SEVENS REPORT

Is the Yield Curve Signaling a Slowdown? 9/14/2017.

Good afternoon everyone, and thank you again for joining us for our *Sevens Report Alpha* webinar.

This week has been a bit of an adventure with Hurricane Irma, but I am happy to say that all of us survived the storm well. We didn't have any real damage other than inconvenience of power out and cable, and I want to say thank you on behalf of our staff for all the well wishes we received and warm comments, and finally I will ask for some patience on the internet.

Infrastructure here in Palm Beach county is still not back up 100%, and as you saw with the delayed send of the Report this morning, I am going to be holding my breath through this webinar to make sure that it gets through and that we don't lose it. So, please be patient, and we will keep our fingers crossed. We have our normal disclaimer slide that we show every single time. So, we can move past that because you have all seen it multiple times at this point, and we will get straight to the meat of today's webinar.

Goals for today's webinar:

First, what do you think about markets? We are going to do that every time so that again we have a very simple concise answer to that question.

Second, RSP, the Guggenheim S&P 500 Equal Weight ETF. I want to cover that one more time and address specifically why I think this is such an attractive opportunity now. This is the ETF we sent in last week's written issue. It our latest recommendation but in an audio format and a little bit different media. I want to again cover why I think this is a compelling opportunity, compelling long-term core holding opportunity right now.

Third, the yield curve that was the title of this webinar. There is a lot going on with the yield curve. It is a very important financial tool to understand, and I want to go through specifically the signals I am seeing from the yield curve and show you some historical precedent and then give some insight into when it may give us a signal that we need to begin to pull in exposure. It is not yet, but it could be coming, and then obviously we will end with Q&A.

What Do You Think About Markets?

So, starting off with the general macro, What do you think about markets?

Well, the reason for the rally this week which has been nice has been more a lack of bad news really than a lot of good news. Quiet more than anything else is responsible for this rally, and if you think about it, it makes sense. The Fed is coming next week, but it should not be hawkish. Even the CPI numbers are going to cause that to happen. The political can has been kicked to December. I have covered that in the report last week. There is not going to be a shut down or debt ceiling drama in September. Longer term, does this show more problems? Yes, it does, but the market is a short-term pricing mechanism for the most part, and right now we are not going to get any sort of Washington-related tape bombs in September. So, that clears a hurdle. North Korea news has quieted for now, although just this morning we read a couple of reports that they were prepping another missile launch. So, that might change.

All of this quiet atmosphere just reveals a simple truth that for stocks to drift modestly or marginally higher, really nothing has to change. This is a very similar setup that we have seen all year, and it is continuing. However, the new highs this week do not make me enthusiastically bullish. I do not think we are about to embark on another 5-10% upside, and I think we are generally still at a tipping point.

Beneath the surface, things have not been great this week. Banks are on a tear, but that is just because of rates this week, and rates despite the bounce are still in a downtrend. Meanwhile on the microeconomic, the bank commentary at the Park Place conference this week was not good. Not strong loan demand, trading revenues beneath expectations. So, if you look beneath the surface these are not exactly rosy forecasts. Again, the yields on the dollar have enjoyed nice rallies this week, but they are still just bounces. I mean, they hit new 2017 lows last week. So, these are still downtrends, folks. We are just seeing a bounce in the downtrend.

So, this all comes back to one singular point. We need a positive catalyst to help spark an extension of the 2017 rally, and I still think if that is going to come, it is going to come from one of two places. It is either going to come from tax cuts, or it is going to come from an economic acceleration that will push earnings higher.

Those are the two things that I think can really add another 5-10% to this market, and absent that, sure we can drift to fractional new highs if the calendar gets really quiet, but I do not think you are going to see the type of enthusiasm that would make you want to put a ton of money into the market right now. So, that is why we keep saying steady as she goes. The rally must be respected, but nothing this week has made me more enthusiastically bullish.

RSP – Guggenheim Equal Weight S&P 500 ETF

Now getting to the specific pieces of the webinar regarding *Sevens Report Alpha*. Let's start with RSP, the Guggenheim Equal Weight S&P 500 ETF. Every client needs a core long-term holding, and we all know that right? I mean, I have them in my IRA, and we think that RSP offers a substantial opportunity to outperform other core equity long-term holdings. Now as you know, the attributes of this and what makes it different is that all 500 positions in this ETF, all 500 stocks are weighted the same, 0.2%. That compares to the S&P 500 where Apple is nearly 4% of the index while News Corp, which is actually the smallest, is barely a fraction. It barely even shows up.

