



MORNING BRIEFING

March 27, 2019

Tossing a Curveball

See the [collection](#) of the individual charts linked below.

(1) A hedged warning about rising recession risk in updated Fed study. (2) Recession risk up from 14% last summer to 50% now. (3) Then again, maybe the yield curve is forecasting monetary policy more than anything else. (4) Credit crunches cause recessions, not inverted yield curves! (5) A false positive signal, again? (6) Guess what the yield curve is predicting the Fed will do next: Nothing! (7) Buffett likes companies that buy back their shares. (8) We agree, as long as they don't offset that with employee stock compensation.

Yield Curve I: The Pause that Refreshes? On Monday, Melissa and I stated that there is “no recession warning in the near-term spread” according to a July 2018 Fed study about the yield curve updated during February this year. Actually, while there was no such warning in the original study, there was a warning in the update, one that might have contributed to the Fed’s remarkable pivot from a hawkish to a dovish stance on monetary policy since the start of this year. However, the warning was hedged considerably. Let’s have another closer look at the study:

(1) *Original note.* Last year, the 7/11 [Morning Briefing](#) was titled “Is the Yield Curve Bearish for Stocks?” Some might argue that it was bearish given the stock market’s selloff late last year. We weren’t making that argument and are relieved by the rebound in stock prices since December 26 despite the fact that the yield curve has continued to flatten since then. In our commentary, we wrote:

“The latest [minutes](#) of the June 12-13 FOMC meeting offers another reason not to worry about the flattening yield curve. During the meeting, Fed staff presented an alternative “indicator of the likelihood of recession” based on research explained in a 6/28 [FEDS Notes](#) titled “(Don’t Fear) The Yield Curve” by two Fed economists. In brief, they question why a “long-term spread” between the 10-year and 2-year Treasury notes should have much power to predict imminent recessions. As an alternative, they’ve devised a 0- to 6-quarter “near-term forward spread” based on the spread between the current level of the federal funds rate and the expected federal funds rate several quarters ahead, derived from futures market prices ([Fig. 1](#)).

“The note’s authors stress that the long-term spread reflects the near-term spread, which they argue makes more sense as an indicator of a recession that is expected to occur within the next few quarters. They also observe that an inversion of either yield spread does not mean that the spread causes recessions.

We continued: “Their current assessment is that ‘the market is putting fairly low odds on a rate cut over the next four quarters,’ i.e., 14.1% ([Fig. 2](#)). ‘Unlike far-term yield spreads, the near-term forward spread has not been trending down in recent years, and survey-based measures of longer-term expectations for short term interest rates show no sign of an expected inversion.’”

We concluded: “What a relief! So now, all we have to worry about is a recession caused by a trade

war!”

(2) *Updated study.* In Monday’s commentary, we reviewed the updated Fed [study](#) dated February 2019 that has a less jazzy title: “The Near-Term Forward Yield Spread as a Leading Indicator: A Less Distorted Mirror.” The authors are two Fed economists, Eric C. Engstrom and Steven A. Sharpe. They observe that their near-term spread “can be interpreted as a measure of the market’s expectations for the near-term trajectory of conventional monetary policy rates.” In addition, they report:

“Its predictive power suggests that, when market participants expected—and priced in—a monetary policy easing over the subsequent year and a half, a recession” was likely forthcoming. The near-term spread “predicts four-quarter GDP growth with greater accuracy than survey consensus forecasts. Furthermore, “it has substantial predictive power for stock returns,” find the Fed economists. In contrast, yields on bonds “maturing beyond 6-8 quarters are shown to have no added value for forecasting either recessions, GDP growth, or stock returns.”

(3) *A highly hedged warning.* Buried on page 7 of the new study, there was a warning that the probability of a recession had increased significantly since the original study was done about a year ago: “As of the end of the sample period in early 2019 (and the time of this writing), the near term forward spreads forecasted a substantially elevated probability of a recession.”

Indeed, Figure 3 in the study clearly shows that it jumped to 50% (based on Q1-2019 data available only through January). Interestingly, this important update wasn’t mentioned in the summary paragraph at the beginning of the study. However, the charts in the paper show that the odds of a recession jump most significantly when the near-term forward spread is markedly below zero, which it was not as of the most recent analysis.

