Monthly Perspective

APRIL 2019

Another positive month for global assets as central banks turn more dovish and rhetoric around the U.S.-China trade talks remains optimistic. The U.S. S&P 500 is up over 3% since the last update and is within 2% of a new all-time high. Meanwhile, the S&P/ASX 200 continues to fluctuate around the 6,200 mark. It was also another strong four weeks for the Euro STOXX, up over 3% again.

Bonds rallied as yields fell on continued weak economic data and accommodative central bank updates. A closely watched spread between short and long term yields also briefly inverted, sparking some short-lived recession worries. The U.S. 10-year yield fell by 14 basis points (0.14%) to 2.5%, while the Australian 10-year yield briefly touched its lowest level in history before rebounding. The Australian 10-year yield is currently trading at 1.9%, 18 basis points lower compared to four weeks ago.

Commodity prices rose, mostly driven by energy prices as Brent crude prices exceeded USD $70 per barrel again. Iron ore prices also remained strong as supply concerns continue.

The Australian Dollar continues to trade around 71 U.S. cents.

Economic Overview

The domestic economy remains weak, with full-time employment falling although the headline employment figures show gains as part-time employment rises and business confidence continues to weaken. Abroad, trade talks continue between China and the U.S., with both sides citing progress, but a deal has yet to materialise. Tariffs between the two largest economies have hurt global growth though there are nascent signs that a rebound could be on the horizon as the tension eases. Chinese economic activity indicators were better than expected, with the manufacturing sector pointing to a rebound back to expansionary territory. In the U.S., retail sales were weaker than expected but another month of strong employment has allayed some of the fear.

A dovish U.S. Federal Reserve (Fed) also helped sentiment and liquidity, with the Fed surprising the market by completely removing expectations for a rate hike this year and signalling a reduction in 'Quantitative Tightening' in May, before stopping this completely in September. Following the announcement, the yield curve inverted. The inversion is a wellregarded indicator of an impending recession, but markets barely flinched.

With the strong start to 2019, valuations are stretched once again and recession warnings are flashing, however, monetary policy remains accommodative and growth looks to be rebounding. The trade talks between China and the U.S. remain a primary concern but reporting season is once again starting up which means that earnings are set to take centre stage once again.

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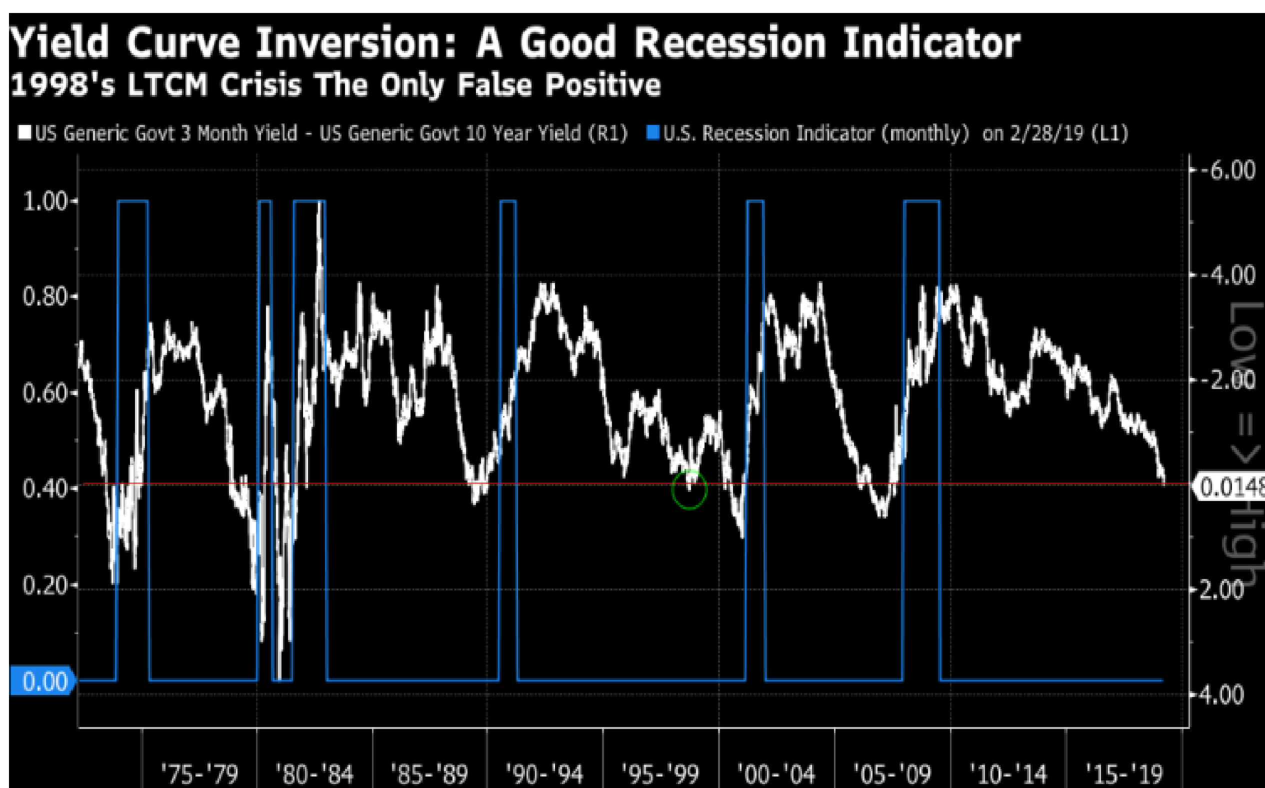
The yield curve inverted; what now?

