Will it be Different This Time?...Maybe, Sort of, Don't Bet the Farm

Curt R. Stauffer
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In this month's investment commentary, we will delve into the two economic debates raging in our country today.

- Does the flattening of the interest rate yield curve, particularly the spread between the two-year Treasury Bill and the ten-year Treasury Note yield, portend a near-term recession?
- Will the very significant jump in the inflation rate that the U.S. is experiencing end up being the beginning of a secular trend of stubbornly high inflation, or will it turn out to be mostly situationally cyclical?

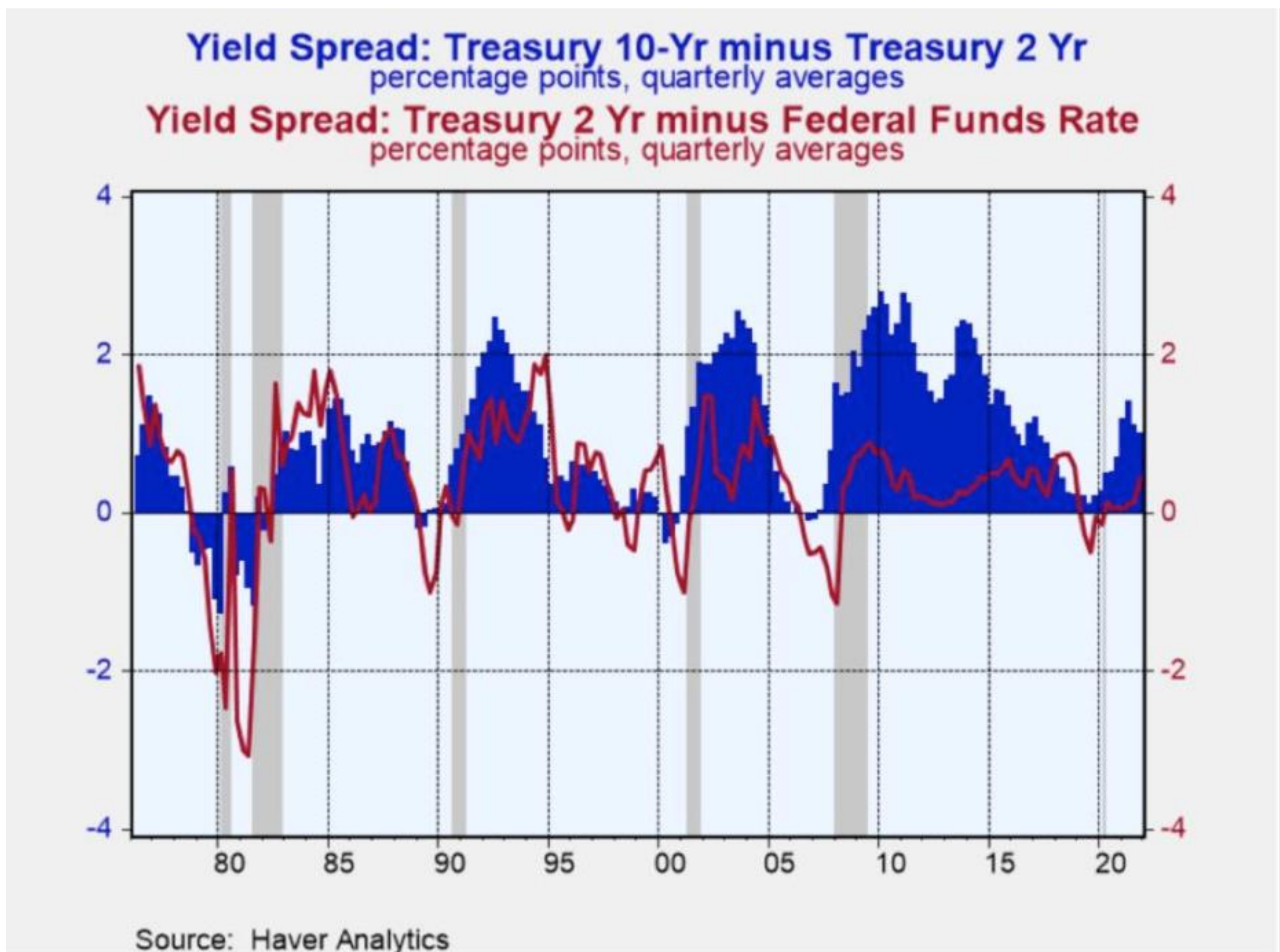
Before we delve into the yield curve and inflation discussion, we need to acknowledge the uniqueness of today's market environment. Markets are struggling to digest and discount an unprecedented confluence of factors that include the rapid onset of high inflation, high economic growth, low unemployment/worker shortage, an aggressively restrictive Federal Reserve, and a horrific military invasion of a large European country by a nuclear superpower. This is a lot for markets to process in an orderly manner. History teaches us that our capital markets, apart from the 2008-09 financial crisis, are very dynamic and adaptable. Thus, we should not lose sight that the principles of long-term equity investing, driven by the discounting of the expected growth in corporate cash flows, are very likely to persist.

