

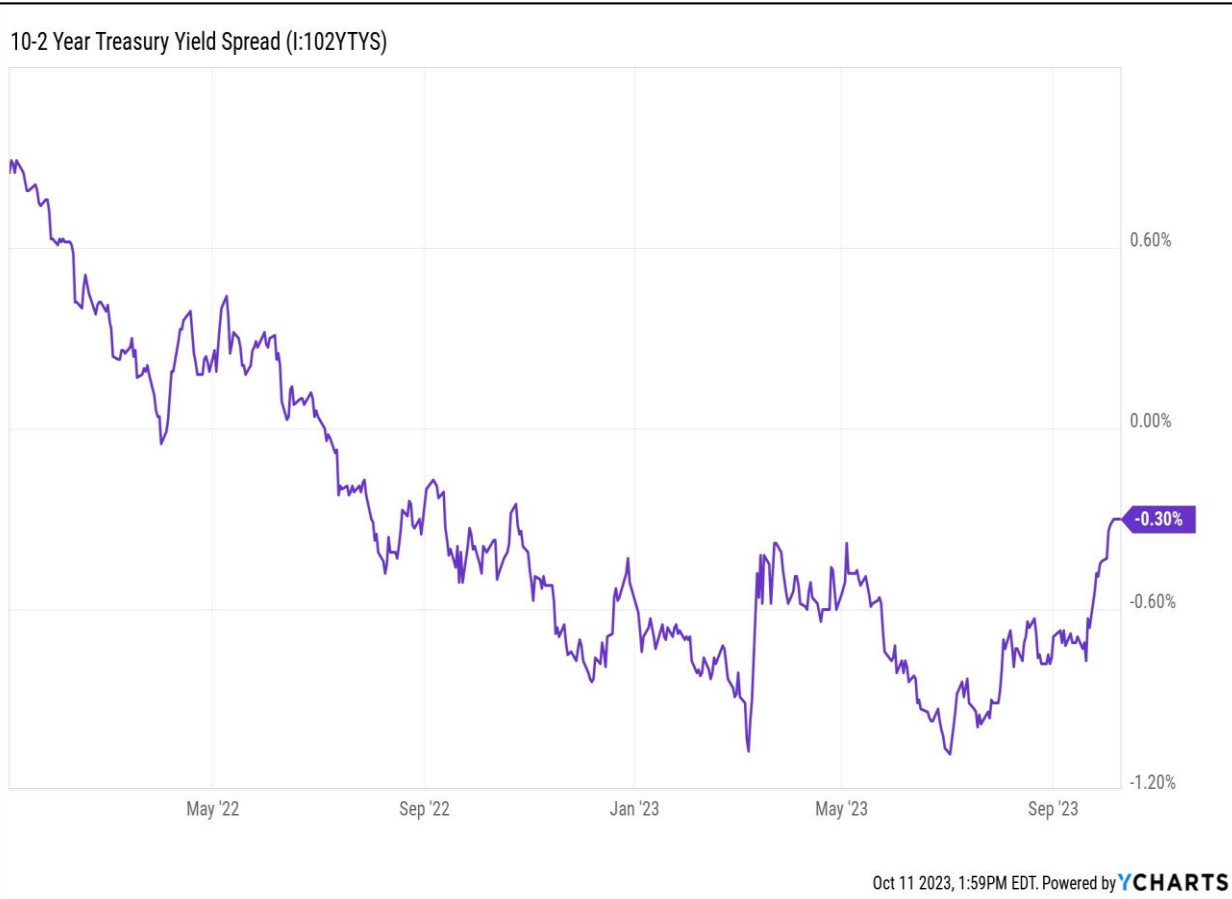
Sevens Report Alpha Webinar – What Does the Flattening Yield Curve Mean for Markets?