So are we freaking out about an impending recession now after we told you not to freak out about an impending recession on Monday? Nope, we aren’t. We are focusing on the idea promoted in the Fed study that the yield curve first and foremost is predicting the outlook for monetary policy. For example, the paper noted that “the near-term forward spread would tend to turn negative when investors decide that the Fed is likely to soon switch from a tightening to an easing stance.”

As we showed on Monday, the yield-curve spread tends to narrow during periods when the Fed is raising the federal funds rate ([Fig. 3](#)). It tends to bottom and then widen when the Fed starts to lower interest rates. It just so happens that past recessions occurred after the yield curve inverted, i.e., at the tail end of monetary tightening cycles.

It might be different this time, if the Fed has paused on a timely basis from raising interest rates any further, thus reducing the chances of a recession. After all, there’s no need to overdo tightening given that inflation and speculative excesses remain subdued. In the past, Fed tightening (not inverted yield curves that coincided with tightening) led to financial crises, which morphed into widespread credit crunches, resulting in recessions ([Fig. 4](#)).

In our view, it is credit crunches that cause recessions, not inverted yield curves and not aging expansions.

(4) *False positive signal.* Drawing parallels between monetary policy in 1998 and today, Engstrom’s and Sharpe’s paper stated: “The most prominent false positive during our sample came with the anticipated easing triggered by the spread of the Asian financial crises in 1998, which did not result in a recession in the U.S. It is not hard to imagine that similar scenarios could generate additional false positives in the future. The near-inversion of the near term forward spread at the end of 2018 seems to have been

associated with market perceptions of significant risks to the global economic outlook, including the threat of escalating trade disputes. Whether those risks manifest in a recession remains to be seen.”

Bottom line: For now, we still don't see a significant risk of a recession.

Yield Curve II: Predicting the Fed. As explained above, the yield-curve spread first and foremost is predicting monetary policy. The Fed study cited above makes that point and convincingly observes that it makes more sense to focus on the shape of the yield curve over the next six quarters rather than over the next 10 years for insights into the fixed-income market's predictions. In this spirit, let's review the market's latest divinations:

(1) *Missing in action.* The Fed study notes: “We define the near-term forward spread on any given day as the difference between the implied interest rate expected on a three-month Treasury bill six quarters ahead and the current yield on a three-month Treasury bill.”

According to Haver Analytics (our data vendor): “We had been in touch with the Board about the 0-to-6 Quarter Forward Spread earlier this year and they had told us they calculated it using an internal fitted zero coupon curve in quarterly maturities. They only make annual maturities available at the moment so we cannot calculate.”

(2) *The 2-year yield curve.* So instead of trying to calculate the Fed study's near-term spread, we will focus on the 12-month forward futures for the federal funds rate, which is available daily ([Fig. 5](#)). The 2-year US Treasury note yield tracks this series very closely, suggesting that it is also a good proxy for the market's prediction of the federal funds rate a year from now.

(3) *Pause prediction.* After all that work, the conclusion is the obvious one: The Fed isn't likely to be raising the federal funds rate over the next 12 months. On Monday, the 12-month forward rate was 2.06%, 32bps below the 2.38% mid-point of the federal funds rate target range. The 2-year was 2.24%, 14bps below the mid-point yesterday.

The Fed study suggests to us that the spread between the 2-year Treasury yield and the federal funds rate may be the simplest way to track the fixed-income market's outlook for monetary policy over the next 52 weeks ([Fig. 6](#)). Anyone can do this at home. But that doesn't mean that the market will be right, as evidenced by how wrong it turned out to be last year.

Buybacks: Buffett Loves Them. Warren Buffett loves buybacks. Joe and I have observed in our recent discussions of this subject that we've loved them too during the current bull market. However, we've also recently concluded that they may not have been as bullish a driver of the bull market as we previously thought, and as is still widely believed. The issue for us from a big-picture perspective is that most of the buybacks have been offset by the issuance of stock as compensation to employees.

