Hamilton-Bates
Market Update

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The Yield-Curve is Inverting!
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The stock market continues to hang around its highs, but in truth its gone nowhere for about 18 months now (chart to follow). However we are seeing increasing signs of volatility—with last week seeing an 800 point DJIA loss with 3 other large percentage moves during the week. The driver of concern last week was a relatively obscure thing called 'the yield curve', and the fact that it 'inverted'. If you have heard or read our thoughts for any length of time you'd know that we have mentioned and written numerous times about the yield curve over the past several months, and in years past.

What is it and What Does it Mean?
Without getting to wonky and into the weeds so to speak, the yield curve is a graphical depiction of interest rates. Normally short-term rates are low, with rates rising the longer-term the borrowing period or payment period is. For example 1-month CD's yield less than 5-year CD's. The longer out you go, generally the greater the borrowing cost.

Interest rates change over time, in response to what the Federal Reserve does and to what investors believe is happening in the economy. Bonds are bought and sold every day and these movements in government bonds create the yield-curve that market watchers like ourselves follow. In rare cases, long-term rates fall BELOW short-term rates, and its definitely not a normal condition. When long-rates (yields) are lower than short-term rates its called an inversion.

Inversions come in all shapes depending on the varying maturity you look at—but one this is clear—true inversions happen ahead of and often predict an economic slowdown and recession. Last week a widely followed measure 'inverted' triggering the tremendous amount of headlines and handwringing in the financial media. In 25 years we have not seen so many mentions and discussions of bond yields and the yield curve. You could say the yield-curve went viral!

What is most curious about last week is that it caused such a violent reaction in one-day. Yield curve inversions happen over time and last for long-periods of time—part of the yield curve have been inverted since 2018! It has been an ongoing issue that we have been watching and has been part of our concern that the economy could be more fragile than believed. Signals from the yield-curve are also not timely. Yield curve inversions have predicted past recessions but the time between the inversion and the recession can be a year or more! An inversion of the yield curve tells us that the economy and financial markets are more fragile than may be believed at the time, and that something is not quite right. But its not a sell trigger. Its more of a symptom than a signal.

What Do We Do?
As an Advisor and Money Manager when we are operating in an environment where the yield curve has inverted, it tells that most client accounts should be

balanced, include high grade bonds, and have an emphasis on dividend paying stocks. Furthermore we also take immediate action should the stock market break our key trend indicator—we get defensive on breaks for managed accounts that include a tactical component. In general we take on an approach where preservation is equally as important as appreciation.

Inversions, the Economy, and Interest Rates

The evidence is mounting that the global economy is slowing down—the question is 'how much and for how long'. China and the US have taken a hit from the trade-war, with China's growth rate likely slowing to the low single digits. Our economy is likely in the 1 -2% range. Germany, the growth engine of Europe, is already in recession (albeit is minor one so far) with 2 of the last 4 quarters showing negative growth. Japan is mired near zero growth. That's the world's 4 largest economies; with two near zero growth and two slowing to very low single-digits. Growth has clearly moderated.

A good deal of attention is paid to the Dow Jones Industrial Average and the S&P 500, and rightly so, these are the very heart or core of the US economy. But weakness doesn't begin at the core, but rather at the edges or margins. By the time weakness reaches the S&P 500 it is pretty well advanced. For clues as to could happen, we look to the fringes of the economy, such as transportation stocks, and small-caps. If a good is sold it has to be moved, and to do business people travel. Transports are a good gauge on the health of the economy. Small-caps, being largely domestic—give us a good read on companies that focus primarily on the US market. When we look at these two areas, our concerns are only heightened.

Transportation Recession

Throughout 2017 and most of 2018, U.S. freight shipment volume was booming, and that was a very strong sign that overall economic activity was rising. But when economic activity begins to decline, freight shipment volume often goes negative, and that is precisely what is happening. In fact, U.S. freight shipment volume has now declined on a year over year basis for eight months in a row. Freight shipments within the US by all modes of transportation – truck, rail, air, and barge – fell 5.9% in July 2019, compared to July 2018, the eighth month in a row of year-over-year declines, according to the Cass Freight Index for Shipments, which tracks shipments of consumer and industrial goods. When something happens for eight months in a row, that is definitely a trend, and we haven't seen declines of this magnitude since the last recession. And other numbers confirm what the Cass Freight Index is telling us. ACT Research says that the trucking industry is officially in a recession after two consecutive quarters of negative growth, according to data tracked by ACT Research. "Every freight metric we look at has been negative for at least six months," is what they noted in their last data release. 60% of our Economy is services, and its possible for manufacturing to struggle while services do ok, but we will continue to keep an eye on this sector.

Small-Caps Weak Also

Good rallies are broad, include most stocks, and are generally led by small-cap stocks and the technology sector. When money flows to small-caps and tech it suggests investors have a healthy risk appetite. Unfortunately small-caps have been lagging, have not made new highs since 2018, and are now below their key long-term trend indicator. This tells us investors aren't so anxious to take risk in such an environment—neither are we!

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Market and Investment Strategy

The most important message we can send even after all of the preceding ‘concerns’ is not to panic. The indicators we mentioned do not give precise ‘sell’ signals. In fact past yield curve inversions have seen the stock market rally for many, many months before any trouble appeared. These are broad brush signals that the economy and economic expansion are long in the tooth, and that we are closer to the end of the cycle than the beginning. That is what we can safely gather from the yield-curve, transports, and small-caps. In that environment we are tightening positions, making sure we have bonds to counterbalance risk, and we increase cash when the overall trend shows signs of breaking.

In our view it would be much too premature to think a recession was imminent, and we see risk more of the 2020 issue in terms of the timing for a recession. That doesn’t mean the market cant go down, in fact its quite possible. We are now entering the late summer/ fall period that typically sees and increase in market volatility. While we do consider the signs discussed important, they are not timing signals. It would be wrong to confuse/conflate seasonal weakness with a sign that a recession was right upon us.

Over the coming weeks, we will likely see further whipsaws in stocks, with key moves occurring when the S&P 500 moves over 2950 or below 2850. As long as the market remains below the 2950 resistance region, our expectations for the market would be for further testing of support. Should 2850 (on the S&P 500) fail we could see a bit more weakness. The action we then see now and into the last quarter of 2019 will tell us whether we will begin the rally back to 3100-3400 sooner rather than later, or if the market indeed weakens as global growth falters earlier than expected.

S&P 500 Long-Term Chart

Lots of chop over the past 18 months with lots of up and down action but not a lot of net gain. The S&P 500 is up just 1-2% since January of 2018, while the Dow and Small-Caps are down. The S&P was unable to build on the ‘breakout’ above 2975 in July, but it has been able to hold above the key 2800 level on any weakness. Now in the dog-days of summer ahead of the seasonally volatile month of September, we’d look for more sideways action before a true move is made. The bulls hold sway as long as the S&P 500 holds above 2800, and a break above 2975 that can hold for a month or two opens