October 12th, 2023

Tom Essaye, President Sevens Report Research

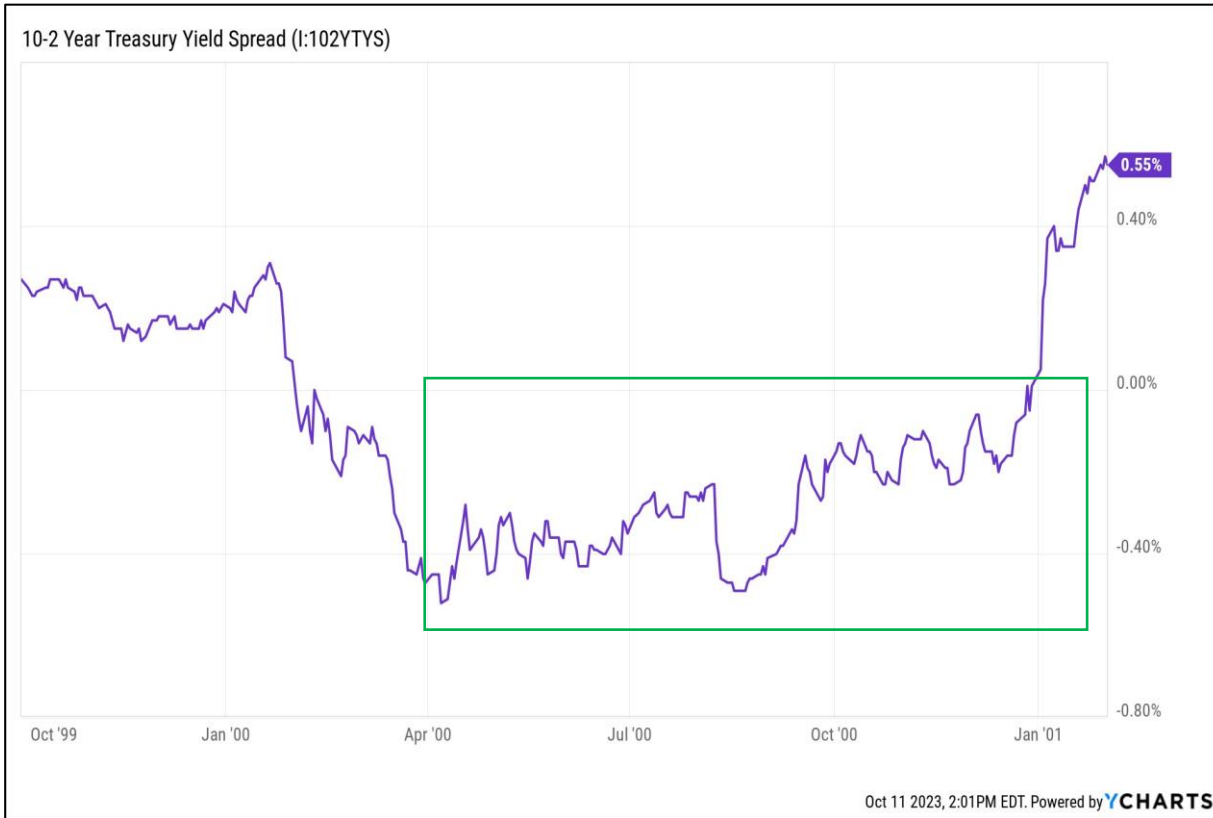
10's-2's Has Risen Sharply

- The 10's-2's yield spread has risen to one-year highs as yields on the 10-year Treasury have surged higher.

