Bull & Bear Bulletin

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Valicenti Advisory Services, Inc.

400 East Water Street
Elmira, NY 14901
607-734-2665
Fax: 607-734-6845

447 East Water Street
Elmira, NY 14901
607-733-9022
Fax: 607-734-6157

24 West Market Street
Corning, NY 14830
607-936-1203
Fax: 607-936-0213

www.valicenti.com

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The Loch Ness Monster or a Yield Curve?

We don't mean the actual beast but rather the Busch Garden Williamsburg's vaunted roller coaster, the Loch Ness Monster. A healthy yield curve more resembles a bunny slope (gently upward sloping) rather than a 114-foot descent thrill ride. What is creating this inverted situation (see graphic) around the interest rate curve and why is it important?

The first thing to note is that the short duration rates at the front-end of the curve are mostly influenced by the Federal Reserve's monetary policy. Varying opinions about monetary and rate setting policy abound, so if we look to recent Federal Reserve member comments on the topic, it is a more direct place to start. The bottom line here is that recent comments by Chairman Powell and other Fed members have seemed to open the door to getting off the roller coaster and moving over to the bunny slope should the ride become too much. In other words, the rhetoric recently appeared to move in the direction of signaling that if they are called for due to more negative growth and outlook concerns, cuts to the short-term overnight interest rate target could occur. That would then likely drop the 3month, 6month, 1year and shorter-term rates subsequently in the market and alleviate the inverted condition where these rates are actually unusually higher than the longer-term yields.

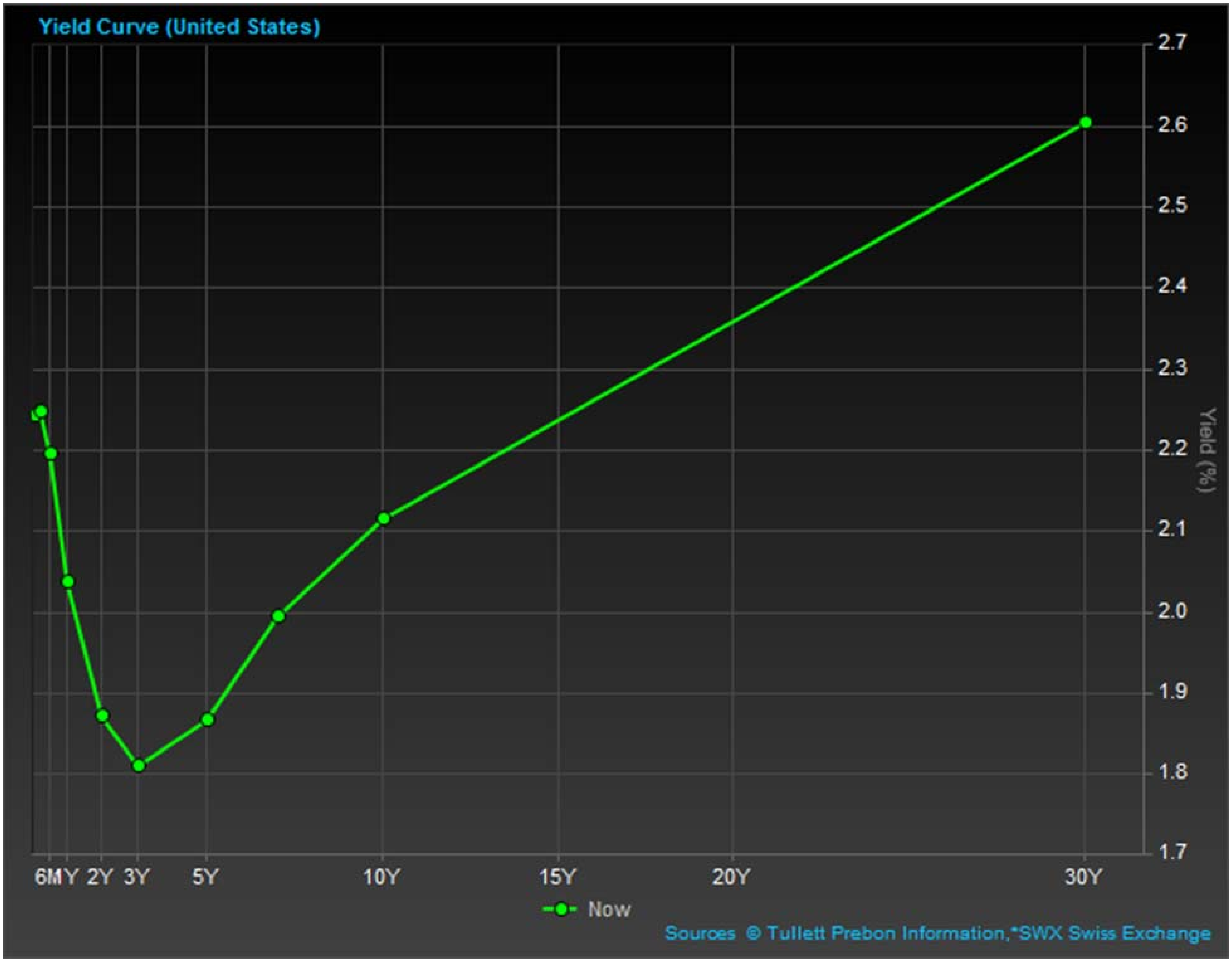
Why is this so important to markets? The New York Fed's recession probability indicator publishes a probability of a recession twelve months ahead as predicted by the treasury spread between the 3 month yield and the 10 year yield on the rate curve. As of May, the reading approaches 30% which is elevated relative to historical probabilities. With the 10 year yield at 2.14% and the 3 month yield at 2.27%, the difference between these two rates stands at -13 basis points. The monthly average of this spread, when it has reached -12 bps, has predicted every recession since 1960[1]. There is never a guarantee that the future will look like the past and the rote empiricism around such predictions could certainly fail in the future.

We haven't quite fully reached that recession signal yet, as we have not been inverted long enough, but perhaps the way to think about the backdrop is that many complex things are occurring such as tariff maneuvers, supply chain changes, geopolitical competition, fiscal and monetary policy inflections, reduced inflation and possibly slowing growth. A yield curve inversion is not likely to be a direct cause of anything, but the historical algorithm suggests that such inversions occur alongside environments where these complex things are occurring and where, coincidentally, we have seen recessions over the last 60 years. Market participants as well as Fed policymakers seem to be very alert to the changing environment and, therefore, are proceeding cautiously.

Not all short-term market movements make rational sense, but in this case the Fed's willingness to open the door to alleviating that inversion pressure or whatever is driving it by actually cutting rates has understandably produced a strong short-term equity price gain. The S&P 500 has sharply rallied 5% month to date in June.

We may be at a critical inflection point where things occur which either extend the business cycle or hasten its end. It is the stuff that bulls and bears fight over. It may simply mean that the last few rate hikes were a touch too much given economic and market realities and the volatility of the last six months was a symptom of that. Now let's move over to the bunny slope.

[1] www.newyorkfed.org



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