—New Albany—
Investment Management

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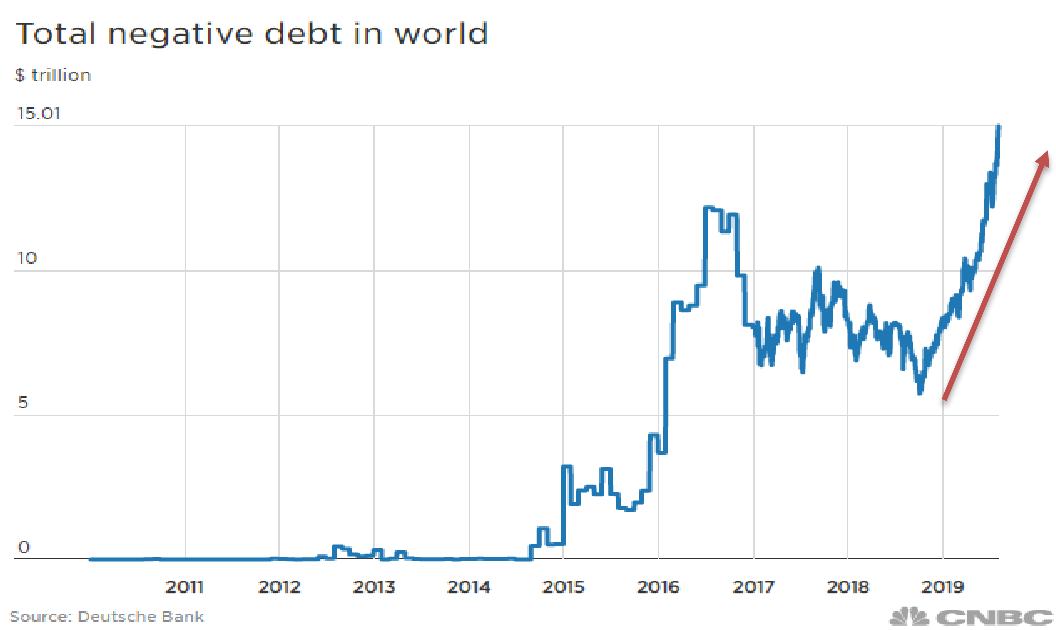
Signals Not to Be Dismissed

SIGNAL | Definition: Anything that serves to indicate, warn, direct, or convey information. (dictionary.com)

