BURNEY COMPANY
INVESTMENT MANAGEMENT

RESEARCH

Yield Curve

The Bull Market has Room to Run

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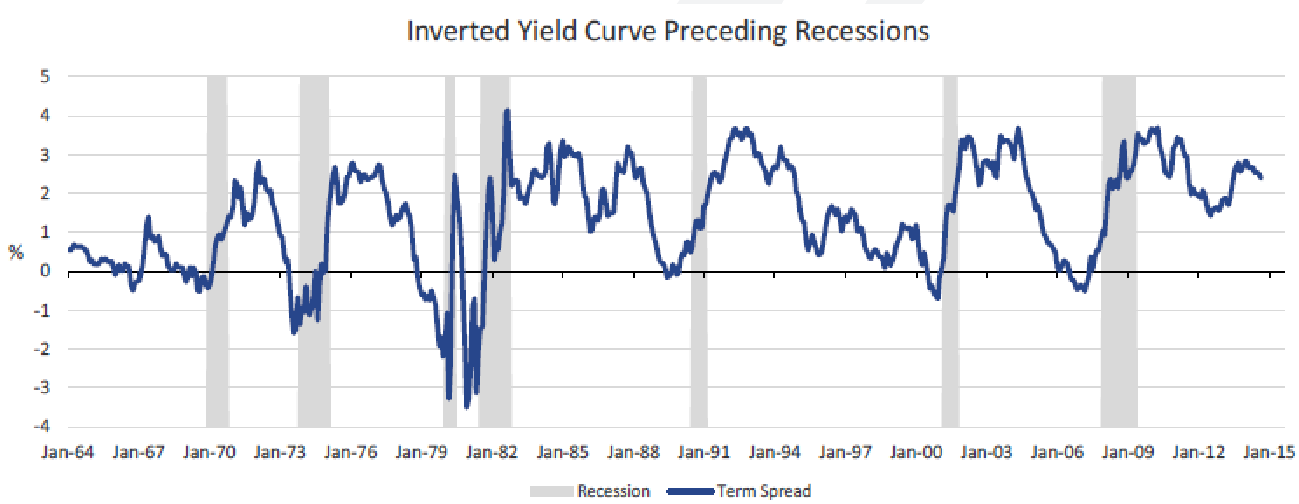
The market run-up post 2007-2008 financial crisis has entered its sixth year now and become the fourth longest bull market in U.S. history. S&P 500 has gone up 206.5% by the end of August since it bottomed out in March 2009. While investors have to be pleased with that kind of advance, questioning where the market goes from here is natural. Whispers of a looming recession emerged in the second half of 2013 and have lingered with mixed economic signals from CAPE to GDP to unemployment, housing, consumption and business activities, as well as international economic and political strife.

All of this has increased volatility for 2014. The stock market was off to a tough start in January and went through frequent small pull-backs.

Our market outlook, however, has remained the same since the very first Size & Style Update of the year: the bull has more room to run and investors should not talk themselves into a recession. It is evident that S&P 500 has been rather resilient and returned 9.9% year-to-date. Why we were and still are confident? We possess no more information than any other investor in the market, but we know where to look. None of the market or economic indicators commonly used by the investors predicts recessions 100% of time, but in the past 50 years, a lesser-known indicator – yield curve inversion – has preceded recessions seven out of seven times. The yield curve inverts when long-term Treasury interest rates go below short-term Treasury interest rates (the difference between which is called the "term spread"). According to the Fed, researchers in the past decades have not found a competing indicator that has recession predictive power coming close to a negative term spread.



So what can we say about the term spread's forecast ability? How consistent of an indicator is it? Does the magnitude of change matter? How does it compare to other harbingers of economic distress?

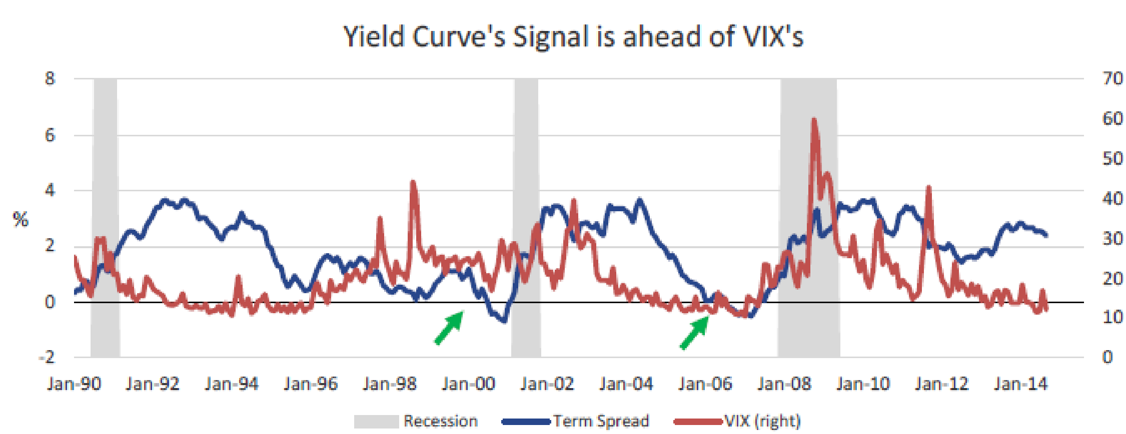
- First, it's robust and persistent over time. The yield curve inversion has predicted essentially every U.S. recession since 1950 with only one "false" signal which preceded the credit crunch and slowdown in production in 1967 (it's not officially classified as a recession by National Bureau of Economic Research (NBER), but the S&P 500 dropped 17% in the following 8 months before quickly returning).

- Second, the level itself or the change in the term spread doesn't matter as long as the spread stays on the positive side. In other words, a term spread change from 4% to 1.2% is not a signal but a change from 0.5% to -0.1% is.

- Third, it's the short-term interest rate that plays the key role. Negative term spread can be a result of a decrease in the long-term rate or increase in the short-term rate or both. Each recessionary episode is preceded by a substantial increase in the short-term rate.

- Fourth, yield curve inversion has to last for about a month or more to be taken seriously. Temporary demand-supply imbalance in the Treasury market can squeeze the term spread to negative for a day or two, which is not reflective of potential economic conditions and should not be viewed as a signal.

- Last and most amazingly, yield curve inversion is ahead of stock market signals like VIX and recession triggers like Lehman Brothers' collapse. By the time the latter happens, it's probably already too late for stock market investors to pull out or hedge their portfolios without taking substantial losses. Monitoring the term sprad gives you extra time to re-position for the approaching economic and market downturns.



Where are we today?

As of the end of August, the term spread between the 10-year Treasury bond and the 3-month Treasury bill stands at 2.39%, well above zero and higher than the 2000-2013 average of 1.99%.

Note that low positive term spreads don't forecast recession – the yield curve has to be entirely inverted for about a month to signal a recession. For that to happen in today's market, short-term interest rates need to increase dramatically and/or inflation needs to spike quickly. These are unlikely scenarios with the consumer price index declining last quarter and the Fed re-assuring the investors as recently as this past Wednesday to keep short-term rates below 1.4% until the end of 2015.

Other than recessions, there's nothing that can beat down the stock market for a prolonged period. The bull will keep running until the yield curve says "whoa".

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