Now we will turn our attention to the economic debates of the day. It should be stated upfront that Seven Summits Capital does not publish economic research, and we are not macro investors first and foremost.

However, because we are active investment managers, we must always be cognizant of material changes in macro factors such as inflation and economic growth expectations and incorporate certain high-level, long-term assumptions into our investment selection process.

So, let’s get started! Does the current relatively flat interest rate yield curve, specifically the spread between the two-year Treasury Note yield and the ten-year Treasury Note yield, indicate that an economic recession is right around the corner? Over the last 40 years, most recessions have indeed been preceded by a flat to negative spread between the two and ten-year Treasury Note yield. However, as noted by my favorite, now officially retired economist, Paul Kasriel in his March 29, 2022, Linkedin article, the two-to-ten-year Treasury Note spread is not the whole story. Below is what Dr. Kasriel wrote:

“Today, 03/29/2022, the Treasury 10-year constant maturity security closed at 2.41%, a mere six basis points above the Treasury 2-year security. There have been many comments in the financial media that if this spread turned negative, it would be a signal of an imminent recession. And indeed, the chart below shows that when this yield spread turns negative, a recession occurs. The shaded areas in the chart represent recessions; the blue mass represents the spread between the Treasury 10-yr and 2-yr, and the red line represents the spread between the Treasury 2-yr and the fed funds rate. The 10-yr vs. 2-yr spread did NOT turn negative before the 2020 recession, but nobody's perfect. But notice that when the 10-yr vs. 2-yr spread turns negative, and a recession follows shortly after, so does the Treasury 2-yr vs. fed funds spread. That's NOT happening NOW. The 2-yr Treasury closed at 2.35% today, and the fed funds rate closed at 0.13% for a spread of 222 basis points. A better spread recession indicator is the spread between the Treasury 10-yr vs. the fed funds rate. It DID signal the 2020 recession. This spread closed today at 228 basis points. A spread of 228 basis points between the Treasury 10-yr and the fed funds rate has NEVER been the harbinger of a recession. For a discussion of the 10-yr vs. fed funds spread, see articles written by the late Robert D. Laurent in the Chicago Fed's Economic Perspectives publications, "An Interest-Based Indicator of Monetary Policy" (January 1988) and "Testing the Spread" (July 1989). Bob did the seminal research on the spread as a leading indicator. There also was a book written about this spread and other market indicators entitled "7 Indicators that Move Markets". I'm sure some copies of this book are laying around in remainder bins that can be had at a greatly reduced price.”