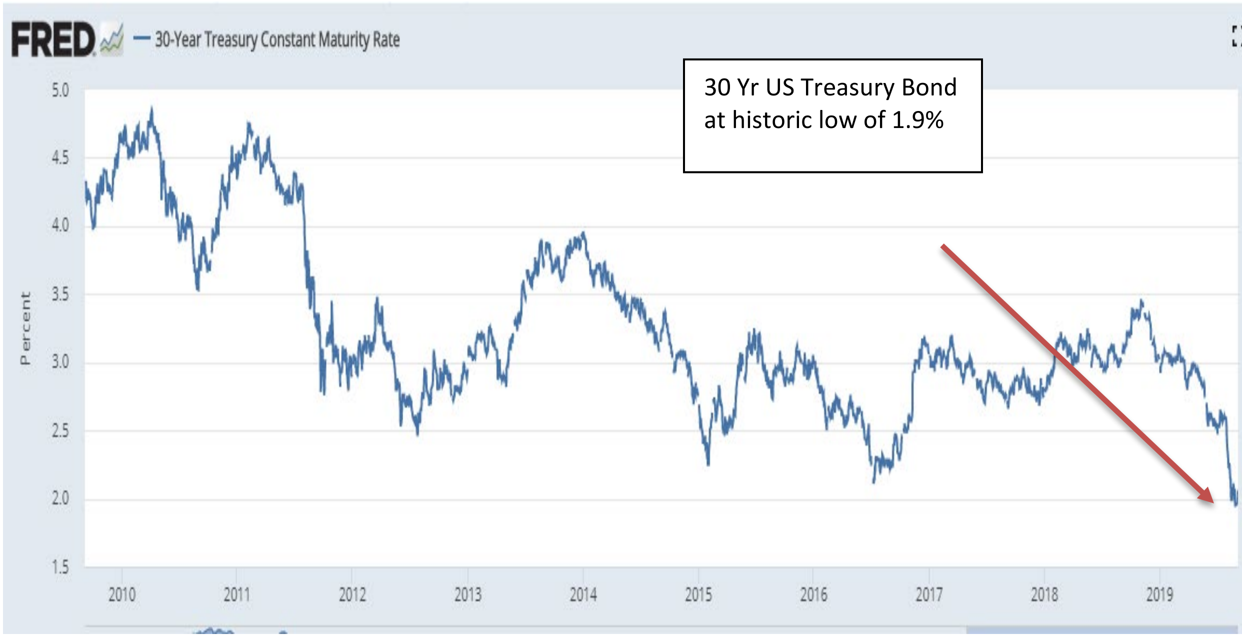
In my thirty-eight years of participating in the stock and bond market, one of the most important lessons learned is to always pay careful attention to market signals. The signals are not always right, never-the-less they do convey important information about sentiment today and expectations of the future. The last ninety days have been yet another peculiar time in the financial world as it seems the stock and bond market are on two very different paths and are conveying opposing signals. While the volatile economic data and trade disputes can explain some of this divergence, the magnitude of the divergence is both eye-popping and radical in terms of the signal or projection about the future direction of the world economy and ultimately global equity markets.

Pictures often can tell the story best. As such, the following charts show the diverging signals.

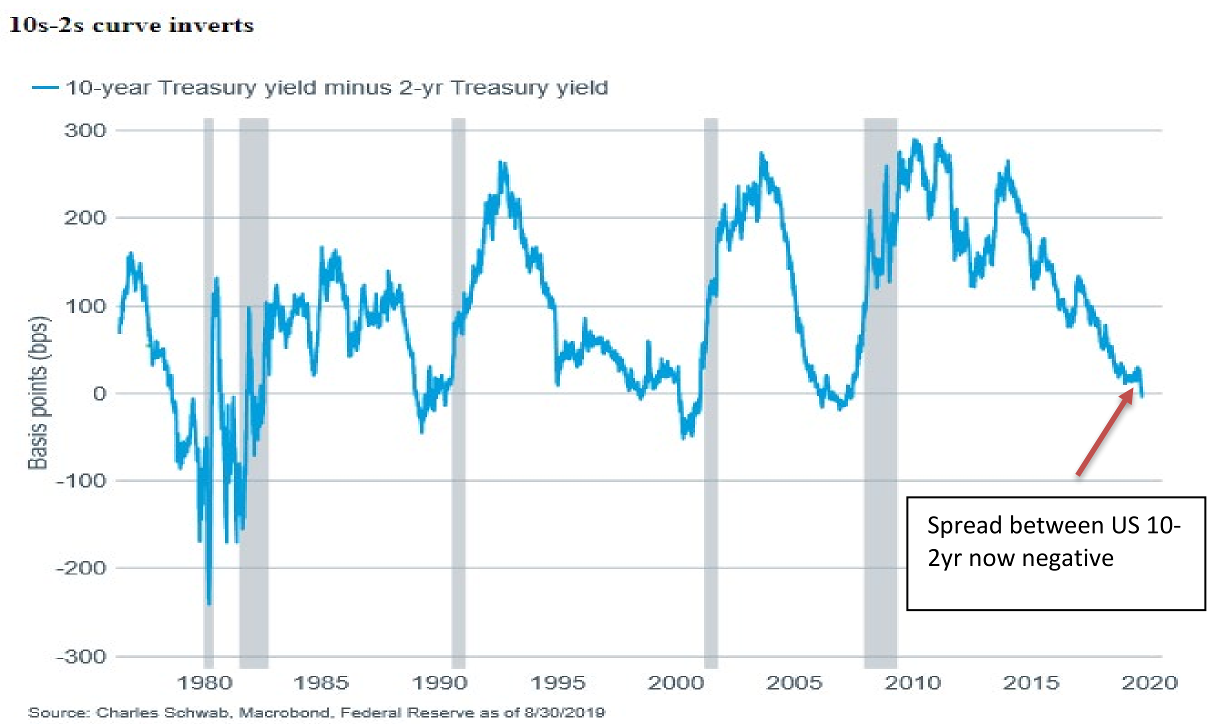
Bond Yields Drop to Historic Low, Signal Slowing Growth: Without Fed manipulation, the Bond market is considered a good leading indicator of future growth and inflation. Thus, when rates fall, it signals slowing growth ahead and can be a 'first warning' to the stock market that earnings could be eventually impacted. In the past, a large drop in rates signaled a large contraction in the economy. Recently, the yield on the 30yr US Treasury Bond rate dropped to an all-time historic low of 1.9%. There is lots of discussion as to why US rates have fallen so hard, so fast. One of the reasons cited is that there is now about $15 trillion of negative yielding global government debt which represents 25% of the world market (Duetsche Bank). This unprecedented situation is due to weak foreign growth and has prompted investors to chase higher yields in the US. If it persists for long, it **could signal a structural contraction in the global economy is underway**. This is a signal not to be ignored. The first chart below shows the amount of global aggregate negative debt. Notice the recent surge since January of this year.