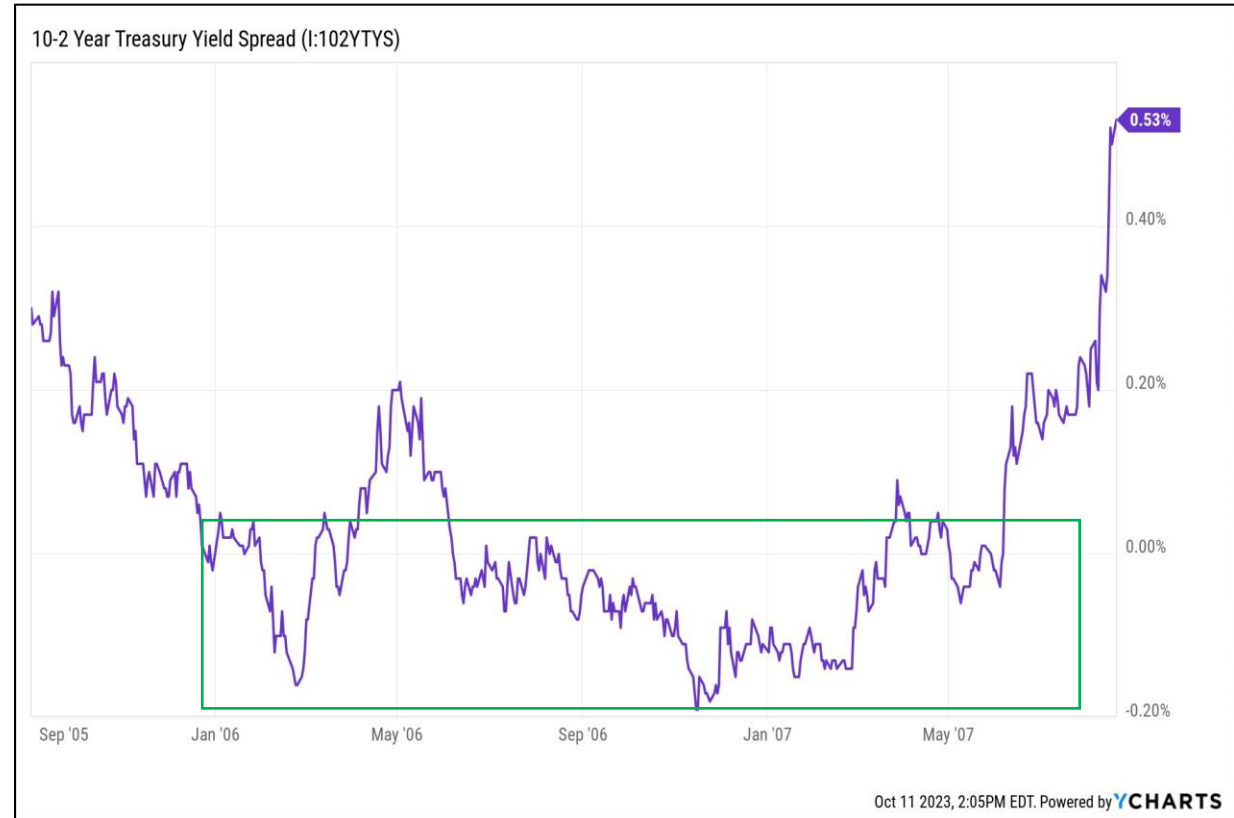


We've Seen This Before

Early 2000's



Mid 2000's



What Happened to Markets When 10's-2's Turned Positive?

Early 2000's

	Trough to Turning Positive	Six Months After Turning Positive	One Year After Turning Positive
SPX	-12.36%	-8.87%	-12.93%
DJI	-2.77%	-3.41%	-6.22%
IXIC	-42.89%	-18.30%	-22.17%
RUT	-10.90%	3.40%	2.77%

Mid 2000's

	Trough to Turning Positive	Six Months After Turning Positive	One Year After Turning Positive
SPX	2.75%	6.32%	-7.35%
DJI	1.60%	11.03%	-0.69%
IXIC	0.54%	8.77%	-8.05%
RUT	1.96%	0.70%	-15.61%

What Happened to Markets When 10's-2's Turned Positive?

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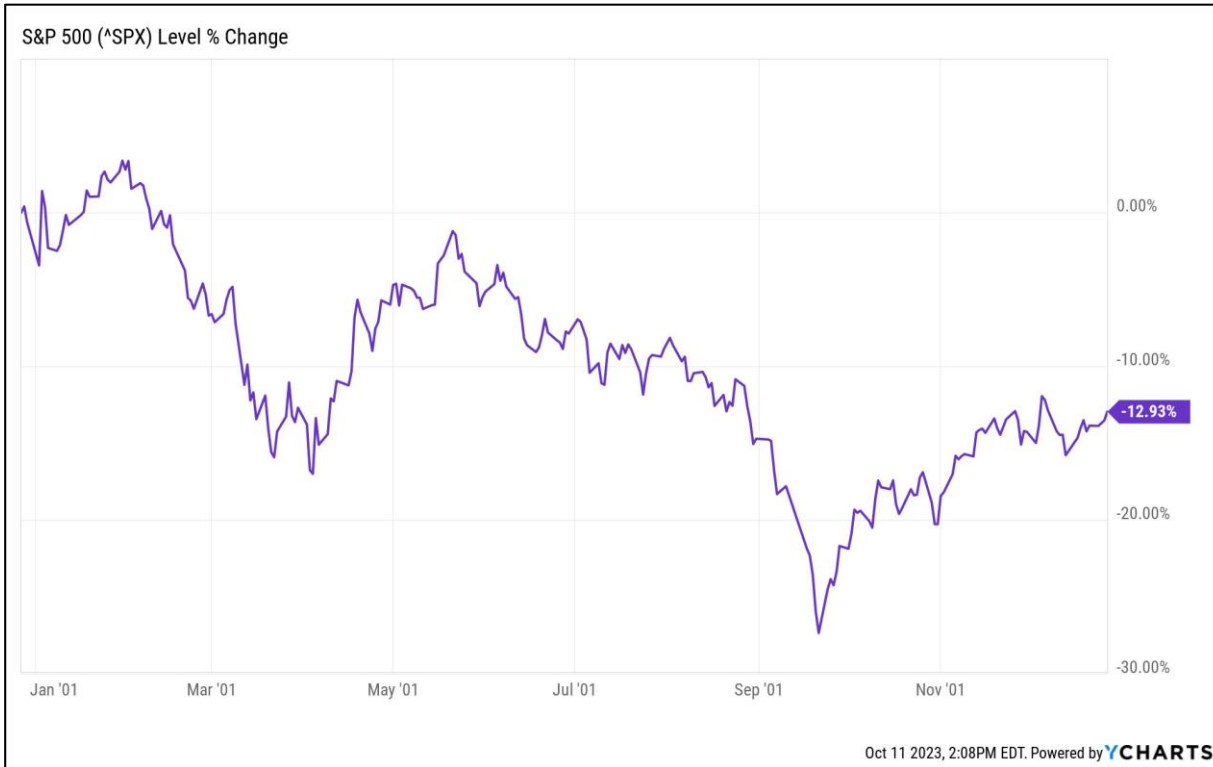
	Trough to Turning Positive	Six Months After Turning Positive	One Year After Turning Positive
XLY	-15.81%	8.13%	15.44%
XLP	29.78%	-11.51%	-7.93%
XLE	17.06%	-7.60%	-18.05%
XLV	-11.60%	7.84%	-0.10%
XLI	5.74%	-5.55%	-8.85%
XLB	-2.19%	2.45%	1.65%
XLK	-46.13%	-17.27%	-24.87%
XLF	24.44%	-3.87%	-9.71%
XLU	23.60%	-5.80%	-12.41%

Mid 2000's

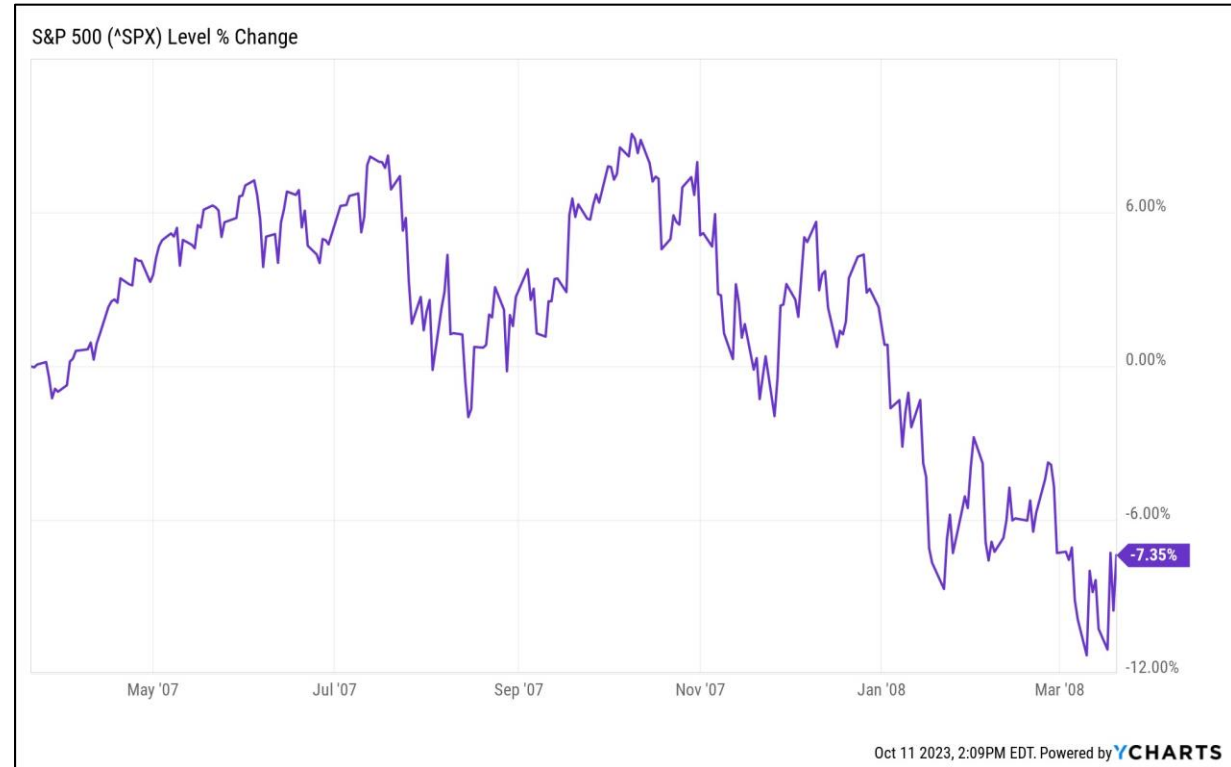
	Trough to Turning Positive	Six Months After Turning Positive	One Year After Turning Positive
XLY	2.72%	-3.90%	-18.37%
XLP	4.67%	5.21%	6.14%
XLE	1.51%	29.58%	21.86%
XLV	3.75%	5.28%	-6.92%
XLI	3.49%	13.47%	3.23%
XLB	13.30%	9.69%	2.33%
XLK	1.39%	12.79%	-4.53%
XLF	2.49%	-3.67%	-25.51%
XLU	12.29%	2.98%	-2.93%

What Happened to Markets When 10's-2's Turned Positive?

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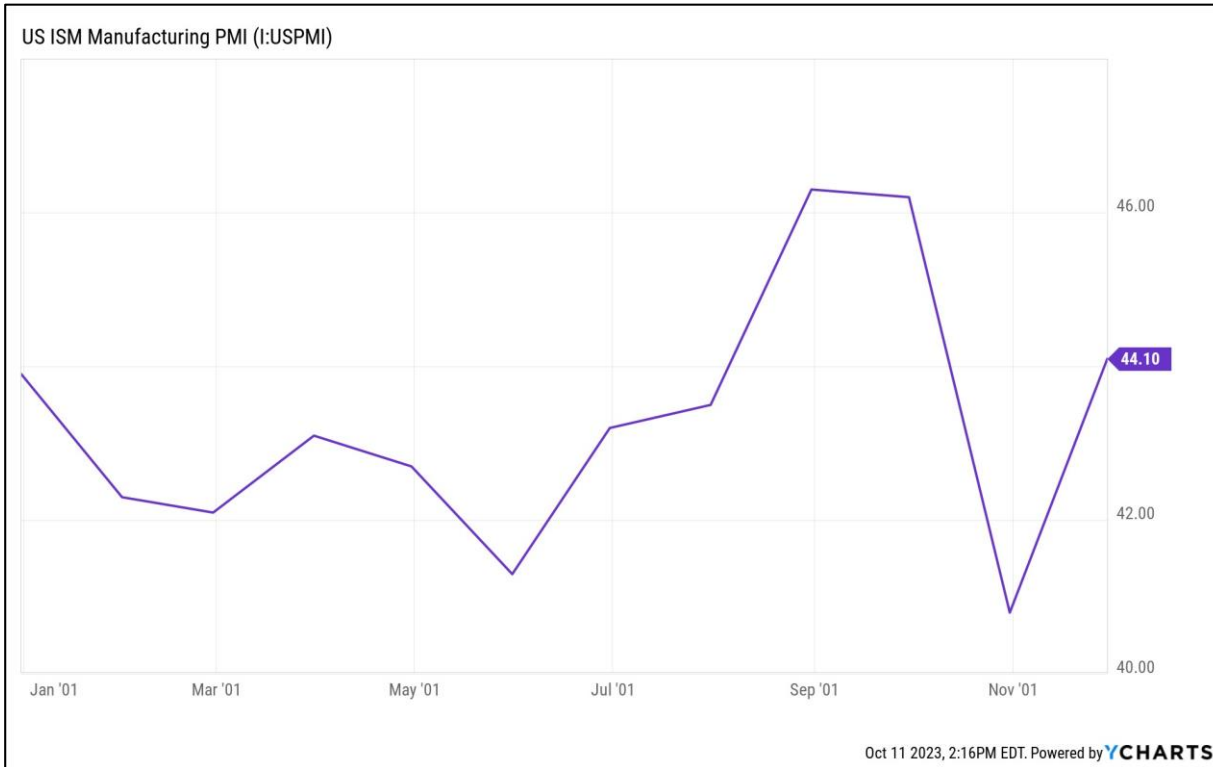