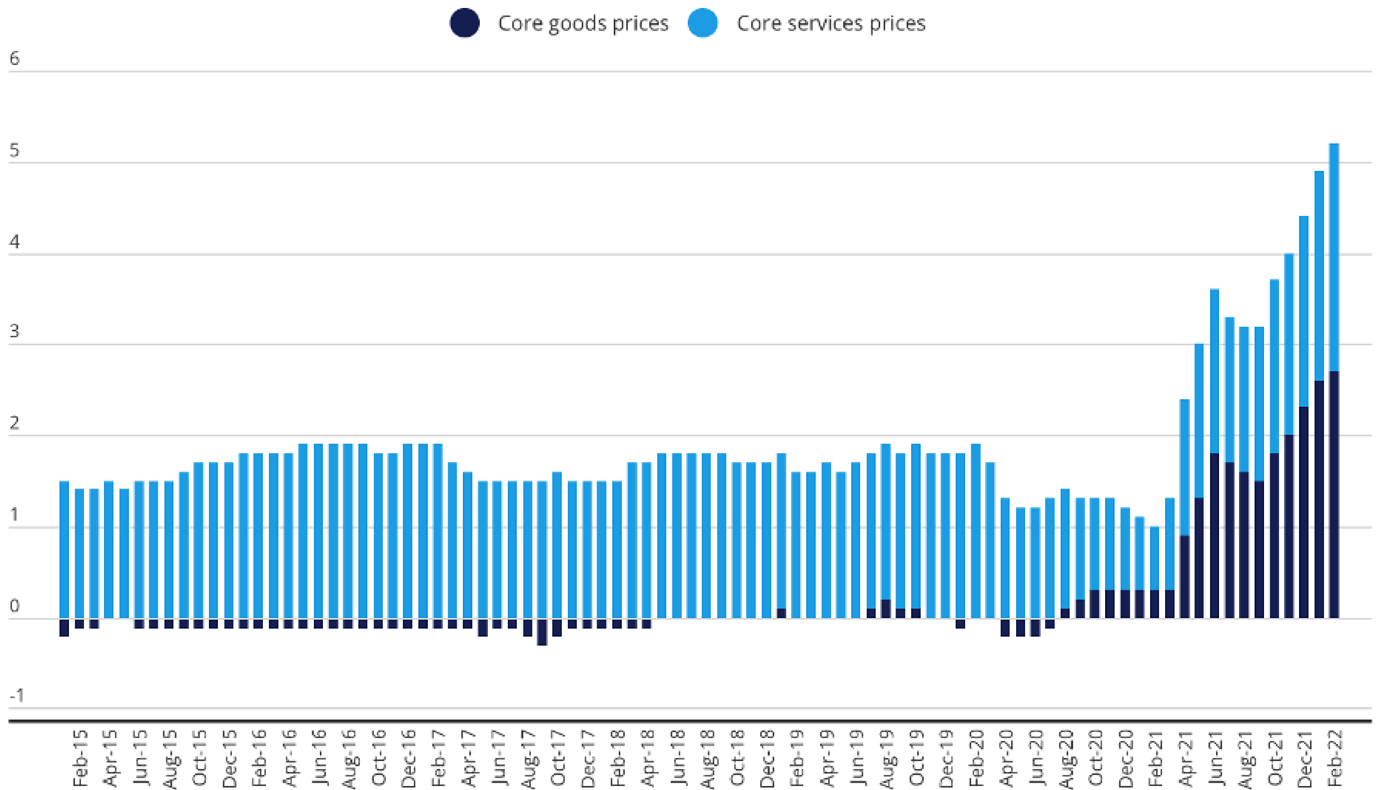


Respecting Dr. Kasriel, the former Chief Economist of Northern Trust, as I do after following his economic forecasting for over 15 years, I am still not in the near-term recession camp. I believe that there is a distinct possibility that the Federal Reserve will over apply the brakes through interest rate tightening to the point where the Fed's Funds rate collides with a falling ten-year note yield later this year. Should this happen, a recession would become almost inevitable, as Dr. Kasriel illustrated above.

