Mitch on the Markets

Why You Should Keep a Watchful Eye on Debt Markets

By Mitch Zacks
Portfolio Manager

There are a few trends shaping-up simultaneously in debt markets that are worth keeping a close eye on. I'll cut right to the chase because this is important: **if these trends continue as-is, history tells us a recession is likely in the works**. That's why investors need to keep checking-in regularly on the issues I'll review below.

The first of these issues is the interest rate environment, and specifically, the yield curve. The Federal Reserve has already raised interest rates twice this year, and Zacks Investment Management expects to see a third rate increase before the year is over. The Federal Reserve essentially controls the short-end of the yield curve, and it's clear that those rates are notching higher.

As this tightening occurs, the longer end of the yield curve – the 10- and 30-year Treasury rates – have been falling all year. The 10-year started the year at 2.45%, and as I write this column, it sits at about 2.35%. The 30-year has gone from 3.04% to about 2.85%.

Pressure on these longer yields may be coming from foreign demand for U.S. debt, as Europe and Japan continue along with their accommodative monetary policies. It may also be coming from lower inflation expectations. On June 14, the Labor Department said the consumer price index – a key measure of inflation – declined by -0.1% in May, its largest drop in 16 months. Expectations were for a 0.2% increase. In all likelihood, longer-term U.S. Treasuries are probably falling because of both factors.

Whatever the cause, the outcome is that shorter-term interest rates are rising as longer-term interest rates are falling. As the spread between long and short rates narrows, the yield curve flattens. And as the yield curve flattens, net interest margins for banks start to get squeezed. That can lead to less lending which can ultimately choke-off growth.

Readers can see this clearly in the chart below. Notice how each time the line dips below zero – which is when shorter-term interest rates dip below longer-term rates – a recession hits just a short time later. You can look back in history and see evidence of this cause-and-effect over and over.

The Spread Between 10-Year U.S. Treasuries and 2-year Treasuries is Shrinking

At Zacks Investment Management, we have made changes to our fixed income strategy in anticipation of the changing interest rate environment. Without going into too much detail here, we continue to favor corporate and municipal bonds for investors searching for income and diversification. And as always, review of credit quality remains utmost in our selection methodology.

Corporate Debt Also Matters

In the high yield space, investors should be looking for the opposite of what you look for in the Treasury/risk-free space. For corporate bonds, you want to watch for widening spreads, which could be a harbinger for market corrections and volatility. Concern on this front has risen recently – high-yield spreads bottomed on March 2nd at 344 basis points, which may signify the start of a trend shift. Also at issue in corporate bond space are rising delinquencies. Corporate leverage sits at a 13-year high. We've seen rising delinquencies in a variety of sectors, including auto loans, consumer loans, and agriculture. Rising delinquencies in these areas have historically preceded recessions, much like an inverted yield curve.

Bottom Line for Investors

Some worrying trends are shaping up in the bond markets, but I do not think the alarm bells are ringing just yet. The yield curve is still upward sloping, and credit spreads are still within the norm. But early signs that the yield curve is flattening and that the credit cycle may be reversing course are extant, and investors need to keep a close eye.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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