This next chart shows the 30yr US Treasury Yield dramatic drop in August, reaching an historic low of 1.9%.



Yield Curve Inversion Signal: Another reliable signal about future growth has been the shape of the yield curve. A positive yield curve means short term rates are lower than long term rates which indicates stable to stronger growth ahead. Likewise, when long term rates are lower than short term rates, sentiment believes growth is, or will be slowing. With the recent dramatic drop in long rates, <u>the curve is now inverted. In the past, an inverted curve has signaled weak growth, possibly a recession lies ahead</u>. Below is a chart of the yield spread between the 10yr and 2yr US Treasury notes and shows the spread just went negative. The gray bars indicate recessionary periods.

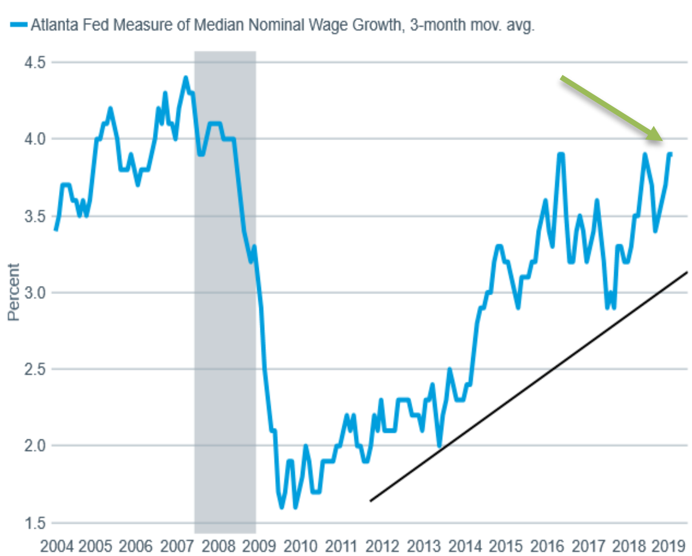


Diverging Bond and Stock Market Signals: Interestingly, the *Stock market appears unfazed by the Bond market move, as it is within 1.5% of its all-time high.* The chart below shows the one-year performance of S&P 500 (Green line) and the Yield of the US 10yr Treasury Note (Blue Line). Notice how stocks and bonds tracked fairly closely from September-December last year. But since late January of this year, the two began to diverge, with bond yields dropping rapidly since June. **The stock market is signaling all is well ahead; the bond market is signaling significant weakness ahead.** This wide divergence will correct, the question is how? Will stocks fall or rates rise?

