TD Wealth

Commentary – Q2 2019 – The Inversion

The story of the second quarter of 2019 was one of relative calm on both the financial and political fronts. The quarter had its share of political melodrama to be sure, but nothing that surprised the markets per se. In addition to the continuing uncertainty surrounding U.S.-Sino trade relations and the specter of Brexit still hanging over the western European economic zone, the other pressing issue that will continue to manifest and act as a source of concern is the very precarious balancing act that the stewards of our global economy (the central banks) are asked to maintain.

That balance involves the maintenance of the status quo; indeed the system has evolved such that it is required. Intended or not, the status quo involves keeping income inequality fairly high, so that large portions of global wealth are concentrated in relatively few hands. This has had the effect of keeping social classes very stratified by maintaining financial barriers to educational opportunity. Median income levels have been relatively stagnant for over three decades in part because of the *de facto* subjugation of organized labour as a political force. The end result of these machinations is the enduring low level of inflation and interest rates, which in turn has demonstrated the ability to increase and maintain real and financial asset values.

Of course, this mandate, whether explicitly stated or not, has to be increasingly balanced by the management of populist uprisings spurred by the frustrations of a large portion of the population that has become disenfranchised and increasingly desperate. One proven method to deflect attention away from the mechanisms employed by the investing class to maintain the status quo is to *divide and conquer*, as it were. History has shown it to be very effective to use tactics such as the scapegoating of ethnic minorities, the threat of illegal immigration, and the fear of the *other* in order to obscure the true source of the misery of the working poor and debt-ridden middle class. This may not change as long as it is in the best interest of the investing class for it not to.

Part of this social and political engineering potentially involves keeping interest rates as low as possible to stave off a full-blown economic recession, but not so low that they spark inflation. Indeed, as recently as this past December, the markets sounded the alarms when central banks had the temerity to begin a series of short-term rate hikes designed to put the brakes on an economy that looked to be overheating. This tone has changed completely, and while the overnight lending rates that central banks use as a policy lever have not decreased, the longer term side of the market certainly has such that the yield curve has now flattened and become inverted. As at the end of Q2, the U.S. Treasury yield curve has now been inverted for a full quarter - an incredibly dull sounding turn of events that happens to be a fairly reliable warning sign that an economic downturn may be on the way. The yield curve has flipped prior to each of the last seven official recessions over the past 50 years, without a single false alarm during that stretch.

When yield curve is *inverted,* what it really means is that the typical order of the debt markets that prevails when the economy is healthy has been turned on its head. Usually, long-term government bonds offer higher yields than short-

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term ones, because investors demand higher interest rates in return for locking up their money for greater periods of time. There are various reasons for this, but a big one is that the longer it takes for an investor to get their money back at maturity, the more risk there is that inflation will erode the value of the investment itself.

The recent inversion of the yield curve seems to have intensified recession fears, both in the U.S. and Canada. Paradoxically, in Canada, these tensions have coincided with mostly above-industry consensus economic data compared to global counterparts. While the general outlook does not guarantee a recession this year, trade tensions and overall household indebtedness are testing the longevity of the current economic expansion heading into next year and may well force the Bank of Canada's (BoC) hand.

What is notable is the magnitude by which domestic data in Canada has outpaced other developed countries. The relative strength of Canadian data may be partly due to the lowered expectations as the Canadian economy sputtered over the second half of 2018. As well, the Canadian labour market has been exceptional, with the unemployment rate near historic lows. While it is true that the Canadian economy is gradually recovering, it is wise to remember that Canada is not an island. The divergence between Canada and other developed countries, both from the perspective of macroeconomic data and central bank rhetoric, cannot be sustained indefinitely. The sustainability of further upside surprises in economic data may require improved global conditions generally and in the U.S. specifically. Moreover, the World Bank's recent downgrade to global growth and global trade for 2019 does not instill confidence. These cross-currents mean the BoC may remain sidelined for the time being.

Interestingly, the markets are looking past the recent strength in domestic data and seem to be flagging recession risks as indicated by the yield-curve inversion. The percentage of the Canadian yield curve inverted in early June is close to levels that have preceded recessions in the past. The balance of risks, then, is clearly tilted toward a rate cut as the BoC's next move. Indeed, the bond markets as of June 2019 are pricing roughly 45% probability of a rate cut prior to the end of this year.

Perhaps the measure most clearly demonstrating that Canada is not isolated from global conditions is the Canadian 10-year Treasury yield which, similar to its U.S. counterpart, has declined spectacularly, from a high of 2.6% in October 2018 to 1.5% as of early June 2019. As noted above, the central bank has been dogmatic in its recent communications on the expected strength in the Canadian economy. Looking ahead, it is possible that if economic conditions are as resilient as the BoC projects over the balance of 2019, markets would gradually price out a rate cut. In this scenario, bond yields may have modest upside from current levels. Conversely, the narrative currently reflected in market pricing is for global conditions to continue deteriorating due to delays in U.S.-China trade resolution and for sentiment to erode further and force the BoC to cut its policy rate. In this scenario, a retest of the prior lows of 1% seen in 2016 is a possibility. Regardless of which scenario plays out, there is a low probability of the Canadian 10-year yield retesting its 2018 highs.

To be clear, it is not a given that we are headed into a recession – yet. But the inversion of the yield curve sends us an unambiguous warning signal about the *potential* for an economic downturn in the next 12 months. The U.S. Federal

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Reserve (the Fed) is likely to take these downside risks very seriously. At the end of the first quarter the Fed looked to remain on hold for the bulk of 2019. But with downside risks re-intensifying and inflationary dynamics weakening, it looks increasingly likely the Fed will now cut interest rates in both July and September.

With unemployment levels at generational lows it could legitimately be asked: where is the inflation? Labour unions were historically responsible for significant improvements in workers' bargaining rights, financial compensation and ancillary benefits. The reduced influence of organized labour in today's employment landscape has seen this trend reverse itself almost completely. Where is inflation? It could be hiding in the *gig economy* we now find ourselves in.

Best regards,

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Sources: TD Wealth – Q2 -19 – Quarterly Market Review; Straight Forward – Summer 2019; Global Economy: Russell Financial Q2 Economic Summary; TD Economics: Canadian Quarterly Economic Forecast - Tariffs Impart a Chill Wind on Green Shoots

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