HOLBROOK
— HOLDINGS —

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YIELD CURVE INVERSION HAS INVESTORS IN A TIZZY

THE 2-10'S INVERTED

The markets sold off early this week because of concerns over an inverted yield curve. Despite much of the yield curve having been inverted for months, 2-10's inverted for the first time since 2007 and financial media decided to propagate this narrative. Let's be clear – the fixed income market has been flashing warning signs for much of the year and the marginal difference between 10 basis points of steepness and a barely-inverted yield curve is negligible. We have been advocates of defensive positioning since the Spring, but don't advise overreacting to the last 10 bps of flattening and do not recommend chasing duration after this dynamic move lower in yields. It is a warning sign, yes, and investors should probably take a look at their overall allocations and not be overweight risk assets – a marginal underweight may even be appropriate.

IS IT DIFFERENT THIS TIME? MAYBE.

The current inversion exhibits some different characteristics from past occurrences. First, typical inversions stem from the Federal Reserve increasing short-term rates (what we often call a Bear Flattener). This inversion stems from strong inflows into the long-end of the curve (Bull Flattener) which I believe stems from a number of reasons. The U.S. economy is an island of strength in an otherwise dreary macro-environment. As such, our yields are higher than most developed nations, and Central Banks across the world have systemically hurt their economies through negative rates. So much so, that pension funds and other institutional investors are now taking on currency risk and buying our treasuries outright. Second, there was still significant short interest in treasury futures. And finally, as yields have fallen, more mortgage exposure has been called away and this is being replaced with treasury exposure. When yields have this sort of dynamic move, mortgage investors are often forced to buy treasuries because their portfolio duration plummets (negative convexity). Hence, the flood into the long-end of the curve. I do not believe the most recent move in treasuries is an indication of extreme economic weakness in the United States, but rather a perfect storm of the above influences. This sort of move can have a mind of its own, and I do not know where it stops (although my feeling is that we are close). Ultimately, I think this long duration trade ends in tears and there is significant vulnerability at the long-end of the curve.

The bad news for risk-assets is that trade war uncertainties continue to persist and there had been significant supply-chain disruption. Moreover, this disruption will likely be passed onto the consumer hurting their purchasing power.

The good news is that the lag time for a recession after an inversion historically has been between 1 and 2 years. S&P 500 dividend yields are now significantly higher than the 10-year treasury yield, and earnings yield differentials are starting to look attractive. And *if* longer-term yields are lower due to global weakness, this latest rate move will prove to be stimulatory for an economy that is already relatively robust.

That being said, I am not an advocate of "its different this time." I think that the U.S. economy will continue to slow, and I would not be surprised if we have a Recession in the next 18 months – albeit a shallow one. I also believe that inflation will remain stubbornly above the Fed's 2% target during that slowdown (stagflation).

POSITIONING FOR STAGFLATION

In this environment we have, and will continue to:

1) Remain on the short-end of the curve where the Fed has our back and will likely keep rates low

2) Retain exposure to curve steepeners that have significant upside as their coupons adjust

3) Keep credit quality high (currently A-)

4) Have exposure to shorter duration TIPS (1-5 years) currently we have 14% exposure

5) Accumulate BDC Baby Bonds if they sell-off as they are covenant protected, provide a great yield, and their portfolios would have to experience losses of 50% or more to hurt bondholders.

CONCLUSION

Yield curve inversion is a warning sign. It does not guarantee recession nor does it mean corporate earnings are going to fall off a cliff. The main driver of the global economy, the American consumer, still has their legs. We have been positioned defensively, and if unemployment claims tick higher and labor reports start to reveal additional weakness, we would further increase the credit quality and lower weighted average maturity of the portfolio. If we do enter a recession, that would be the impetus for us to become more aggressive as risk-assets reprice.