Basis Points – December 6, 2018

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Above the Fold

The financial markets were closed yesterday to honor and mourn the passing of President George H.W. Bush. This time off may have also been a welcome respite for the markets after a steep decline on Tuesday of 800 Dow points, amid increased concern about both the viability and timing of an actual trade deal with China, and a flattening yield curve.

On the trade front, the optimism the market reflected on Monday after an apparent outline of a deal with China on Saturday turned to pessimism on Tuesday after it became apparent that there was no set framework for a deal between the U.S. and China, only a 90-day delay in the implementation of higher tariffs on Chinese goods. The news last night of the arrest of the CFO of Huawei Technologies, a large Chinese telecom equipment company, will only increase the tensions between the two countries, and is rattling an unstable equity market this morning. This trade-based market volatility has been dogging the markets all year and now seems as if it will be a continuing news topic well into 2019.

The real issue for investors on Tuesday involved the Treasury yield curve, which has flattened considerably over the past two weeks. The yield curve may not be a user-friendly idea for most investors to understand, but at its very core the yield curve is a barometer of investor sentiment for economic growth in the future. The yield curve, specifically the difference between the yield on the 2-year government bond and the 10-year bond, is what investors focus on the most.

In a normal economic environment, investors buying bonds would demand a higher interest rate for a 10-year bond than a 2-year bond, as they are tying up their capital for a much longer time, and the higher rate for the longer-term bond compensates an investor for the greater risk that inflation will diminish the value of that investment over time. The yield curve's natural state is upward sloping, with lower yields on short-term bonds and higher yields on longer-term bonds.

Bond investors attempt to predict where the Fed will peg interest rates in the future. If the market expects economic growth to be strong, the natural expectation would be for the Fed to continue to raise interest rates to slow that growth and prevent excesses in asset prices that could lead to a financial crisis. If growth is expected to be slow in the future, then there would be no need for the Fed to raise rates so expectations for future rates would be more muted.

Government bond yields broadly track where the Fed is expected to set interest rates in the future. That is what we are seeing now, with a near-flat yield curve. The flattening yield curve reflects the market's perception that if economic growth in the future is sluggish, inflation is low, energy prices are moderate and there are no bubbles brewing in any market segments, then there is no need to raise interest rates to slow the economy.

Today, the 2-year yield is 2.82 percent and the 10-year yield is 2.91 percent. The difference is only nine basis points, which is very close to a flat yield curve. An "inverted" yield curve occurs when the 2-year yield is higher than the 10-year yield. While an inverted yield curve is usually seen prior to an economic recession, the yield curve has inverted in some periods without the economy going into a recession, such as in 1998. Inverted yield curves don't cause recessions, nor provide new information about the economy. They simply reflect a market assumption that growth will slow, based on all the data currently available to investors and analysts.

Three Things

- On the 40th anniversary of the invention of the 401(k) account, many folks may look with rose-colored glasses at the transition from employer-funded retirement plans, such as pension funds, to the employee-funded retirement plans now widely used such as the 401(k). While it may seem that 50 years ago most U.S. workers were covered by pension plan payouts in their retirement, it was not actually the case. In 1975, only 22 percent of people age 65 and older received income from pensions of their former employer. This number peaked at 38 percent in 1992 and has been declining ever since. Today, only about 32 percent of all retired people receive income from a pension plan. And the total amount of income for those 65 or older coming from pension funds has never been higher than the 22 percent seen in 1992. With the popularity of 401(k) accounts these days, the employee is now responsible for planning and funding his or her own retirement. But a past where the large majority of workers were taken care of by company and government pension plans was not, in fact, the reality.
- Cornerstone Macro Research notes that inflation is likely to slow from 2.5 percent in October 2018 to a 1.7 percent year-over-year rate in the first half of 2019. The decline in inflation, due mostly to the sharp decrease in energy prices seen this quarter, will weigh on bond yields, boost real consumer spending power and could support the housing market with lower mortgage rates. Food prices are weakening also, which should help keep a lid on consumer inflation in 2019.
- If you feel like the noise level while eating at a restaurant these days is louder than ever, it is not because you are getting older, and you are not alone. The Atlantic reports that the decibel level at the average restaurant is much higher than it was 40 years ago, and there are many reasons why. The materials used to dress out the interior of a restaurant these days are much different than in the past. High ceilings and metal, slate and wood surfaces are the common interiors of eateries these days, compared to the plush drapes, carpets, upholstered furniture and low ceilings of restaurants past, which led to a much quieter dining experience. The restaurant and bar used to be separate areas, but these days the bar is very much exposed to the dining area, and bar patrons are much louder than diners. The open kitchen is now a staple in even the finer establishments, which creates a lot of extra noise in the dining area. And ensuring a noisy dining room is a conscious choice by owners, as research shows that patrons both drink more alcohol and make poorer food choices in a noisy restaurant than in a quiet one, so restaurant owners prefer a louder space as it generates higher profits, by selling more alcohol and turning tables more quickly.

Did You Know

As we pause this week to remember the life and legacy of President George H. W. Bush, it is interesting to note a little-remembered accomplishment that continues to pay dividends today. Brian Mulroney, the former president of Canada, who gave one of the eulogies at his funeral yesterday, worked with Bush to attack one of the most important issues of their day. In the 1980s, “acid rain” was a major hazard in North America, and threatened to develop into an environmental catastrophe if left unchecked. Sulfur-rich coal was burned in large quantities in the U.S. and

Canada, and the resulting smoke entered the atmosphere, combined with clouds, and came back down as acid rain. Lakes and waterways across the northeastern U.S. were doused in rain laced with sulfuric acid, which killed trees, fish and other wildlife. Over a quarter of the lakes and ponds in the Adirondack Mountains were so acidic that they could no longer support fish by the end of the 1980s.

Upon assuming the presidency, Bush teamed with Congressional leaders to pass an amendment to the Clean Air Act in 1990 and a new U.S.-Canada air-quality agreement in 1991. Over the next two decades, U.S. emissions of sulfur dioxide would fall by 67 percent. While lakes are still recovering and acid rain has still not been completely eliminated, President Bush's focus on this important issue was a resounding success for his presidential term.