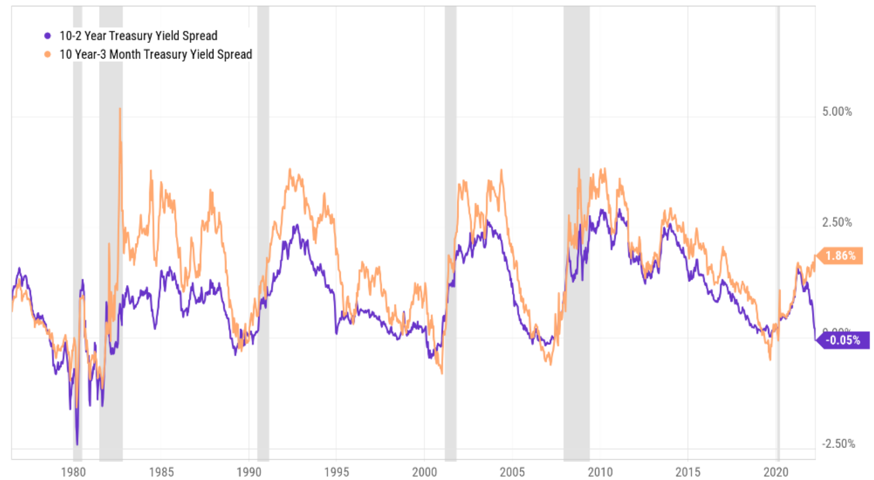
# BCA Market Perspective ©
# Will a Spread Doom the Fed?
# April 2022




Market timing has been one of if not the single least successful endeavors by investors in history of markets. Consistently studies such as Brinson, Hood, and Beebower's "Determinants of Portfolio Performance" have indicated that market timing is one of the least important factors in determining the performance of a portfolio, accounting for less than 2% of the variation of portfolio returns. Furthermore, looking at the 5,036 trading days from 2001 to 2020, if an investor missed just the 10 best days in the market during that period, their annualized return would have been more than halved, down from +7.4% to 3.3%.[1] That is a cumulative return of over +125% an investor would have left on the table being out of the market for just 0.2% of the time. That is why the most prudent and successful investors focus on time in the market and not timing the market.

Despite the abundance of evidence to the impossibility and insignificance of market timing, investors continualy seek out signs and indicators that can provide them a glimpse into the future of the market. One indicator that is universally deemed a signal for an impending recession and market correction is the inversion of the treasury yield curve. An inversion of the yield curve is simply when yields for treasuries with long-term maturities dip below the yields for short-term maturities, creating a negative yield spread (long-term yield – short-term yield). Since the mid 1970's, each of the six U.S. recessions have been precipitated by an inversion of yield curve, with both the spreads for the 10yr-2yr and the 10yr-3mo going negative. Most recently this occurred in August 2019 and was subsequently followed by the pandemic-induced recession in February 2020.

The rationale for an inverted yield curve is that investors expect the Fed to push up interest rates so much in the short run to fight off inflation that it ends up squeezing credit, causing a recession, then forcing the Fed to backtrack and cut rates down the road.[2] This logic may be what is taking place in the present. The U.S. is experiencing its highest inflation levels in over 40 years, spurred by a supply/demand imbalance caused by the Pandemic, further exacerbated by continuing supply-chain constraints, domestic energy policies/prices, and the Russian invasion of Ukraine. The Fed moved the Fed Funds Rate up a quarter point (0.25%) in March 2022 and set the tone that additional half point (0.50%) moves are likely at future FOMC meetings.While most indicators point toward a recession in the near future, it is actually those trusty yield spreads that are currently giving investors mixed signals. Yes, the 10yr-2yr spread went negative (-0.05%, purple line) April 1, but the 10yr-3mo spread is still well in positive territory (+1.86%, orange line). Nor has the 18mo-3mo spread gone negative, which has been the focus of the Fed Chairman as support that the Fed has further room to raise short-term rates in the months ahead. Time will tell if the Fed can successfully bring down inflation and avoid recession with their planned rate hikes and reduced open market operations.

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[1] Source: Morningstar
[2] Source: Wall Street Journal: "Economist Seek Recession Clues in the Yield Curve"