QUARTERLY COMMENTARY
Notes from the NewSquare Community

NewSquare Capital

3rd Quarter • 2019

Reframing the "Inverted Yield Curve"

With the record-long economic expansion now in its 11th year, a lot of people want to talk about when it's going to end. Almost daily, you can find news stories about the latest "signal" of a recession. The most recent centers on the inversion of the yield curve, which has preceded every U.S. recession since 1955. However, there is more to the story.

What is an inverted yield curve?

The yield curve plots the interest rates on both shorter-term and longer-term bonds. When the rate on a shorter-term bond is higher than the longer-term bond, the yield curve is "inverted." U.S. Treasuries, like all bonds, are loans. You lend the government money, and the government pays you interest for the risk you've taken by lending your money. Typically, the longer you lend money, the more you get paid. That's not true at the moment, however, which is unusual.

What does the inverted yield curve mean to you and me?

If you talk to 20 different economists, you are likely to get varying answers. An inverted yield curve can be associated with negative economic circumstances, which is why it's an eye-catching headline. So are short-term market corrections, escalations in global trade tensions, and signs of a slowdown in Europe. If the day's news leans toward the negative, you'll hear pundits talk about signs of an impending recession.

That does *not* mean it's time to overreact, or even shift your portfolio. Yes, an inverted yield curve has preceded recent recessions, but not right away. A study by Credit Suisse showed that economic downturns come an average of 22 months—and as long as 34 months—after an inversion. Is that caused by the inverted yield curve? Maybe. It may also be just another data point that shows its importance only in hindsight.

If inversions don't immediately lead to recessions, what tends to follow? The answer may surprise you. Credit Suisse found that the S&P 500 rallied an average of 15% *after* the inversion, so investors who pulled out of the market missed out on those gains, which can be difficult to watch and potentially hazardous to long-term investment outcomes.

> *"First, there were double-dip recession fears. Next, it was the sovereign debt crisis in Europe. A soft landing in China has been a worry for years now. Then it was the surprise presidential election results in 2016.* ***Now the big worry is an inverted yield curve. There will always be something to worry about, because good news is gradual while bad news is a headline."***
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> —Ben Carlson, CFA, Director of Institutional Asset Management, Ritholtz Wealth Management, September.

At NewSquare Capital, we don't make market predictions for any of our portfolios, because markets are inherently unpredictable. We don't know when the downturn will come, and neither does anyone else. What we do know is that informed investors don't overreact. They understand that although there are no guarantees, their portfolios are designed to make them money over time, and that a well-constructed plan will adjust to keep working for them over the long haul.