Because of that change, we have a performance effect. RSP will underperform SPY in short-term rallies, and we can see that this year, but RSP outperforms SPY in down markets. So, it is basically like a simple hedge fund. Remember the original hedge funds? They touted, hey, we will underperform when the market is rallying, but we will outperform when the market is down because they are hedged. Over time, that leads to significant outperformance, and we can see that in the return data. On this slide, I have highlighted in the green box what I think is the most important piece of information about this idea.

The longer you go, the longer you hold RSP, the greater the probability it will outperform the S&P 500. So, on a one-year basis, as you can see, it is 50% of the time. It is basically a coin flip, but if you stretch it out to three years, it is almost three out of four times, and if you go out to 10 years, it is all the time. This is our 20 years of history basically that we have on this ETF. So, we know that over the longer term it outperforms. Yet, right now, because mainly of the outperformance of tech in 2017, it is trading at a discount to the S&P 500. It is underperforming, and that I think is an opportunity to get into RSP at a relative discount and increase the outperformance for long-term core holdings.

I was talking about this position with one of our subscribers yesterday, and basically he said that it seemed to me that you could make the analogy that buying RSP when it is underperforming the SPY, it is like buying a closed-end fund at a discount to NAV because we know statistically over the longer term it will outperform, and it is obviously not a perfect analogy, but I think it is a pretty good one.

Looking more tactically, the outlook for the market is starting to change, and you can see that in what I am writing in the *Sevens Report*. Tech outperformance like this cannot last forever. We are already starting to see cyclical sectors try and start to recoup some of the underperformance they have seen in 2017. If inflation data keeps going up, if economic growth picks up, then you are going to see cyclical sectors like financials, like industrials outperform tech. That will cause RSP to outperform SPY. So, there are two opportunities here. Number one, I think we are buying something at a long-term discount to its peer, and this is a great opportunity to get into RSP on one of the few years when it is underperforming SPY. Second, I think it is poised to outperform the S&P 500 if we do see the start of this sector rotation that you know we have been looking for and are waiting for quite a long time. So, I think there are two opportunities here, and that is why we are basically, that is why I am basically pounding the table on RSP saying not only does this outperform over the long term, but right now you can buy it at a discount to SPY on a performance basis, and that is why we are so convicted on this.

Yield Curve: Is It Signaling an Economic Slowdown?

Now, moving to the more macro, we want to get to the yield curve, and I want to talk about the yield curve. The yield curve is sort of a tough thing because it is hard to explain everything that is going on with it in the short bit of real estate I get in the report every single day, and that is why I was excited to make this the topic of one of our first webinars because I can expand a bit on this, and I can cover a lot more ground and do a better job of explaining what is happening. So, as we look at the yield curve, basically the reason that I and other analysts and economists look at the yield curve is because it tells us in a very visual and easy-to-read format what the bond market expects for economic growth. If the bond market is expecting positive economic growth and accelerating economic growth, then the yield curve will be steep, and it will get steeper. That makes sense for a multiple of reasons. However, if the bond market thinks that we are about to see an economic slowdown, the yield curve will get flatter, and we are going to cover that in a nice little table here on the next slide.

To go into why that is, it has to do with buyers and sellers and the bond market frankly. When bond investors expect the economy to be strong, they sell bonds. Number one, inflation is going to rise, and number two equities outperform in times of economic acceleration, and investors sell longer-dated bonds more heavily than they sell short-term bonds. Because those long-term bonds are falling faster, the yields are rising faster, and it causes the curve to steepen. Conversely, when bond investors expect the economy to slow or to contract, they pile into long-dated securities because it is the largest guaranteed safe return, and that causes yields on longer-dated Treasuries to drop very quickly, and the curve then flattens, and that is basically the buy and sell market dynamics around the changing yield curve, but within those changes it can give us great insight into the bond market's expectation of economic growth. So, here is a table that just keeps things very simple.