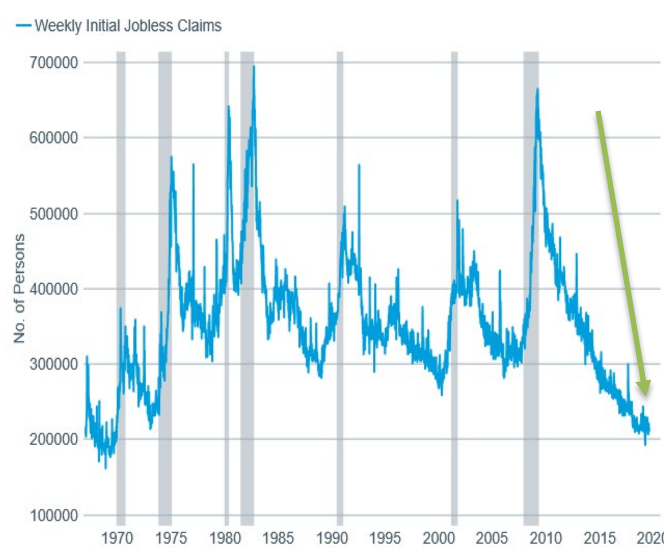
Source: CNBC

'Non-Market' Signals: Signals from the Bond market are very important but should not be looked at in isolation as there are other 'non-market' economic signals that also provide valuable input.

Wage Growth & Jobless Claims Signal Strength: Consumer spending is almost 70% of GDP, and so watching the health of the labor market, in terms of wage growth and unemployment, is a good barometer of spending and economic stability - at least in the near term. The charts below show <u>wage growth (left) remains very strong, and Jobless claims (right) remain very low indicating the labor market/consumer is very healthy and signals the economy is on solid ground.</u>



Source: Charles Schwab, Macrobond, Federal Reserve Bank of Atlanta as of 8/30/2019
Shaded areas represent recessionary periods.



Source: Charles Schwab, Macrobond, U.S. Department of Labor as of 8/30/2019
Shaded areas represent recessionary periods.

Purchasing Managers Indices give Mixed Signals: Two good leading indicators of future economic activity are the Purchasing Managers Index for both the Service and Manufacturing sectors. The charts below show the PMI Index for both sectors. A reading above 50 indicates expansion, while a reading below indicates contraction. Not surprising, the **Service PMI is still expanding**, as it measures the US consumer appetite for domestic services. Meanwhile the **Manufacturing PMI is contracting** as it is more sensitive to global growth and the trade disputes.

Service PMI, Above 50 Signals Expansion

Manufacturing PMI, Below 50 Signals Contraction

Source: YCharts

In sum, while the Bond market is signaling weakness lies ahead and the trade disputes are weighing heavy on the global economy, the US consumer is still powering the US economy forward. But the longer uncertainty over trade persists, the more likely the weakness seen abroad will spill over into the US. And given the US election is only 13 months away, China could very well 'wait it out'. Thus, at this point, the near-term risk could be to the downside; however, any agreement on trade would immediately send equity prices and bond yields soaring. Net, as an investor, it is prudent to be somewhat defensive and broadly diversified as bouts volatility will continue.

Investment Strategy: We continue to maintain a neutral, balanced, and broadly diversified strategy. No change in stock/bond allocation. However, with the Bond market signaling a potential slowdown, we reduced credit exposure on the bond portion of the investment strategy. Overall, **the portfolio strategy is working very well in current volatile market environment**. Please contact me with questions or concerns.

These are my thoughts. Your feedback is always appreciated.

Best Regards,
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