One of the most widespread notions about buybacks is that companies use them to reduce their share counts and thereby boost earnings per share. But our analysis finds that lots of buybacks have been used to offset the earnings-per-share dilution attributable to stock issuance for employee stock compensation plans. Consider the following:

(1) *The Oracle's spin.* In his latest letter to the shareholders of Berkshire Hathaway, Buffett wrote: “All of our major holdings enjoy excellent economics, and most use a portion of their retained earnings to repurchase their shares. We very much like that: If Charlie [Munger] and I think an investee's stock is underpriced, we rejoice when management employs some of its earnings to increase Berkshire's ownership percentage. Here's one example drawn from the table above: Berkshire's holdings of

American Express have remained unchanged over the past eight years. Meanwhile, our ownership increased from 12.6% to 17.9% because of repurchases made by the company. Last year, Berkshire's portion of the \$6.9 billion earned by American Express was \$1.2 billion, about 96% of the \$1.3 billion we paid for our stake in the company. When earnings increase and shares outstanding decrease, owners—over time—usually do well."

I asked Joe to calculate the share count for American Express. He reports that the company's share count has been reduced an average of 1% per quarter since Q4-2010, and is down 29% overall ([Fig. 7](#)).

(2) *Our spin.* Joe also reports that S&P just released Q4-2018 data on S&P 500 buybacks. They totaled a record \$806 billion last year ([Fig. 8](#)). Yet the difference between the y/y growth in S&P 500 operating earnings per share (22.5%) and in aggregate net operating income (20.2%) was just 2.3 percentage points ([Fig. 9](#)). Joe estimates that the share count of the S&P 500 during Q4 was just 1.3% below the year-ago level ([Fig. 10](#)).

(3) *Drilling down.* Buybacks rose to record highs in four of the 11 S&P 500 sectors last year: Information Technology (record: \$279bn), Financials (record: \$150bn), Health Care (record: \$109bn), Consumer Discretionary (\$87bn), Industrials (\$78bn), Consumer Staples (\$33bn), Energy (\$30bn), Communication Services (record: \$20bn), Materials (\$14bn), Real Estate (\$3bn), and Utilities (\$2.0bn) ([Fig. 11](#)).

Joe calculates that the share count for the S&P 500 sectors changed as follows from Q4-2017 to Q4-2018: Communication Services (up 6.4% y/y), Utilities (3.5), Materials (2.4), Real Estate (1.8), Energy (1.5), Health Care (-1.1), Consumer Staples (-1.2), Industrials (-1.6), Consumer Discretionary (-2.5), Information Technology (-4.1), and Financials (-4.3) ([Fig. 12](#) and [Fig. 13](#)).

CALENDARS

US. Wed: Advanced Trade Balance -\$57.5b, MBA Mortgage Applications. **Thurs:** GDP & PCE 2.4%/2.6%, GDP Deflator 1.8%, Jobless Claims 225k, Pending Home Sales 0.0%, Kansas Fed Manufacturing Index, EIA Natural Gas Report, Bullard, Clarida. (DailyFX estimates)

Global. Wed: Draghi. **Thurs:** Eurozone Economic Confidence 105.9, Germany CPI 1.6%/m/m/1.5%/y/y, Japan Jobless Rate 2.5%, Japan Industrial Production 1.3%/m/m/-1.2%/y/y, Japan Retail Trade 0.8%/m/m/0.9%/y/y, Japan Headline, Core, and Core-Core CPI 0.9%/1.1%/0.7% y/y, Mexico Overnight Rate 8.25%. (DailyFX estimates)

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Confidence has been somewhat volatile over the past few months, as consumers have had to weather volatility in the financial markets, a partial government shutdown, and a very weak February jobs report. Despite these dynamics, consumers remain confident that the economy will continue expanding in the near term," Lynn Franco of The Conference Board noted. The Consumer Confidence Index (CCI) dipped to 124.1 this month after climbing from a 16-month low of 121.7 in January to 131.4 in February; it was at a cyclical high of 137.9 during October. The present situation component sank to 160.6 this month after reaching a cyclical high of 172.8 last month, while the expectations component fell from 103.8 to 99.8; both remain at relatively high levels. Consumers' assessment of the labor market was less upbeat this month, with the percentage of respondents saying that jobs are plentiful (to 42.0% from 45.7%) continuing to fall from November's peak rate of 46.8%—which was the highest since January 2001—while those saying jobs are hard to get (13.7 from 11.7)

edged up from last month's cyclical low. The six-month jobs outlook also deteriorated slightly this month, though the spread between the percentage expecting more jobs (to 16.4% from 19.0%) and the percentage expecting fewer jobs (13.4 from 12.3) remained positive. It had turned negative in January for the first time since August 2016.

