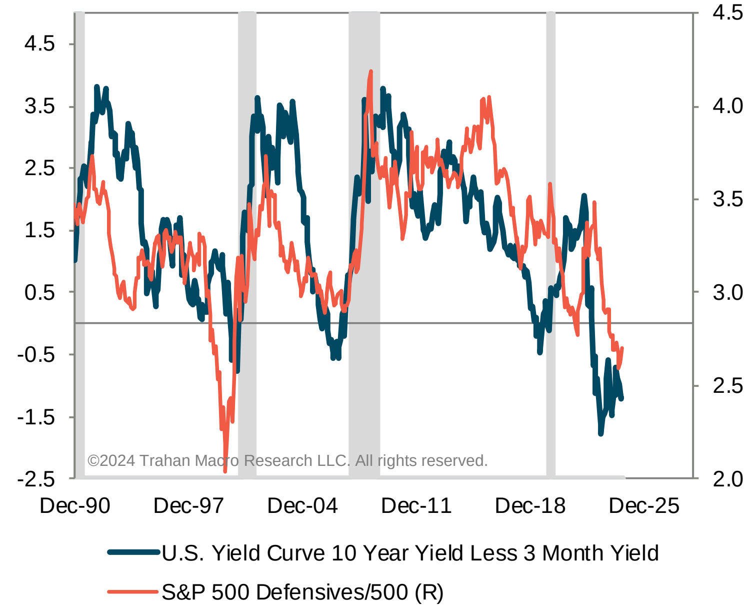


The chart on the lower right shows that defensives, broadly defined, usually lead the performance charge when the yield curve is steepening. This should not be surprising. On the conference call next week, we will spend quite a bit of time focusing on factors that tend to benefit from the steepening backdrop. The conclusion is not all that different from the work we have done on the "Fed Easing" portfolio, but the correlations help us understand the link between macro and micro in this case.

Div. Yield Outperforms During Steepening



Defensives Consistently Outperform



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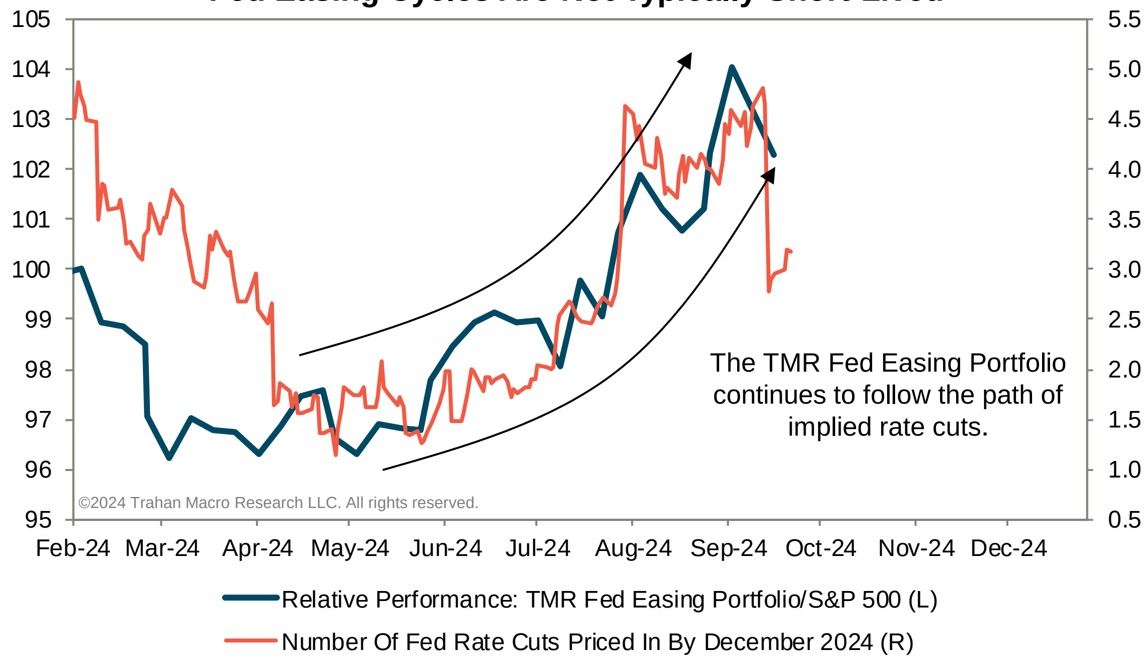
The Fed Easing Trade Is Already Working, And Likely Just Beginning!

Our Fed Easing Portfolio is a simple 5-factor screen that focuses on the stock selection criteria that have generated consistent alpha over the many past easing cycles. These include proxies of profitability, risk, and of course sensitivity to the economic cycle. In general, this screen tends to skew toward the more stable names in the equity space. The relative performance of this strategy has correlated well with the amount of easing anticipated by investors in the near future. It's our assumption that more easing implies a weaker economic backdrop, and therefore quality equity factors will be in vogue.

Fed Easing Cycles Are Not Typically Short-Lived



The full screen for the TMR Fed Easing Portfolio is available for the S&P 500 as well as other common indices. Simply email quant@trahanmacroresearch.com for the full list. Again, this is a simple screen of 5 factors that has systematically generated alpha in prior easing cycles. We will keep updating it for the next year and probably longer. After all, the average Fed easing cycle has lasted about 18 months and some cycles have been even longer.

A Sample Stock Listing Of The Five Factor Fed Easing Portfolio

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Lower Values Rank Better In All Categories

Universe: S&P 500
TMR Fed Easing Portfolio

Ticker	Name	Portfolio Rank	Profitability	Cyclicality	Sentiment	Governance	Operating Efficiency	Sector
MCD	McDonald's Corporation	1	1	1	1	1	1	Consumer Discretionary
VZ	Verizon Communications Inc.	1	4	1	2	1	1	Communication Services
BRK.B	Berkshire Hathaway Inc. Class B	1	8	3	2	1	1	Financials
AMT	American Tower Corporation	1	3	6	3	1	1	Real Estate
IBM	International Business Machines Co	1	7	1	9	1	1	Information Technology
MRK	Merck & Co., Inc.	1	2	1	2	2	1	Health Care
PG	Procter & Gamble Company	[illegible]	2	6	[illegible]	2	1	Consumer Staples
SBUX	Starbucks Corporation	1	5	3	5	2	1	Consumer Discretionary
NSC	Norfolk Southern Corporation	[illegible]	[illegible]	[illegible]	[illegible]	3	1	Industrials
SHW	Sherwin-Williams Company	1	3	6	6	3	1	Materials

For complete list, different benchmark, or monthly model updates:

Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

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