Last month, for a short period, the difference (or spread) between the 10-year and 3-month bond yields on U.S. treasuries went negative for the first time since 2007. Although spreads at other points in the yield curve had inverted prior to this, the 3-month and 10-year spread is more significant in predicting recessions. Historically, a spread inversion between these two points has preceded most of the recessions since the 70s and is widely monitored by the markets. The relationship is shown in the graph below.



Source: Bloomberg Data

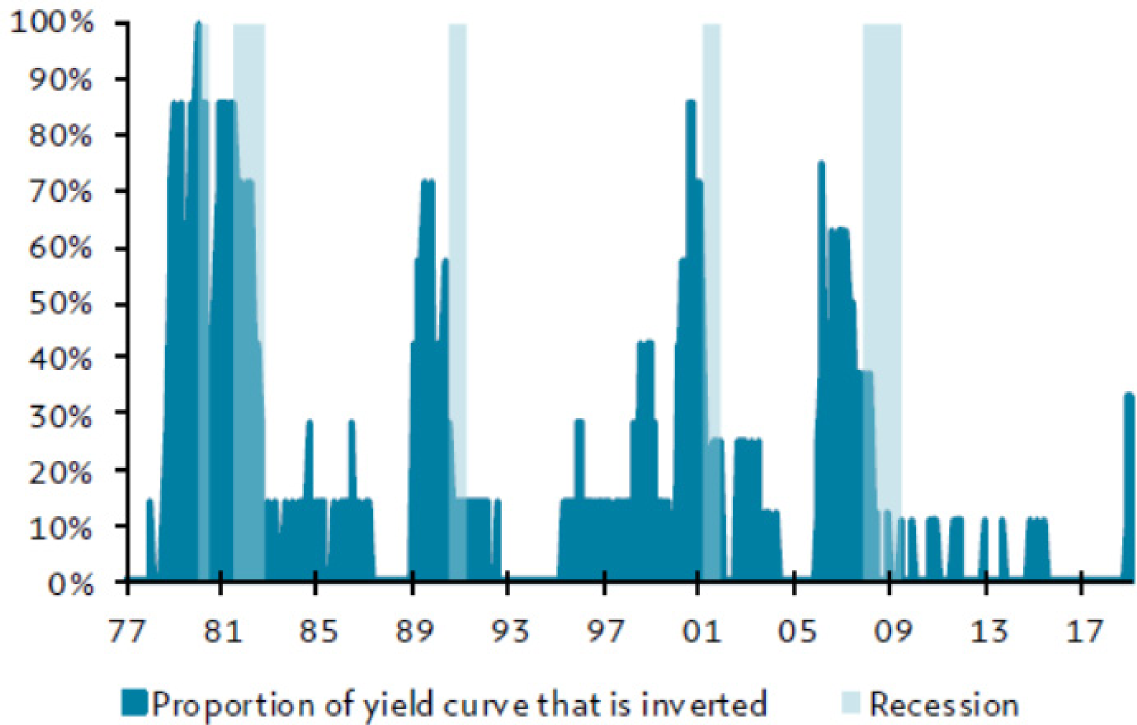
Since the 70s, all six U.S. recessions had been preceded by a 3-month and 10-year spread inversion, with the exception being 1998 where the spread inverted for a brief period before rebounding. A recession would only materialise three years later, and only after another inversion.

Even though this is focussed on the U.S., the implications are global given the relative size of the U.S. economy and its even bigger presence in global markets. As the saying goes, when the U.S. sneezes, the rest of the world catches a cold.

So, the question for investors is: Is there a recession coming in the near future, or is this a repeat of 1998?

There are reasons to see this as a repeat of 1998. Firstly, the inversion occurred as a kneejerk reaction to a more dovish than expected Fed at a time when the yield curve is already flat following years of quantitative easing. Given that just four months ago, the Fed was quite adamant that the U.S. economy was doing well and that two or more rate hikes would be necessary this year, the drastic swing in Fed policy played a big role in forcing long-term rates lower.

Further to this, given that the U.S. yields are currently much higher than other developed markets, strong global demand for U.S. government bonds have exerted downward pressure on long-term U.S. yields. Another source of optimism was that the inversion was shortlived and prior recession-signalling inversions lasted for much longer periods of time. Finally, as the graph below shows, the proportion of the yield curve that has inverted is less compared to prior recessions.



Source: Datastream, Julius Baer

Source: CBA, Bloomberg

The same issue has appeared in the domestic yield curve. The 90-day bank bill swap rate is the domestic equivalent to the U.S. 3-month treasury bill, and its spread with the Australian 10-year bond yield also went negative in the same period.

Despite the arguments presented in this article, this yield curve inversion should not be taken lightly and certainly, the probability of a recession has been on the rise over the last year. Therefore, investors should be cautiously positioned moving forward.

Want more information?

This month's perspective highlights that market sentiment on all asset classes is constantly changing. It is important for us to quickly recognise any threats, to preserve your investment capital or to identify yearly investment opportunities to maximise any return advantages. At **Greenwich Wealth** we don't get complacent with the current state of play and constantly monitor investments and your portfolios.

If this article has raised questions regarding your personal situation, please contact your Greenwich Wealth advisor directly or on **08 6555 9500.**

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