CETERA® INVESTMENT MANAGEMENT

COMMENTARY

08/15/2019

Interpreting the Inverted Yield Curve

- Volatility has increased and the S&P 500 is now down over 6% from its peak.
- While the Treasury yield curve is inverted, it is still hard to predict future equity declines.
- We expect volatility to remain elevated and recommend diversifying risk factors.

The S&P 500 recorded its second-worst one day loss of the year, down roughly 3%, after new data showed China's industrial output grew at just 4.8% over the past year, well below projections and its lowest rate in over 17 years. China's unemployment rate also jumped to its highest level on record.

Adding to this bad global economic news, Germany's economy contracted slightly in the second quarter, its lowest growth rate since 2011 and fueling fears of a recession for the Eurozone's largest economy. Overall Eurozone economic growth expanded by just 0.2% in the second quarter, a meaningful slowdown from the 0.4% growth reported in the first quarter.

This bad data caused investors to sell equities and buy longer-dated Treasury bonds, which are viewed as a safe haven. Treasury yields move inversely to Treasury prices, so yields fell as investors purchased bonds. This buying, along with the nearly twelve-month rally in bond prices, pushed the yield on 10-year Treasury bonds below that of 2-year Treasury bonds.

Taking a step back, this seems counter-intuitive as long-term borrowing costs are cheaper than short-term borrowing costs. Since bond yields tend to track future economic growth prospects, this is the financial markets signaling that future economic growth will slow and it is better to lock these current long-term yields in today, before they decline further. This so-called "inverted" yield curve has happened many times in the past. While not always the case, recessions usually follow these yield curve inversions. With that said, keep in mind Eurozone nations, such as Germany and France, have negative interest rates. There is more than $16 trillion worth of negative-yielding debt globally. This makes U.S. Treasury rates attractive on a relative basis. Considering Treasury's relative attractiveness, this could put into question the predictive value of the inverted yield for an impending recession.

While an inverted yield curve is a bad sign for the economy, trying to time the stock market can be difficult. In the table below we show the last five times the yield curve has inverted, the start of the ensuing recession, and the return of the S&P 500 between that inversion until the official beginning of the ensuing recession.

Date of Yield Curve Inversion	Recession Start Date	Lead (Months)	S&P 500 (Total Return)
Aug-1978	Jan-1980	17	23.0%
Sep-1980	Jul-1981	10	11.9%
Dec-1988	Jul-1990	19	37.7%
Feb-2000	Mar-2001	13	-15.6%
Dec-2005	Dec-2007	24	22.2%
	Average	*17*	*15.8%*

Source: Cetera Investment Management, National Bureau of Economic Research, Morningstar, Standard & Poor's. A yield curve inversion is when the 2-year Treasury Yield is greater than the 10-year Treasury Yield. The yield spread measures the difference between two and 10-year Treasury Yields. The S&P 500 Total Return shown is from the Yield Curve Inversion date to the start of the recession.

On average, the past five recessions took 17 months to occur following the inversion of the yield curve and S&P 500 returns were positive between the inversion to the start of the recession in four of the five occurrences. We are not suggesting returns will be positive this time, but we are merely suggesting timing equity declines is not easy and there are other factors involved.

After experiencing the second-worst day for the S&P 500, there are a couple potential catalysts that could reverse equity markets. The Federal Reserve raised interest rates seven times in the past two years before cutting interest rates 0.25% last month. The Fed could cut interest rates more aggressively to possibly prolong the economic expansion. Additionally, the United States and China could come to a trade resolution which would also be viewed favorably by market participants. Predicting the timing of these events is not easy and these are huge factors when determining the direction of equity markets.

The first half of 2019 saw little volatility as the stock market rarely moved up or down more than one percent in any given day. On the other hand, as we have seen recently with the sharp fluctuations in the stock market, we think volatility will remain elevated throughout the second half of this year as investors try to navigate the crosscurrents of mixed economic signals. For example, the consumer, labor markets, and the services side of the economy look strong while manufacturing continues to weaken.

Making a stock market prediction is difficult with all the factors that could derail predictions and there are many more factors than just the major two we mentioned earlier. We recommend looking over long-term risk and return objectives and sticking to that plan.The current bull market, the longest in history, has skewed many portfolios resulting in equity exposure that may be too high as suggested by long-term investment objectives. Diversifying risk factors, by not having too much exposure to any one risk, asset class, sector, or security is also important.

This is especially true in fixed income, which should be considered a portfolio’s safety net. While fixed income can be a good diversifier to equity risk, during the current bull market, many investors overallocated to riskier and higher yielding bonds with lower credit ratings. Since these bonds likely have a high correlation to equities, they could suffer when equities fall, making them less of a diversifier to equity risk. Diversification is even more important in times of market volatility.

This report is created by Cetera Investment Management LLC

About Cetera® Investment Management

Cetera Investment Management LLC is an SEC registered investment adviser owned by Cetera Financial Group®. Cetera Investment Management provides market perspectives, portfolio guidance and other investment advice to its affiliated broker-dealers, dually registered broker-dealers and registered investment advisers.

About Cetera Financial Group®

Cetera Financial Group ("Cetera") is a leading network of independent firms empowering the delivery of professional financial advice to individuals, families and company retirement plans across the country through trusted financial advisors and financial institutions. Cetera is the second-largest independent financial advisor network in the nation by number of advisors, as well as a leading provider of retail services to the investment programs of banks and credit unions.

Through its multiple distinct firms, Cetera offers independent and institutions-based advisors the benefits of a large, established broker-dealer and registered investment adviser, while serving advisors and institutions in a way that is customized to their needs and aspirations. Advisor support resources offered through Cetera include award-winning wealth management and advisory platforms, comprehensive broker-dealer and registered investment adviser services, practice management support and innovative technology. For more information, visit cetera.com.

"Cetera Financial Group" refers to the network of independent retail firms encompassing, among others, Cetera Advisors, Cetera Advisor Networks, Cetera Investment Services (marketed as Cetera Financial Institutions), Cetera Financial Specialists, First Allied Securities, and Summit Brokerage Services. All firms are members FINRA/SIPC.

.

Disclosures

The material contained in this document was authored by and is the property of Cetera Investment Management LLC. Cetera Investment Management provides investment management and advisory services to a number of programs sponsored by affiliated and non-affiliated registered investment advisers. Your registered representative or investment adviser representative is not registered with Cetera Investment Management and did not take part in the creation of this material. He or she may not be able to offer Cetera Investment Management portfolio management services.

Nothing in this presentation should be construed as offering or disseminating specific investment, tax, or legal advice to any individual without the benefit of direct and specific consultation with an investment adviser representative authorized to offer Cetera Investment Management services. Information contained herein shall not constitute an offer or a solicitation of any services. Past performance is not a guarantee of future results.

For more information about Cetera Investment Management, please reference the Cetera Investment Management LLC Form ADV disclosure brochure and the disclosure brochure for the registered investment adviser your adviser is registered with. Please consult with your adviser for his or her specific firm registrations and programs available.

No independent analysis has been performed and the material should not be construed as investment advice. Investment decisions should not be based on this material since the information contained here is a singular update, and prudent investment decisions require the analysis of a much broader collection of facts and context. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The opinions expressed are as of the date published and may change without notice. Any forward-looking statements are based on assumptions, may not materialize, and are subject to revision.

All economic and performance information is historical and not indicative of future results. The market indices discussed are not actively managed. Investors cannot directly invest in unmanaged indices. Please consult your financial advisor for more information.

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The **S&P 500 is an index** of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.