Zero In On This Yield Spread
When Gauging The Climate For Equities

View from the Observation Deck

1. The yield spread between the 2-Year T-Note and the benchmark 10-Year T-Note has been a useful barometer through the years with respect to gauging the state of the U.S. economy and equities.

2. Since 1977, when the spread between the 2- and 10-Year T-Notes has narrowed to zero, or inverts to a negative posture, it is likely an indication that the Federal Reserve has been tightening monetary policy.

3. The Fed normally raises the federal funds target rate when seeking to temper economic activity and/or curb inflationary pressures. On occasion, the Treasury yield curve inverts, where short maturities yield more than longer maturities.

4. That scenario should be interpreted by equity investors as a warning sign that earnings may soon be challenged due to slower economic growth or recession.

5. As the chart clearly shows, the spread exceeded 200 basis points on August 30. There have only been three other periods since 1977 when the spread topped 200 basis points, and stocks tended to perform relatively well during those periods.

6. We believe that the current economic climate still favors equities. The Fed’s decision yesterday to delay the tapering of its bond-buying program suggests that it could be quite a while before this yield spread heads toward zero.

This chart is for illustrative purposes only and not indicative of any actual investment.

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