If the economy is getting stronger, the yield curve gets steep, 10-year Treasury yield minus 2-year Treasury yield gets bigger. The number increases, and that 10-year Treasury yield minus 2-year Treasury yield, that is the key that I look at for the yield curve, "10s – 2s." You have seen it in the Report many times. What it means for stocks, buy them. The economy is losing momentum, the yield curve gets more flat and flatter, the 10-year Treasury yield minus 2-year Treasury yield gets smaller. The number decreases. What it means for stocks, hold them.

Sector selection becomes the key to outperforming. If this sounds familiar, it should because this is the environment we are in right now. Finally, if the economy is expected to contract, the yield curve will invert. The 10-year Treasury yield minus the 2-year Treasury yield becomes negative, and what it means for stocks, get ready to sell them. Not right away as the effect, the negative economic effect is often delayed, but that is a pretty big alert that you need to get ready to sell some stocks. Looking at what is happening right now in our yield curve, is the Treasury yield curve is signaling an economic slowdown? The answer is yes, it is. The yield curve has been flattening in 2017 for two very specific reasons. Number one, the Fed is expected to continue to hike rates. That is causing investors to sell short-term bonds. As they sell short-term bonds, short-term yields go up. However, nobody expects a big uptake in economic growth. As a result, people are still buying long-dated US Treasuries for the yield. That is making the yields on the 30 year and the 10 year go down. Short-term yields up, long-term yields down. That means we are getting a flattening yield curve, and you can see it here on the chart.

Look, we started the year basically at 1.3%, and we just hit a new low a couple of days ago. So, the yield curve is flattening, and as we showed in the last slide, that means that we need to focus on sector selection and not be too aggressive in just piling money into equities. Now getting to inversion. That is a clear signal that the economy is rolling over. Excuse me, there is a typo in that slide. An inverted yield curve is historically one of the most reliable signals that a recession is looming, although the timing of when that hits stocks is tricky, and you will see in the two examples I provide here in a few minutes. As a rule, there is a general guideline. These are the steps that occur that cause an inverted yield curve.

It always begins with the Feds starting to hike rates, and before this current cycle, the previous two examples were January ’99 and June ’04. As the Fed hikes rates, the yield curve inverts as investors sell short-term bonds and buy long-term bonds because they get nervous about economic growth. Does this sound familiar? It should, because that is what is happening right now. That causes short-term yields to rise and long-term yields to fall. The Fed rate hikes then eventually cause an economic slowdown and a stock market decline, and it has happened the two previous times. It has not happened yet for us, but that is what will happen if we continue along this path. So, then we get an economic slowdown. We hit a stock market decline. Step 4, the Fed reacts, and they begin to cut rates to help the economy. When they begin to cut rates, the yield curve then turns back positive. The economy recovers, and the Fed goes on hold.

This is the general path of how raising interest rates causes the yield curve to invert and affects the stock market, and I have two very compelling examples of this, the only two over the past 20 years, but they paint a very similar picture. The inverted yield curve signals the 2000 and 2002 recession and bear market. So, in January 1999, the Fed begins to hike rates. They go from a 4.5% to 6.5%. On February 2nd, the yield curve inverts. A month after they begin to hike rates, the yield curve inverts. The market continues to rise until 2000 when growth slowed and the tech bubble burst. Then down we come. In December 2000, the Fed reacts. The Fed reacts, and it starts to cut rates from 6.5%. A month later, the yield curve turns back positive, but the economic damage has already been done, and you can see the three-year return. Obviously 2001 was at least partially skewed by the tragic events of September 11th, but you can see the point.

The Fed cuts rates, cuts rates, cuts rates, cut rates all the way down to 1% from 6.5% down to 1% in July 2003. The yield curve gets incredibly steep, peaks at 2.66%. That 10s minus 2s goes from inverted, a negative number, to 2.66% in September 2003. The market bottoms in 2003 posts up a big return nearly 29% and is positive in ’04, ’05, ’06, and then ’07. Now inverted yield curve signals the great recession. June 2004, the Fed begins to hike rates. A while later, the yield curve inverts. It took a long time because you are starting at 1%, right? You are starting at 1%. So, it takes a while to get the yield curve to invert. The market continues to rise until 2007 when growth slowed and the housing bubble burst. Meanwhile, the Fed has been hiking rates. So, they go from 1% now to 5.25%. August 2006, the Fed stops hiking rates because they are getting nervous about the economy. On June 7, 2007, the yield curve turns positive, but again the economic damage has already been done. The Fed begins to cut rates basically a month after the yield curve turns positive, the S&P 500 ekes out a small gain in 2007, and for those of you that remember, almost all of that gain was because of a deep rate cute in December of that year. The market was basically, I think, negative or flat going into December. The Fed gave us either a bigger or surprising rate cut that month. I cannot remember which one it was, but that popped the market into year end, but then everybody knows what happens in 2008, down 37%. The Fed cuts rates to 0% in December 2008. As the Fed crushes rates down from 5.25% down to 0%, what happens, the yield curve turns positive, and it steepens. The 10s minus 2 spread tops out at nearly 3% in late 2014, and that happened to coincide with the end of QE, the end of, well you could call it the end of additional accommodation.

