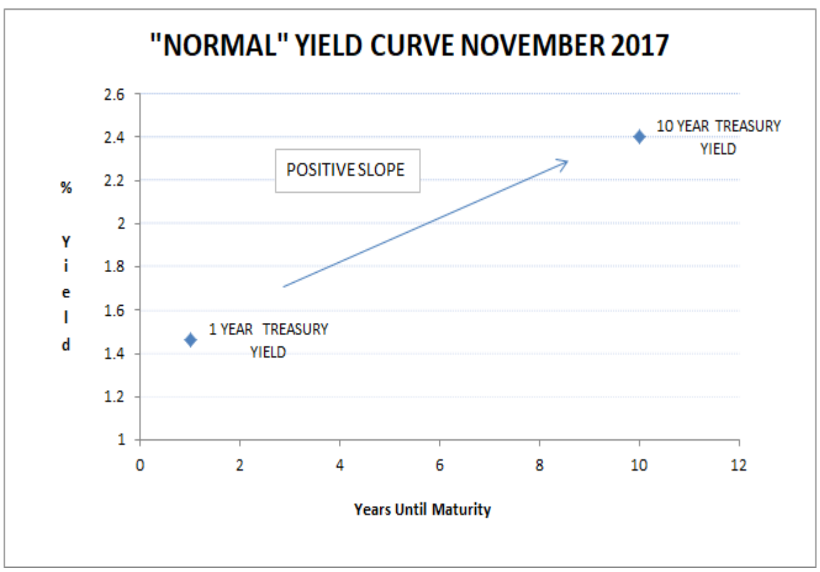
PINNACLE Capital Management, LLC

Mid-Fourth Quarter, 2017 COMMENTARY

Time to Review the Recession Checklist: The Yield Curve

The bull market in US stocks is alive and well but the number of concerned investors seems to grow each day. Everyone wants to know when will it end and why?

The most likely reason the market turns is that the economy enters a recession. As far as timing is concerned, we analyze several indicators that could be good signals that a downturn may be on the horizon. One of the items on our checklist is the yield curve and it is the focus of this piece. Before we start it is important to note that none of our indicators are flashing red today!



Recessions & the Yield Curve

Bear markets are associated with recessions and are bad news for investors. Since 1926, the average annualized return for the S&P 500 in bear market recessions is negative (29%). The good news is that bull markets last much longer and delivered average annualized returns of 19%.

Looking at today, the US has been in a recession-free bull market for nine years where stock market returns have averaged +17.9%. This historical comparison is enough for some investors to call it quits.

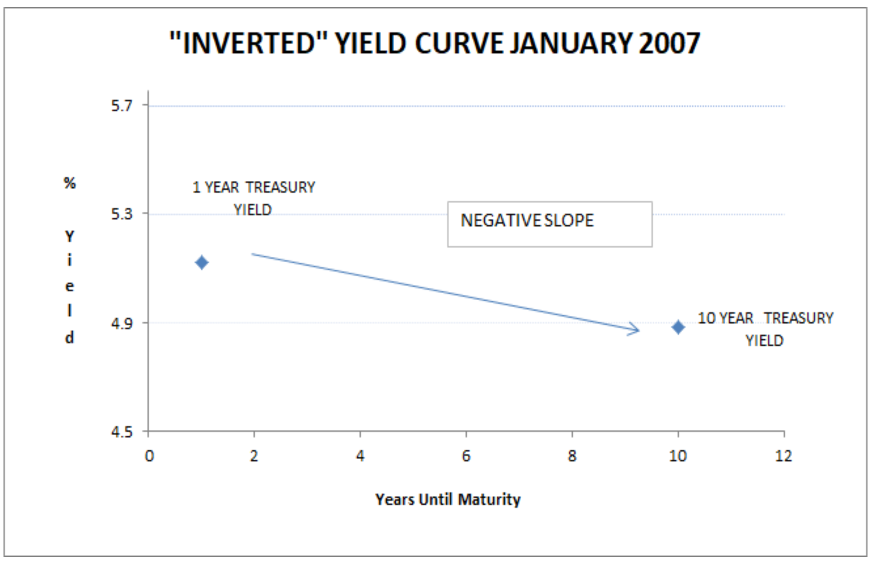
It does not make sense however to assume that a downturn is eminent because of time and returns alone. In fact, we believe signs point to a longer recovery and more upside to the markets. One reason is that a key factor in our business cycle analysis, the bond yield curve, is still healthy and positive.

The yield curve is the difference between the yields on bonds of varying maturities. For example, today the yield on a US Treasury bond that matures in 1 year is around 1.4% while the yield on a ten year bond is approximately 2.4%. The difference between the two is a positive

+1%. Investors should get a higher return if they invest for a longer period of time, so it makes sense that a 10 yr. bond has a higher yield than one that matures in 1 year.

Here is an example of the yield curve today. It is positive or "upward sloping".

A recession normally follows a period of unsustainably high growth. In this case, the Federal Reserve will raise short term interest rates to slow pressure from inflation. If the Fed steps on the breaks hard, short term yields could surpass long term yields. This "inverted" yield curve typically occurs between 6 and 18 months prior to the start of a recession. Importantly, the stock market usually anticipates the slowdown before it actually happens so getting a hint from the yield curve can be a big help.



As we showed before, the yield curve is positive and healthy today.

The Fed & the Outlook

The yield curve takes into account many factors like growth and investor sentiment, but as we hinted to before, Federal Reserve policy can exert a powerful influence on its shape. For example, if the Fed keeps short term interest rates low then the slope is likely to remain positive. If short term rates rise too fast the opposite is true.

Today, interest rates are still low and we think that the Fed will move gradually as they raise them. The current recovery is one of the weakest on record and indicators of inflation pressure are well below expectations. The Fed can be measured and cautious about each move.

Overall, the combination of a supportive Fed and a positive yield curve should provide a strong tailwind for the markets. The effects are flowing through and accelerating corporate earnings, driving higher dividends and supporting stock prices. At some point investor's fears of a recession are sure to materialize, but it's not now.

Regards,
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Sources: *First Trust Advisors L.P., Morningstar. Returns from 1926 - 9/30/17. www.Treasury.gov*

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