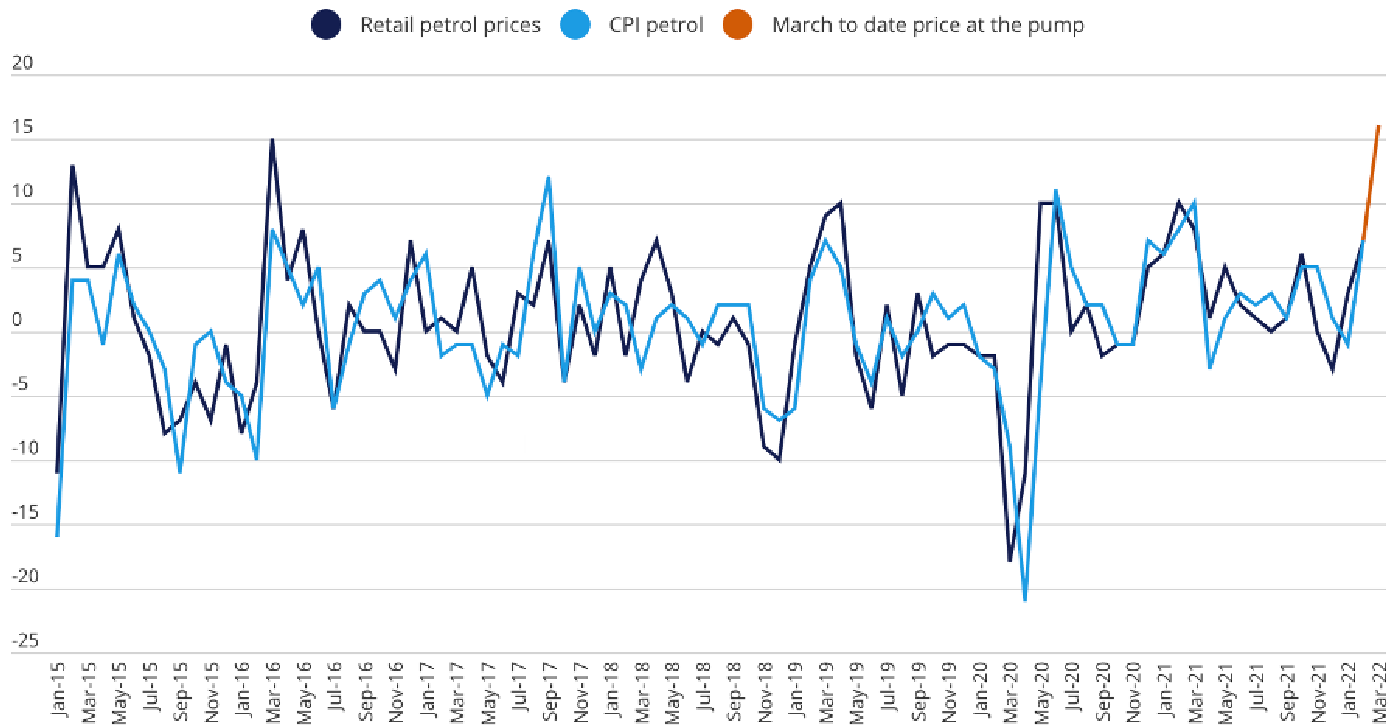
Regarding inflation and what today's very uncomfortable high inflation signals about the future of prices in the U.S. over the next 3-5 years, we remain unconvinced that we are entering a new high inflation paradigm (stubbornly above 3%). We are open to the idea that technological advancement, facilitating what is known as "gig economy" jobs, overlayed upon the genuine attitude difference between younger and older workers, can put upward pressure on wages in areas of the economy that do not lend themselves to remote work options and less rigid schedules.

Thus, our baseline assumption is that the current spike in inflation will moderate over the next six to twelve months, and overall inflation will settle back to levels that are only modestly above where it was before the pandemic. Post the 2008-09 financial crisis, inflation rates in the U.S. averaged slightly below 2%. Demographics, technological innovation, and more attention to income inequality will likely drive labor costs higher in specific sectors of the economy during the 2020s. Thus, we see inflation running higher than the trend over the last twelve years, but we do not believe that this will constitute a long-term inflation problem as many are currently envisioning. After nearly 25 years of capital market experience, we have seen a pattern of the

consensus opinion falling prey to the "recency effect" during times of abrupt and significant deviations from prior long-term trends. In other words, when there is an unexpected break in a long-term trend, it is commonplace for the consensus opinion to extrapolate a new linear trend from what usually turns out in retrospect to have been a temporary extreme. See an illustration of how this current high inflationary environment abruptly appeared approximately one year after the initial outbreak of the COVID-19 pandemic:



