Seymour Investment Management

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The markets experienced a strong recovery to start the year following a volatile fourth quarter. The Canadian market rallied from December lows with the S&P/TSX Composite Total Return Index ('TSX') reporting a total return of 13.3% in the first quarter. The rally was similarly felt around the world with the S&P 500 rising 13.1%, MSCI World Index up 12%, and the United Kingdom's FTSE 100 up 8.2%.

The broad-based sell-off that left equity valuations below historic levels to end 2018, helped pave the way for a dramatic rally during the first quarter

The broad-based sell-off that left equity valuations below historic levels at the end of the year helped pave the way for a dramatic rally during the first quarter. This rally was spurred in large part by the Central Banks' swift reversal in planned interest rate direction and favourable developments in certain, namely trade related, geopolitical risks.

In response to market volatility and signs of moderating global growth, the Bank of Canada along with the U.S. Federal Reserve and many other central banks around the world switched gears to more accommodative monetary policy, pausing interest rates hikes in the near term. This low rate environment, paired with moderate inflation levels, employment gains, and slowing yet positive growth, creates a positive backdrop for equity investments.

The Yield Curve – Why You Are Hearing About It in the News

The recent inversion of the 10 year and three month yield curves has been dominating recent headlines. Below, we provide a brief background and share our perspective on how this indicator may not be as gloomy as some headlines have made it out to be.

A yield curve represents the interest rate, or yield, for equivalent debt instruments at various maturities. This curve provides a tool to gauge bond investors' feelings about risk and is often used as a proxy for overall investor sentiment towards the direction of the economy. By comparing the interest rates of equivalent credit quality debt the investor is able to see the required return for the risk associated with committing funds over longer periods of time.

Recently, the long term Government 10-year bond yield dropped slightly below that of short term, 3-month bills

Typically, the normal yield curve slopes upwards from left to right, suggesting the longer the maturity of the bond, the higher the interest rate. Recently, the long term Government 10-year bond yield dropped slightly below that of short term, 3-month bills (see Exhibit 1). This 'flattening' has been slowly taking place over the past several years as central banks increased short term rates while a reduction in longer term inflation and growth prospects lowered long term interest rates.

Exhibit 1: Canadian Government Bond Inverted Yield Curve

Source: Bloomberg News, National Post

Investors look for recessionary signals from many sources. One such signal is an inverted yield curve. Unlike the normal yield curve described above, an inverted yield curve is the result of long term interest rates dropping below short term interest rates. Many economic models suggest that an inverted yield curve which stays inverted for a full quarter can be considered an early warning indicator of a recession.

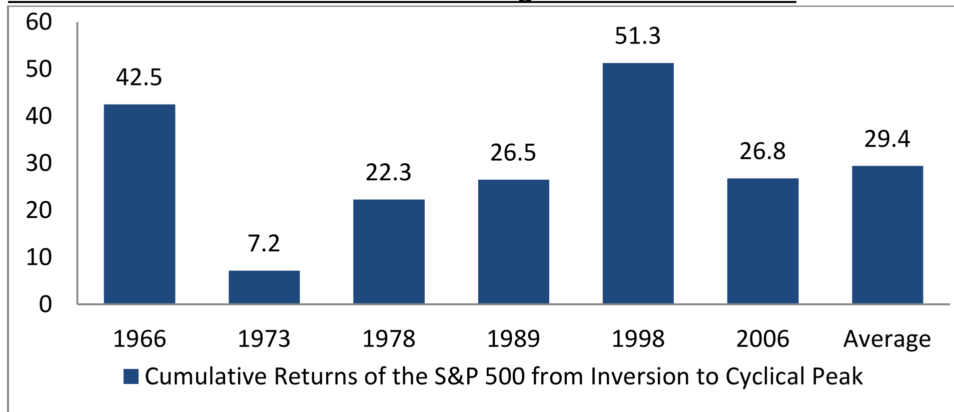
The low interest rates that the yield curve is predicting provide a tailwind for equities

As the debate rages on as to whether the recent inversion can be considered a recessionary red flag or not, we take this opportunity to address the yield curve and discuss our thoughts on indicators, recessions and timing the market.

Investors are monitoring today's yield curve to see if it will decisively invert. We note the lower norm for longer-term interest rates that has prevailed during this cycle requires much less movement in short term rates to invert the curve. This implies that the curve would have to invert by more than usual to raise a signal.

In the meantime, flatter yield curves have typically been better for equities. The low interest rates that the yield curve is predicting provide a tailwind for equities. The average TSX gain in the 18 months following a yield-curve inversion has been 15%. The S&P 500 similarly experienced positive cumulative returns during the period following a yield curve inversion to its cyclical peak (Exhibit 2 below). Notably, two false recession signals occurred in 1966 and 1988 which skew the average upwards; excluding both the average return is 20%.

Exhibit 2: Historical Performance Following Yield Curve Inversion



Source: Bloomberg, NBF Economics and Strategy, Seymour Investment Management

The average lag time following a decisive inverted yield curve to an economic downturn has been 17 months. As the longest economic expansion to date, both the early-cycle and mid-cycle phases have extended beyond historical averages. Likewise, indicators suggest the later phase of the economic cycle could prove to be similarly drawn out. With stable or decreasing rates predicted in 2019, we may see the easing monetary policy extending the cycle further.

We can say with confidence that a recession will come – eventually. Recessions are a normal part of a healthy economic cycle. With a long term time horizon, recessions are reoccurring events in the upwards march of the equity market. As we have spoken about in previous letters, attempts to time the market often result in missed opportunities. We feel that the outlook for equities, against a favourable rate backdrop, remains positive for the year ahead and continue to find attractive opportunities in the Canadian market.

The sell off and subsequent rally serve as a healthy reminder of the inherent volatility that comes with investing

Although global uncertainty will always be present, and trade and tariff risks remain, the macroeconomic backdrop remains favourable for corporate earnings growth, supported by historically low interest rates. The Canadian economy demonstrated resilience this year with GDP rebounding 0.4% in January marking the largest increase in 13 months, supported by rising oil prices and employment gains. We are encouraged to see earning expectations stabilizing following negative analyst earnings revisions last year with corporate profits beating expectations and showing moderate growth. Equities remain within reasonable valuations with the TSX still below the long-term average historical Price to Earnings multiple.

The sell off and subsequent rally serve as a healthy reminder of the inherent volatility that comes with investing – volatility that ultimately rewards the investor who maintains their long term focus.

We look forward to hearing from you and thank you for your continued support.

Warm regards,

The Seymour Team