

# Signs of the Future

## February 27, 2006

Lately domestic individuals and foreigners have been big buyers of common stocks. Recent reports indicate that January was a stellar month for equity mutual fund sales. The January over December increase was 35%. In 2005 foreigners were the largest purchasers of US common stocks since 2001. If history is any guide, these two occurrences are very bearish for the stock market.

As concerns the bond market, the most important thing is the inversion of the treasury yield curve. Since 1970 every recession has occurred after the inversion of this curve. By inversion we mean short-term rates are higher than long-term rates. This inversion has been under way for some maturities for almost two months. The average lead-time to a recession is about one year. As far as interest rates are concerned the market is saying that short-term rates, a year or so from now, will be lower than they are today. At the same time long-term rates will also drop making today's long government bond market an excellent buying opportunity thus a good strategy. Why will this be? A recession or at least an economic slowdown is expected.

The Chart Store [www.thechartstore.com](http://www.thechartstore.com) has a quite exhaustive study of the inversion that was published recently. The following is their summary along with one of their numerous charts. Our economic outlook agrees with the yield inversion.

- Every recession since 1970 has been preceded by the yield curve inverting.
- The yield curve inversions are broadly based, across various maturities (not just a single, particular spread).
- Normally, the yield curve is still inverted at the onset of the recession (1990 is an exception).
- Choosing the Target Rate vs. the 10 year as our proxy, the lead times in calendar days from inversion to the onset of the recession are:
  - January 1970 to November 1970 Recession - 357 days
  - December 1973 to March 1975 Recession - 276 days
  - February 1980 to July 1980 Recession - 497 days
  - August 1981 to November 1982 Recession - 307 days
  - August 1990 to March 1991 Recession - 553 days (Inverted from 1-25-89 to 1-17-90, but not at onset of recession)
  - April 2001 to November 2001 Recession - 315 days
- The Federal Reserve's campaign to find a "neutral rate" has pushed the yield curve to the brink of inverting.
- The historical record suggests a recession in the future should be preceded by a broadly based inversion lasting at least nine months.

Target Rate and Spreads (in basis points)

