MARKET OBSERVATIONS
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INVESTMENT COUNSEL

# Jumble

The pandemic brought a jumble to all facets of life. Financial markets reacted as expected, first pulling back with higher risk and then recovering on the backs of policy initiatives around the world. Even now, much is jumbled for markets and investors. Inflation accelerated but has trended lower most recently. It remains higher than desired. A highly anticipated U.S. recession has not materialized, in part due to robust consumer spending fueled by government initiatives. Higher interest rates have yet to dampen activity outside of a few sectors such as housing. A review of some key relationships can provide perspective for economic activity and investing ahead.

## PERSPECTIVE

Much attention has been given to the phenomenon of short-term interest rates being higher than long-term rates. Historically, economic recessions have occurred during these periods of yield curve "inversion". The New York Federal Reserve Bank has created a model for predicting recessions as a function of inversions. Chart I shows the recession probability over time and relative to actual periods of recession. The model has a 12-month lead. The probability of recession is on the rise currently, moving from 25% now to 71% in May 2024. It would seem that a meaningful reduction in yield curve inversion would be necessary to avoid a recession.

Nominal interest rates have moved higher since the onset of the pandemic. The 10-year U.S. Treasury yield has risen from an historic low monthly average of 0.6% to a recent high of 4.2%. A proper assessment comes from looking at real yields, nominal adjusted for inflation. Chart II shows the trend in real yields (nominal Treasury yield less the trailing 12-month Consumer Price Index or "CPI"). Both inflation and bond yields have been in secular decline since the 1980s. Over 60+ years, the 12-month CPI has averaged 3.8%, nominal 10-year U.S. Treasury yields have averaged 5.8% and the resulting real bond yield has averaged 2.1%. Even with the recent rise in nominal yields and the declining CPI, the real bond yield is low at less than 1%. Periods of recession have been accompanied by low real yields. Perhaps not this time.

For longer term growth, stocks remain the preferred investment. The 12-month return for the Dow Jones Industrial Average ("DJIA") has averaged +10.1% since the 1960s. As shown in Chart III, stock market downturns have occurred apart from an economic recession. But recessions have not occurred without a stock market correction. The DJIA has performed quite well amidst the latest jumble of inflation, rising interest rates and economic uncertainty. The trailing 12-month DJIA return recovered from -13.4% last September to +14.2% this May. Past such recoveries have occurred with a recession yet ahead.

CHART I

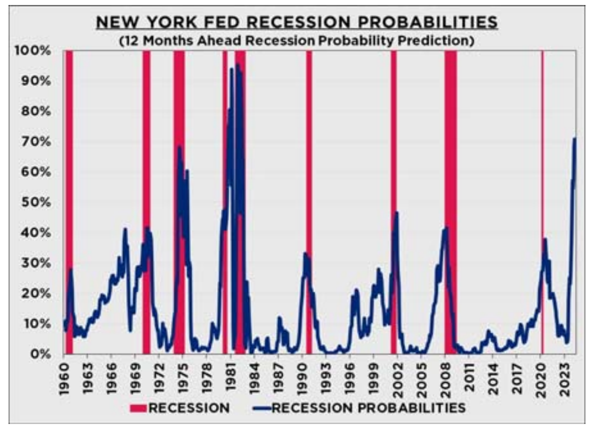



CHART II

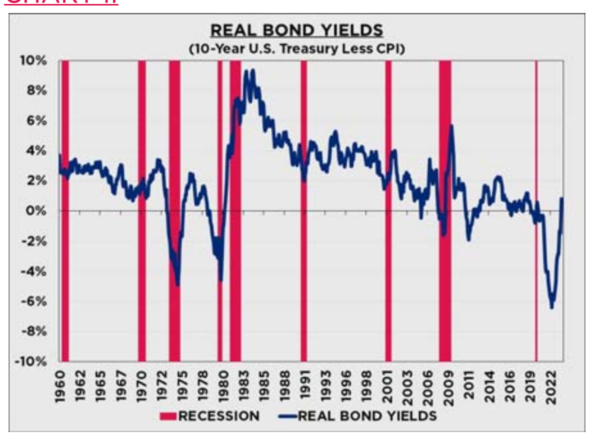
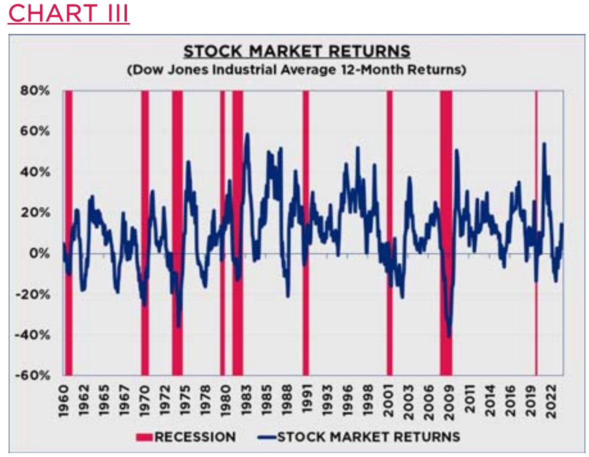



CHART III




## INVESTMENT IMPLICATIONS

Successful investing requires the assessment of a jumble of information on key factors, including inflation, interest rates, economic activity, earnings growth and credit spreads. Relationships vary over time but often return to familiar patterns. New patterns mean new levels of risk that must be addressed relative to return expectations. What should not be a jumble are individual goals, time horizons and tolerance for risk. Certainly, these can vary over time, but changes must be understood and addressed in a strategy appropriate for now.