Market has gone a historic multiyear run. So, you can see two examples of where Fed rate hikes lead to an inverted yield curve that then caused a market pull back and an economic contraction. Two very different examples and different times, but with the same result. So, here we are in 2017-2018, ok? December 2015, the Fed begins to hike rates. So, the next question we need to ask is does the yield curve invert, and it is certainly going down. If it does, if the Fed continues to hike rates and the yield curve inverts, then that is a signal for us that we need to wake up and get ready for something potentially painful down the line. The chart on the right here is a bit busy. Excel is tough to get this to construct this and get it graphically the way I want to show you, but I think it illustrates the point. The red circles are when the 10s minus 2 spread turn negative, and then you can see the red lines are the subsequent S&P 500 performance.

So, here we are in 2000-2001, the yield curve turns negative, and then you have three years of negative return. ’06-’07 yield curve turns negative again. You have ’07 which was a small gain, again thanks mainly to that December bounce, but then you have the 37% down disaster year of 2008. The question around this, of course, is when. That is the million dollar question, and that is why you have to continue to watch this, but some important takeaways from the yield curve are this. First, an inverted yield curve is not a sale signal at that moment. You will see some newsletter writers and people like that, they will scream at the top of their lungs yield curve inverted, get out of stocks. Well, history would tell you, no, do not sell right then. There is probably more upside because these effects are significantly delayed.

Second, an inverted yield curve is a signal to design an exit plan, especially for long-term investors, and you are going to hear us say that a lot, if and when the yield curve inverts. At the end of the day, the key question we have to figure out is this: After years of 0% rates and multiple QEs, what level of Fed funds causes a yield curve inversion and an economic slowdown?

In the first example I gave you in 1999 and 2000, the Fed funds rate got as high as 6.5% before it caused the yield curve to invert. The yield curve inverted along the way and then caused an economic slowdown. In the 2006-2007 example, the Fed funds got to 5.25%, but at what level now does the Fed rate hikes begin to really cause some significant damage? It is not 1%. It is probably not 1.5%. if I had to guess, I would say it is probably somewhere between 2.5-3.5% depending on economic growth. That means we still have a ways to go, but again we are nearing a bit of a tipping point in this, and there are a lot of things that have changed in this economy since the last time we had an inverted yield curve, and it makes me a bit more nervous about what is happening. Bigger picture, this is something I want everybody to be aware of because it is signaling caution over the longer term. It is not saying get out, but it is signaling caution. Figuring out where that interest rate hike level is that starts to cause pain is something we are going to be working very hard on to try and ascertain here over the coming months and quarters. Bottom line, watch the 10s minus 2s Treasury yield spread. That is the most important long-term economic indicator that I watch. Yield curve flattening is a signal of future slowing in economic growth. It should make all medium- and longer-term investors cautious.

Over the longer term, that does not mean sell now, but it does mean we are coming potentially to the end of this run over the coming quarters and potentially years, and it implies a defensive sector should continue to outperform over the longer term. Tactically, we may be seeing a switch where we could see some cyclical outperformance, but over the longer term defensive sectors should continue to outperform. Meanwhile, a major steepening of the yield curve would be a major market economic positive. So, if something changes, we will obviously tell you, and that will change this opinion, but for now given that the 10s minus 2s spread is making new lows, we need to be aware that it is starting to send some concern in long-term signals.

Q&A

With that, we will go into Q&A. We have a couple right off the bat here. Henri, my friend from Louisiana wrote in and asked, **"Can you please address the Fed's plan to reduce the balance sheet and the impact on bonds and the markets?"** Well, it is interesting. Lost in all the different noise, bits of noise hitting the market right now, nobody is talking about the fact that the Fed is going to start reducing its balance sheet this month and will do so most likely at next week's meeting. It will actually stop reinvesting those bonds.