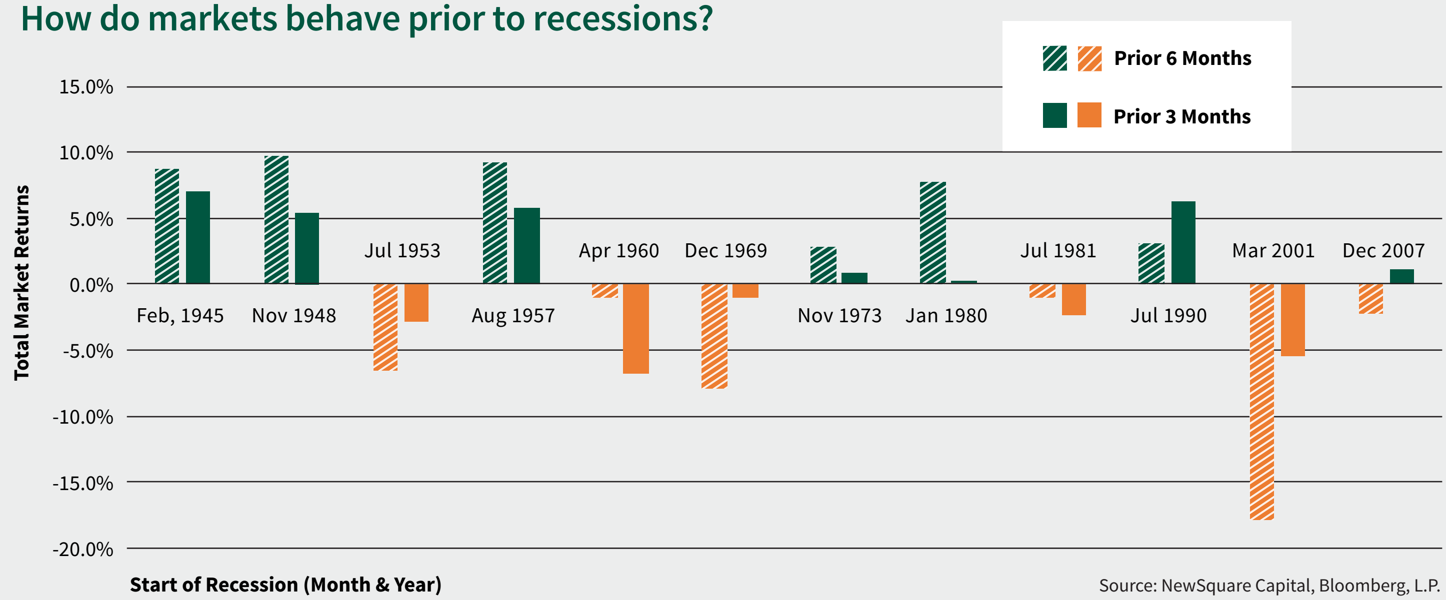
Mr. Carlson writes about—and debunks—the conventional wisdom that market corrections can predict big economic downturns. He points to the old saying that the market has predicted nine of the last five recessions. It's funny, in part because it's true.

Later on, Mr. Carlson notes that since World War II, the U.S. economy has been in recession about 15% of the time. That's an interesting point. It reminds us that downturns and recessions are part of investing, not wildly unusual events. It also means that over the last 75 years, the economy has expanded 85% of the time. "The problem for investors," Mr. Carlson writes, "is most of us spend 85% of our time focusing on events that happen 15% of the time instead of the other way around."

The moral is: Most investors spend too much time worrying, and many let emotions compromise their long-term investment strategy.

(Continued on page 2)

How do markets behave prior to recessions?



Source: NewSquare Capital, Bloomberg, L.P.

Market Review

Despite a decline in August, large-cap U.S. equities closed the quarter up slightly. Given all the gloomy headlines, remember: The S&P 500 Index is up approximately 20% in 2019. And, although widely followed small- and mid-cap indices showed a recent slowdown, both have posted a 14% return or greater on a year-to-date basis.

The U.S. Federal Reserve (Fed) cut interest rates twice during the quarter, citing U.S.- China trade tensions and signs of a global slowdown. Note, though, that Fed Chair Jerome Powell said he expected the economy to "expand at a moderate rate." There's plenty of good news out there, too. Unemployment remains near a 50-year low, and wage growth has been strong for more than a year. Consumer spending remains strong, fueling corporate profits, and the housing market has picked up momentum.

From a fixed income perspective, there was a great deal of talk about the market value of the Bloomberg Barclays Global Negative Yielding Debt Index reaching $17 trillion in August and the pressure put on U.S. yields by the flight to higher-yielding U.S. markets. Indeed, a lot of international governments are actually charging investors interest to hold their bonds, from Europe to Japan. Still, the recent Fed rate cut helped fuel a continuing bond rally, with the Barclays U.S. Aggregate Bond Index posting a year-to-date return above 8%, which is a healthy 9-month return in fixed income.

Portfolio Discussion

During the third quarter of 2019, our broad asset allocation and portfolios remained largely unchanged, with no drastic moves. The bottom line: Market movements have not been drastic enough for us to shift toward a more defensive mode.