Regional M-PMIs ([link](#)): Four Fed districts have now reported on manufacturing activity for March so far—Philadelphia, New York, Dallas, and Richmond—and show growth at a four-month high, though little changed from February's pace. We average the composite, orders, and employment measures as data become available. The composite (to 8.9 from 8.5) index was slightly above the 5.1 average posted the prior three months, and only a third the pace of last year's high for the year of 26.7 in February. The Philadelphia region's composite (13.7 from -4.1) index shows growth expanding again this month after turning negative in February for the first time since May 2016, though is growing at roughly half the pace of H2-2018; gauges for Richmond (10.0 from 16.0), Dallas (8.3 from 13.1) and New York (3.7 from 8.8) all slowed—with the latter's the weakest since May 2017. The new orders gauge (4.1 from 7.8) dropped closer to the breakeven point of zero—expanding at the slowest pace since October 2016. The pattern was similar to the composite index, with new orders in the Philadelphia (1.9 from -2.4) region moving from contraction to expansion, while Richmond (9.0 from 19.0), New York (3.0 from 7.5) and Dallas (2.4 from 6.9) billings decelerated. Meanwhile, the employment (14.9 from 11.6) measure shows hirings faster than February's pace, with Philadelphia (9.6 from 14.5) factories adding to payrolls at a slower pace this month and Richmond's (23.0 from 15.0), New York's (13.8 from 4.1), and Dallas' (13.1 from 12.6) at faster rates. In the meantime, inflationary pressures remained on an easing trend according to prices-paid indexes for the four regions, while the prices-received measures were a mixed bag. Here's a look at the prices-paid indexes for March versus their respective peaks during 2018: Philadelphia (to 19.7 from 60.0), Dallas (20.4 from 54.4), New York (34.1 from 54.0), and Richmond (2.8 from 5.7)—with only New York showing a slight acceleration this month. Meanwhile, Dallas' prices-received index ticked up to 6.9 after easing from June 2018's peak of 26.2 to 5.2 in February, while New York's measure eased to 18.1 after accelerating the prior two months from 12.8 to 22.9—nearly matching its recent peak of 23.3 last June. The prices-received index for the Philly region has hovered in a flat trend around 26.3 the past six months, still below its peak of 35.0 last July. Richmond's (2.1 from 2.8) rate remained at 2.1% y/y this month, not far from its recent peak. (Note: Richmond prices are not diffusion indexes but rather average annualized inflation rates.)

Housing Starts & Building Permits ([link](#)): Housing starts posted its biggest monthly decline in eight months in February, as single-family building fell to its lowest level since May 2017, though weather likely impacted building last month. Total starts dropped 8.7% to 1.162mu (saar) after an 11.7% surge in January and a 5.5% drop in December. Single-family starts tumbled 17.0% to 805,000 units (saar) last month and are 10.6% below year-ago levels. Meanwhile, multi-family starts rebounded 17.8%, to 357,000 units (saar) last month, after a two-month slide of 23.9%. Building permits fell 2.3% during the two months through February, to 1.296mu (saar), after jumping 4.8% the last two months of 2018. Single-family permits were unchanged at 821,000 units (saar) last month, leading housing starts of 805,000 units—a good sign for future building. Multi-family starts dropped 4.2% to 475,000 units (saar), though exceeded February starts of 357,000 units. The National Association of Home Builders Housing Market Index (HMI) was unchanged at 62 this month (remaining above December's low of 56), as the buyer traffic component slipped to 44 after climbing from 43 to 48 the first two months of the year. Meanwhile, both the current sales conditions (to 68 from 61) and expected sales (71 from 61) components posted impressive gains for the first three months of this year.

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