Now clearly, if the Fed is going to stop reinvesting those bonds, that is going to reduce demand for Treasuries. So, that should be, generally speaking, Treasury negative, yield positive. That will take some time I think to begin to affect the markets, but clearly we are getting a significant reduction in buy demand and Treasuries. So, I think that is medium- and longer-term bond negative, yield positive. It has to be unless you are going to find some sort of substitute for that tremendous demand. I think that the Fed reducing its balance sheet is a wild card to watch. No one is really worried about it, nobody is talking about it, but the Fed has never had to do this before. So, what could go wrong is something that pops into my mind significantly. With regard to the market, if you see a big spike up in interest rates, I mean you know a quick quick spike, that will be a headwind on stocks. If it is a gradual sort of rise that is coming with better economic data, if it is a general rise in yields that is better economic data, that could be a positive for stocks. Again, it has more to do with the shape of the yield curve than it does the absolute level of bonds.

Alright, Josh writes in, **"What is the best way to implement cash right now?"** Well, Josh, I guess, you know, it is hard for me to answer that because I do not know a lot of what client's needs are and things like that, but as a general sense, if you are underinvested in this market, I would probably try and correct that. I do not think that it is the appropriate time to be overinvested in the market. I think an appropriate allocation to equities makes sense. I think the majority of that allocation being focused on defensive sectors, utilities, super-cap tech, healthcare, and then international opportunities including Europe, emerging markets, KWEB, which has done very very well and will actually address that in a second. That is where I would put cash. If you are fully invested in what your traditional equity allocation is in a client, I would not say take out of bonds and dump more into equities right now. The outlook is not good enough for me to say that yet, but if you are underinvested in equities, I do not think we are looking at the precipice of you know a 10, 15, 20% correction. At least, not yet. So, I would probably increase some of that allocation in new cash into equities to at least get it to wherever your full allocation to equities is.

Ian writes in, **"KWEB is up 6% basically since you recommended it. It just hit a new 52-week high. Should we hold it?"** The answer is… yes. I think for longer-term investors, yes. Remember this was an index rebalance play. The index rebalance will continue through June of next year. If you are a short-term trader, which I do not think a lot of people here are short-term traders, but if you want to demonstrate a quick game to a client, you know, could you put some in your pocket, absolutely. Tyler, who is our technical analyst was saying that there is some resistance just above the $60 level, and I think that may be a decent place to take short-term profits, but over the medium/longer term, I would absolutely continue to hold it. Obviously, there will be ups and down with this. It is not going to go straight up all the time, but it is a good position. There is a good story behind it. It has the index rebalance as the tailwind, and I am holding mine even though it is up on some nice gains.

The next question comes from Bob, and he said, **"When is the next issue coming out, and what are you going to be talking about?".** Well, the next issue will be coming out the middle of next week. We are going to try and get it out Tuesday. I do not know if we will succeed in that. We are still sort of recovering as I mentioned from Hurricane Irma, but if it is not Tuesday, it will be most likely Wednesday then, and what we are going to be actually covering in the next issue is we are going to be taking a bit of a thematic turn, and we are going to be looking at ETFs and some signal stocks in the auto industry, and specifically covering two big changes that are going to be occurring in the auto industry.

Number one, autonomous driving, and number two gasless cars. These are sort of a thematic megatrend investing primer for lack of a better word that I want to come out with along with the ETFs that are exposed to this that have all done very well this year, and I think can do much better over time. Additionally, a couple single stocks because the ETFs are not as pure play as you would want them to be. So, as I typically do in the Report, I am going to sprinkle in a couple good single stock names, as well, that I think could take advantage of that trend, and we are working on that issue right now, and we are very excited to get it out to you guys.

Ok. That about wraps up our time for today. I like to try and keep these things for 30 minutes. I know everybody is busy. I want to thank everyone for coming on. Again, thank you for your attendance, and thank you for your patience this week with us. We are getting things back to normal. I think by next week, we should be back at full strength. Everybody have a great rest of the week, a great weekend. Please look for our next written issue with the new recommendations coming out Tuesday or Wednesday of next week, and we will speak to you again here in two weeks, our next webinar. Thank you everyone, and have a great day.