Zanetti Monday Missive 2022.03.28
The Yield Curve and Recession

“It’s not what we don’t know that gets us in trouble. It’s what we know for sure that just ain’t so.”
~ Mark Twain

I’ve written about inflation quite a bit recently. As you all may recall, the Federal Reserve Bank has been tracking the upward trend of inflation…

Wait!

Let me go back a ways and remind everybody that last year the Fed kept reassuring all of us that the inflation we were experiencing was only… “Transitory.”

Most rational folks knew that statement didn’t make sense. What did they mean by "transitory"? After all, all things are "transitory." The dinosaurs were transitory... The Roman Empire was transitory. The idea that we shouldn't worry about inflation didn't seem right. And we

were correct.

Well, we at Zanetti Financial, started making investment decisions based on trends we saw that we knew weren't "transitory". And, while the mantra "transitory" helped keep the money flowing into the Stock Market as we watched the Dow reach historically high levels, we started making better investment plans.

Another laughable note from the Fed is that inflation grew to 7.8% last month – the highest since January of 1982. The high inflation isn't laughable, what is laughable is that they are calculating inflation at only 7.8%.

Let me ask you all, gentle readers, what can you think of that has only gone up 8% over the past year? Not much that I can think of. Everything that comes top of mind has been in the double digits.

If the Fed calculated inflation the way they calculated it in 1982, we'd probably be somewhere north of 14%. But, hey, at least the Fed is showing us that inflation is rising and not falling. I guess I'll give that one to them.

I also want to point out that Russia invading Ukraine did not cause this inflation. Enough about that.

And enough about inflation. That's not what this post is about.

This post is about… YIELD CURVES!

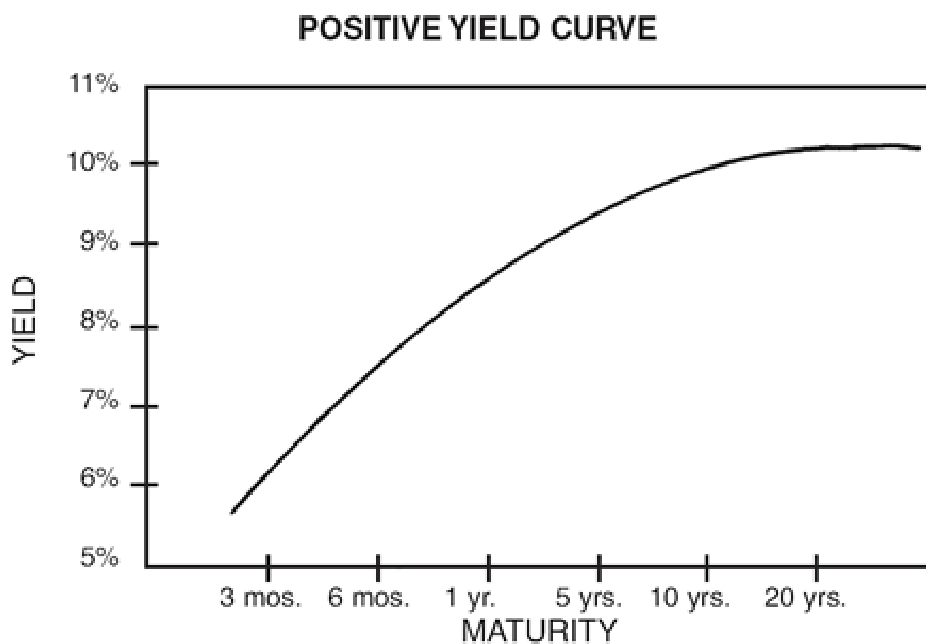
Yes, buckle your seatbelt for an exciting presentation on bond yield curves ;-). They are a predictive indicator regarding recessions.

For those who are unfamiliar with bonds, they are issued at interest rates for investors who want a specific return for their money. The investor is the "lender" and the bond issuer is the "debtor."

Typically, if someone loans money for a short period, they get a smaller return. And if they are willing to lock it in for a longer period, they typically only do so for a higher yield.

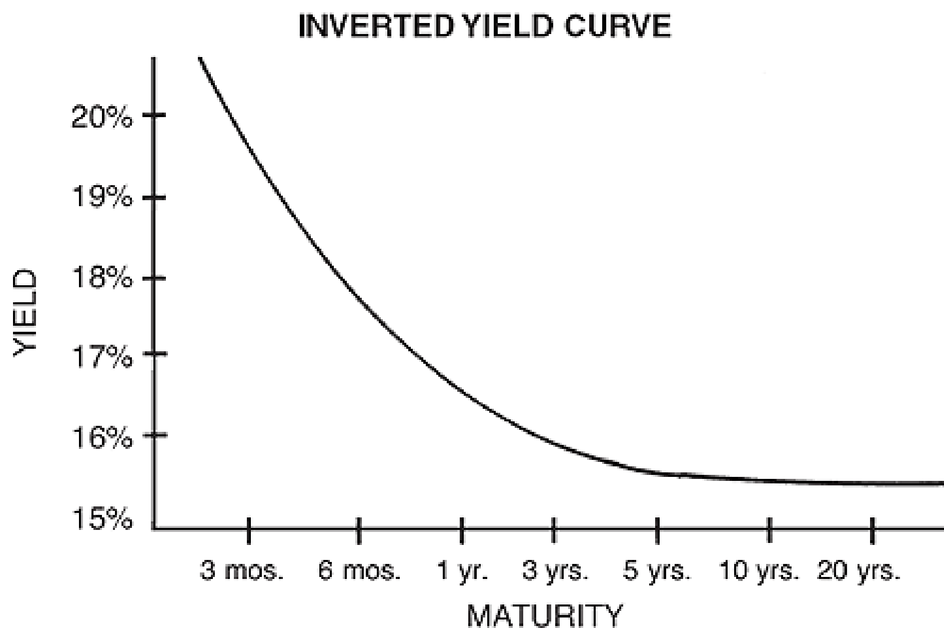
Makes sense, right? Why would someone loan a bond issuer money for a long time period unless they could make more money than if they loaned it for a short time period?

Historically, when times are good, short-term bonds yield a smaller percentage, while long-term bonds yield a higher percentage. That's called a "positive yield curve."



If short-term bond yields are higher than long-term bond yields, it means that investors don't trust short-term periods. They need a motivator to invest for a short period because they feel it is riskier than the long-term.

When the short-term yield is higher than the long-term yield, that is called an “inverted yield curve.”



Here’s the thing about inverted yield curve’s – they tend to be accurate predictors of recessions. And, guess what is currently happening to our yield curve?

Well, it’s not inverted yet, but it’s definitely flattening. Right now, the 2-year Treasury is at 2.03%, while the 10-year Treasury is at 2.24%. We’ll see where the curve goes in the weeks ahead, but with inflation continuing to go up, I think we’re looking at an upcoming recession.

With inflation so high and a recession looming, even the more traditional houses like Morgan Stanley and Goldman Sachs are encouraging their investors to brace for a “bear market” (that means a downward trending stock market) and invest in “real assets” like raw materials, infrastructure and increasing their diversification.

Thanks, Morgan and Goldman… have you been reading our missives?

Your Regardless-Of-The-Next-Supreme-Court-Appointment-They'll-Still-Be-Ruthless Financial Advisor,

Walt

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