Gasoline prices are hitting levels not seen for more than eight years in many areas of the United States. Although these significantly higher prices are a very real "tax" on certain businesses and people who fall into the middle to low-income segments of the population, we have seen many temporary spikes in crude oil prices for various reasons in the recent past. Each time these spikes have been followed by precipitous declines. See the chart below, which records month over month percent changes in prices for retail gasoline (petrol) and the CPI's measure of gasoline prices:



Source: Haver, abrdn Research Institute, March 2022

The takeaway from this month's commentary should be that historically it has been very unwise for an investor to react to short-term positives or negatives when it comes to most economic metrics. Like vacillating stock prices, when it comes to economic metrics, history teaches us that abrupt changes should be treated as temporary with a tendency to revert to the mean far faster than the consensus anticipates. Additionally, with all statistical measures, data points are easily observable, and there is a tendency to strive to seek patterns and assign anecdotal causation to an isolated factor. However, as in the case of the 2-10 year Treasury Note Yield inversion, simply finding an apparent pattern does not necessarily strengthen the possibility that such a one-dimensional pattern observation is reliably predictive. In many cases, as with fixed income yield curve observations, one must search for additional factors or secondary data points that may be equally important before designating something as reliably predictive based upon historical patterns.

We have many times over the history of our monthly commentary dismissed using equity price fluctuations as reliably predictive, however, we are less inclined to ignore meaningful price changes when it comes to bonds. Since January 1, 2022, we are seen the most significant sell-off in bonds relative to annual returns dating back to 1977. See the illustration below:

Bloomberg Barclays Aggregate, Total Return (1977 - 2022)

Year	Return	Year	Return	Year	Return
1977	3.0%	1993	9.7%	2009	5.9%
1978	1.4%	1994	-2.9%	2010	6.5%
1979	1.9%	1995	18.5%	2011	7.8%
1980	2.7%	1996	3.6%	2012	4.2%
1981	6.2%	1997	9.7%	2013	-2.0%
1982	32.6%	1998	8.7%	2014	6.0%
1983	8.4%	1999	-0.8%	2015	0.6%
1984	15.1%	2000	11.6%	2016	2.7%
1985	22.1%	2001	8.4%	2017	3.5%
1986	15.3%	2002	10.3%	2018	0.0%
1987	2.8%	2003	4.1%	2019	8.7%
1988	7.9%	2004	4.3%	2020	7.5%
1989	14.5%	2005	2.4%	2021	-1.5%
1990	9.0%	2006	4.3%	2022 YTD	-7.2%
1991	16.0%	2007	7.0%		
1992	7.4%	2008	5.2%		

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Chart by Compound Advisors

This month’s commentary can be summed up by stating that we do not reflexively extrapolate trends and we resist the idea that there are sure-fire methods for predicting the future, especially pertaining to economics. However, we must take notice of signs that we might be witnessing an inflection point for interest rates. The magnitude of loss that we have seen in bonds since the beginning of the year cannot be ignored. If we are indeed witnessing a bond market inflection point, this will have major ramifications for the investment industry. A forty-year bull market in bonds has fueled a secular expansion in equity multiples. A secular reversal of the bond bull market will have secular implications for almost all asset classes and all investors, particularly passive-oriented asset allocation investors.

Fortunately, we have remained significantly underweight in traditional bonds for the last ten years, and although we seek out large equity “compounders,” which tend to be companies that are growing faster than the average company, we are valuation sensitive. We are convinced that if we are indeed witnessing a bond bull market inflection point, being a “growth at a reasonable price” equity investor will be very advantageous, and conversely, being a “set it and forget it” index investor will no longer offer the “free lunch” that it has historically appeared to offer.

Curt R. Stauffer

President & CIO

Seven Summits Capital

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