TFA Monthly Newsletter

September 2019

Signal or Noise? What You Should Know About the Inverted Yield Curve

By Braxton Sato

Financial news in August was dominated by speculation about a pending US economic recession. In addition to real factors such as weakening economic data and a possible trade war with China, many pundits pointed to an indicator called an "Inverted Yield Curve." In this month's newsletter – we present a cliff-notes version of this indicator and what it means to our tribal clients.

The Yield Curve – What is it and What does an Inverted Curve Mean?

The Yield Curve is a plot of the "yield" (or effective interest rate) on United States government debt ("Treasuries") by term, ranging from 1-month T-Bills through 30-year Bonds. Normally – short-term bills yield less than long-term bonds (inflation, risk, opportunity cost). If I'm locking my money up for longer, I should get a higher return. In a normal economic environment, we expect the yield curve to look like the blue line in Figure 1.

However, recall the inverse relationship between price and yield. The higher the price of a bond, the lower the yield and vice versa. Treasuries are widely considered to be a "safe haven asset" or "risk-free" since they are backed by the US government. If there is a negative near-term economic outlook, investors will park more of their money in Treasuries relative to riskier equities in the stock market and high yield corporate bonds. This drives up the price of long-term treasuries, and therefore yield decreases. The result is a yield curve with a shape that usually looks like the orange line in Figure 1.

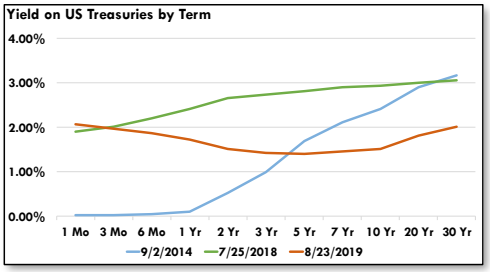

Figure 1: The Yield Curve (Source: US Department of Treasury)

The inverted yield curve (where it slopes downward and longer-term rates are lower than shorter-term) has historically been a leading indicator of recession. Since 1970, all recessions have been preceded by an inversion. As shown in Figure 2, the New York Fed's predictive model based on yield curve inversion has

(continued on Page 2)

IN THE NEWS

Opportunities And Challenges For Sports Betting In Indian Country
8/1/19 – IndianGaming.com

Coharie Tribe Member Claims National Indian Gaming Commission Chairman Position
8/2/19 – WorldCasinoNews.com

Gila River Achieves First For School Construction Financing In Indian Country
8/3/19 – NativeBusinessMag.com

Forest County Potawatomi Community Applies For Commercial Casino License
8/5/19 – Indianz.com

Cherokee Nation Businesses Unveils Plans For $225M Legends Resort & Casino Arkansas
8/12/19 – NativeBusinessMag.com

Siletz Tribe To Launch Professional And Collegiate Sports Betting At Chinook Winds
8/25/19 – NativeBusinessMag.com

Shawnee Tribe Announces September 12 Opening Date For Long-Awaited Casino
8/26/19 – Indianz.com

(continued from page 1)

accurately predicted past recessions. On average, there is a 14-month lag between inversion and recession per JP Morgan Asset Management. Last week, the yield inversion had reached levels not seen since 2007.

Recession Fears Overblown

However, it is important to note that **not all inversions have been followed by a recession.** So, while this indicator might be a red flag, we do not view this as an immediate doom-and-gloom scenario. Other leading indicators of the economy have not yet flashed red. Many are strong. The ISM Purchasing Manager's Index, a measure of business sentiment, is still sitting above 50%. While the OECD Consumer Confidence Index is declining, it is still above pre-2008 recession levels. The US Census Bureau's June Durable Goods Report showed a 2% increase in new orders, meaning businesses are still buying. In an August 2019 Bloomberg survey of economists, 40% of economists expected a recession by the end of 2020, **down from 52% in February.**

The yield curve has flattened generally since 2008 (see green line in Figure 1), even in a strong economy. Factors outside of recession expectations may be driving this inversion. As pointed out by Rex Evans of Derivative Logic, "a yield curve inversion, which historically almost always precedes US recessions, is not as powerful a signal in the current environment and U.S. recession risks are exaggerated. Most of the panic evident from the fall in U.S. Treasury yields is being imported from China and Europe's darkening economic picture. Negative rates in Europe and Japan, the expected restart of bond buying by the European Central Bank and the massive Fed balance sheet are all distorting the yield curve and muting the traditional signal." (see Figure 3)

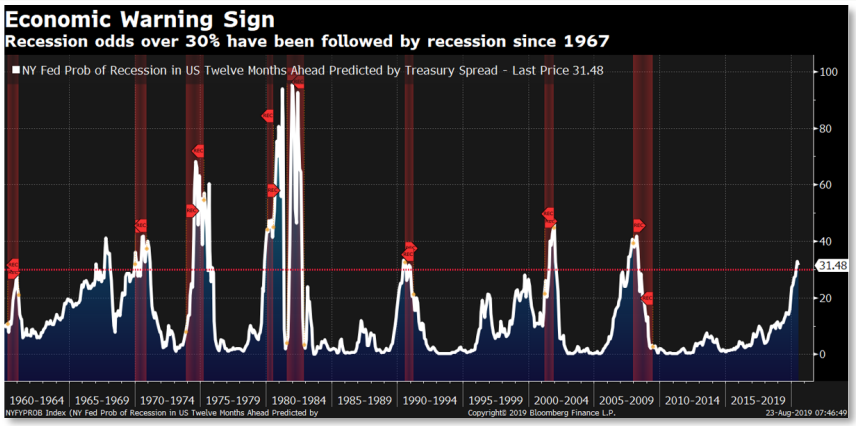

Figure 2: Probability of recession as predicted by Treasury Spread (Source: Bloomberg, courtesy of Derivative Logic)

Figure 3: Difference between 10-year and 2-year Treasury Yield (Source: Bloomberg, courtesy of Derivative Logic)

What does this mean for Tribes?

Don't Panic – Keep an eye on the market and other economic indicators, especially consumer and purchasing drivers. If working on 2020 budgets or evaluating economic development projects, management and tribal leadership should recognize this risk, but don't use the downside as the "base case."

Credit Markets Still Strong – Access to capital remains strong in Indian Country. Bank and institutional lenders are still active and looking for new deals. Running up to the 2008 recession, credit markets froze and new lending (especially to Tribes) dried up. It is still a good time to finance solid projects and growth initiatives.

As always, please contact us if you would like to discuss the potential impacts of these economic headwinds on your economic development or capital raise process.

TFA
201 Continental Boulevard
Suite 110
El Segundo, CA 90245
tfacp.com

KRISTI JACKSON
CHAIRMAN
310.341.2335
kjackson@tfacp.com

DAVID HOWARD
CEO
310.341.2795
dhoward@tfacp.com

WILLIAM NEWBY
PRESIDENT
310.341.2796
wnewby@tfacp.com

WILLIAM CRADER, CFA
MANAGING DIRECTOR
310.341.2336
wcrader@tfacp.com

TFA CAPITAL PARTNERS

FOLLOW TFA ON: