Some 'Initial Rate Cuts' May See The Market Go Nuts

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by: The Fortune Teller

Summary

- The 3-month/10-year spread inverted three months ago, for the first time since 2007.
- The 3-month/5-year spread has inverted for over a full quarter.
- The yield curve is steepening over the last couple of months.
- The Fed is about to conduct some 'initial rate cuts'
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It was late March, when the 3-month/10-year spread inverted for the first time since 2007.

Although the ultimate 2-year/10-year spread hasn't inverted, this wasn't something investors could (or should) ignore, simply because an inverted yield curve is one of (if not) the most reliable indicators, ahead of a recession.
Exhibit 2: US 10y-2y spread tends to invert earlier than 10y-3m, but not in this cycle

Since curve inversion has preceded the past 7 recessions, there's a good reason to believe that it's likely to precede the next recession too.

As the above chart suggests, not only that might only have 14/17 months (since late March 2019) till the next recession, but we should also expect the yield curve (once inverted) to steepen before any significant stock market move down takes place.

In the below chart, you can see when the inversion started (marked 1), as well as the recent steepening (marked 2), across the curve.
Of course, since the 2-year/10-year spread hasn't inverted at any given point (this year), one might wish to dismiss this completely. Fair enough, but then allow me to move from the yield inversion discussion to another, at least as important, topic: Monetary policy.

But before doing so, a friendly reminder to what we wrote two weeks ago:

*Cam Harvey, the economist who first linked an inverted yield curve to economic declines, pinpoints the 3-month/5-year curve as a key recession indicator once it inverts for a full quarter.*

*Guess what? Last week, this specific spread has officially finished a full quarter of being inverted...*
In case you're wondering, the 3-month/5-year spread is still deeply inverted. Furthermore, as you can clearly see, it is steepening too, rising from as low as -49 bps to the current -33 bps (exactly where the spread was two weeks ago).

Much of the recent rise in stock valuations is attributed to the Fed's sharp u-turn in its monetary policy. After adopting a hawkish tone, throughout 2018, the Fed is now talking about some "initial rate cuts". How many exactly? Well, according to what the market is currently pricing in, with an over 90% probability (!), at least two "initial rate cuts" until the end of this year.
Source: CME Group

The market is assigning zero probability for rates to remain at the current level of 2.25-2.50%, and about 56% chance for three rate cuts inside 2019.

For the sake of (the remainder of) this article, let's assume/agree that over the next six months we're going to have two "initial rate cuts". For the (though-provoking) argument that I'm going to make, it's enough to assume "only" two rate cuts, but of course - be my guest and assume more.

What I'd like to share with you here is the historical data around the last two "initial rate cuts" done by the Fed: January 2001 and September 2007.

In both cases, these "initial rate cuts" marked the very beginning of two of the most brutal bear markets investors had seen in decades. During these periods, the Fed continued to cut rates aggressively, long after the initial cuts.
First, here are the "initial rate cuts" path that started in January 2001, lasted for almost a year, and saw the Fed funds moving down about 5%.

This period of aggressive rate cuts was accompanied by the following market performance (Total return over an 18-month period: 1/1/2001-6/30/2002):
I trust that at this point you might come up with two arguments:

1. The 2001/2 was, predominantly, a technology crash, rather than a market crash. While you're technically right - the Invesco QQQ Trust (QQQ) lost much more value than any of the other main indices - I wouldn't dismiss the -25% total return of the SPDR S&P 500 ETF (SPY) so easily.

2. The 9/11 horrific events were the main cause for much (if not most) of the damage. When it comes to this point, I must disagree, for two reasons: i) All the main indices were down (double-digits) way before 9/11 occurred. ii) Except for the QQQ, the other main indices lost less value post 9/11 (till mid-2002) than they did till (but excluding) 9/11. While the SPY traded, more or less, at the same level, both the SPDR Dow Jones Industrial Average ETF (DIA) and iShares Russell 2000 ETF (IWM) actually gained ground during the ~10 months post 9/11.

Now, let's take a look at the second 18-month period, from the beginning of September 2007 (when the "initial rate cuts" started) till the end of February 2009.

Interestingly, once again, the Fed funds moved down about 5% during that rate cuts cycle, although the path (of persistent rate cuts) lasted more than a full year this time round.
Here is the performance (total return) of the main indices during this period:

During this period, as we all know, it was one big "Ouch!", for all main indices.
Of course, the current level of the Fed funds doesn't allow for a 5% cut (in total). That, of course, unless the Fed decides to move the Fed funds into negative territory, just like the ECB has been doing for a long time.

Nonetheless, we believe that the fact that the Fed has less ammunition than it had in the past (2001/2 and 2007/8) only makes things worse, not better. Should the Fed start fighting a slowing economy - and this is very likely to be the case as early as this month - it will face an uncharted territory.

In a day where everybody cheers the positive (?) meeting between president Trump and premier Xi, it may seems irrelevant to ring the cautionary bells. However, as far as we're concerned, there are no better times to ring these bells than days like these, in which many investors feel that nothing bad can happen.

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Comments (18)

Cashflow Curator
In the historical examples, I don't think it was the initial rate cuts that caused the downturn in the market, it was the thing that caused the Fed to cut rates in the first place that caused the downturn, and it would've probably occurred regardless of if rates were cut or not, so I fail to see how initial rate cuts have much predictive power.

01 Jul 2019, 05:19 PM

The Fortune Teller, Marketplace Contributor
Author’s reply » Hi @Cashflow Curator
I'm not trying to figure out here what is the hen and what is the egg.
All I'm saying is that instead of everybody cheering the (upcoming) rate cuts, the most recent examples of (initial) rate cuts went hand-in-hand with bear markets.

No matter what came first - the economic slowdown, the rate cuts, or the market crash - what is certain is that the Fed doesn't cut when everything is awesome...

01 Jul 2019, 05:32 PM

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