Mid 2000's

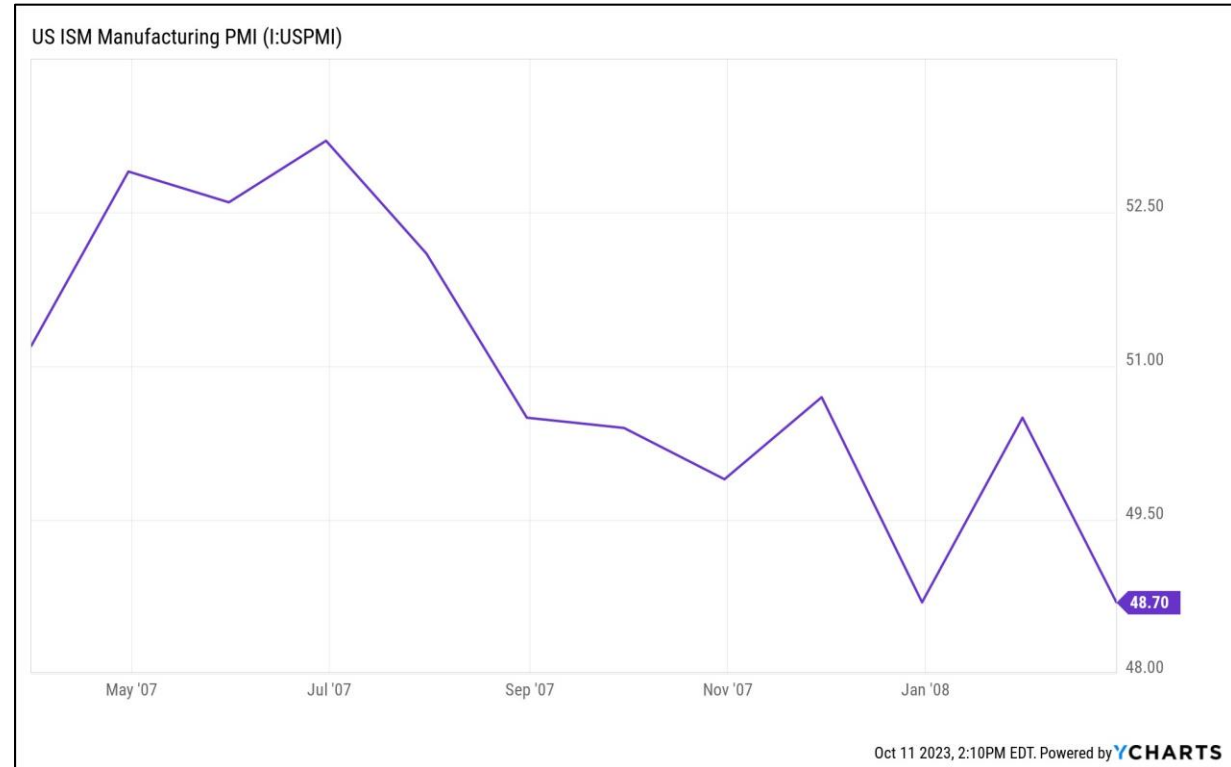


What Happened to the Economy When 10's-2's Turned Positive?

Early 2000's

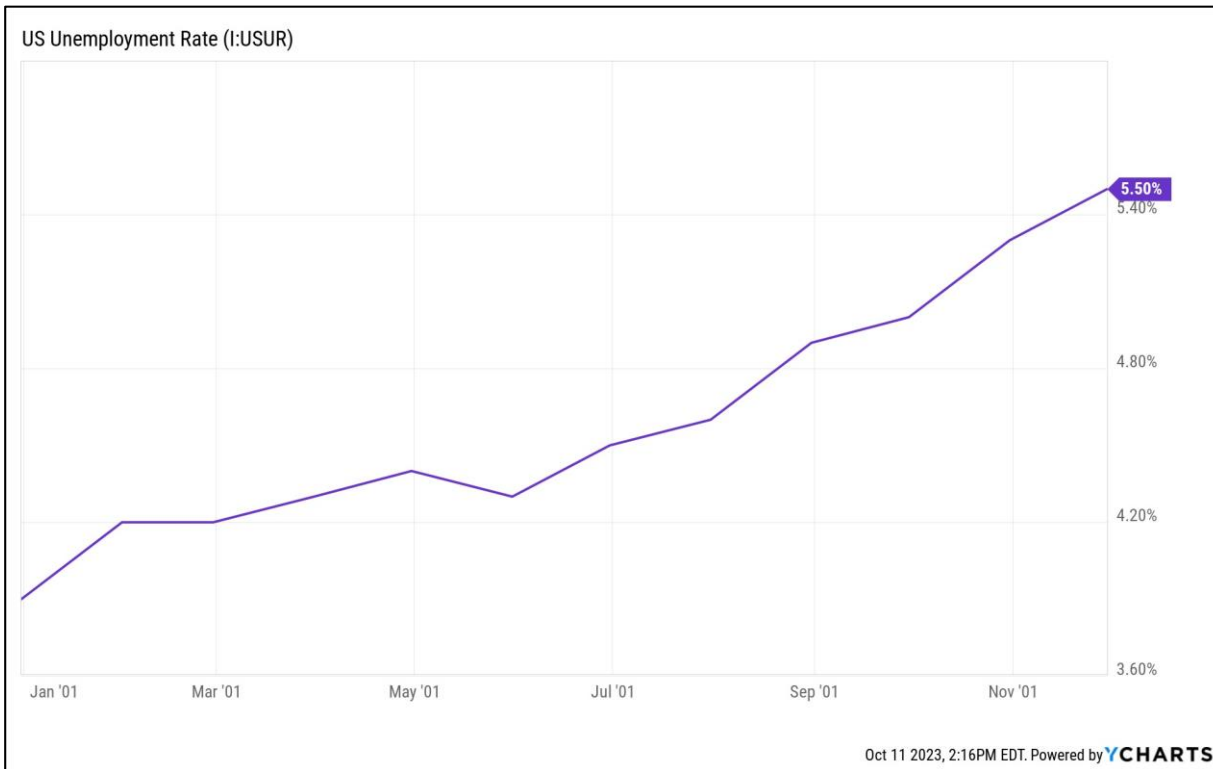


Mid 2000's

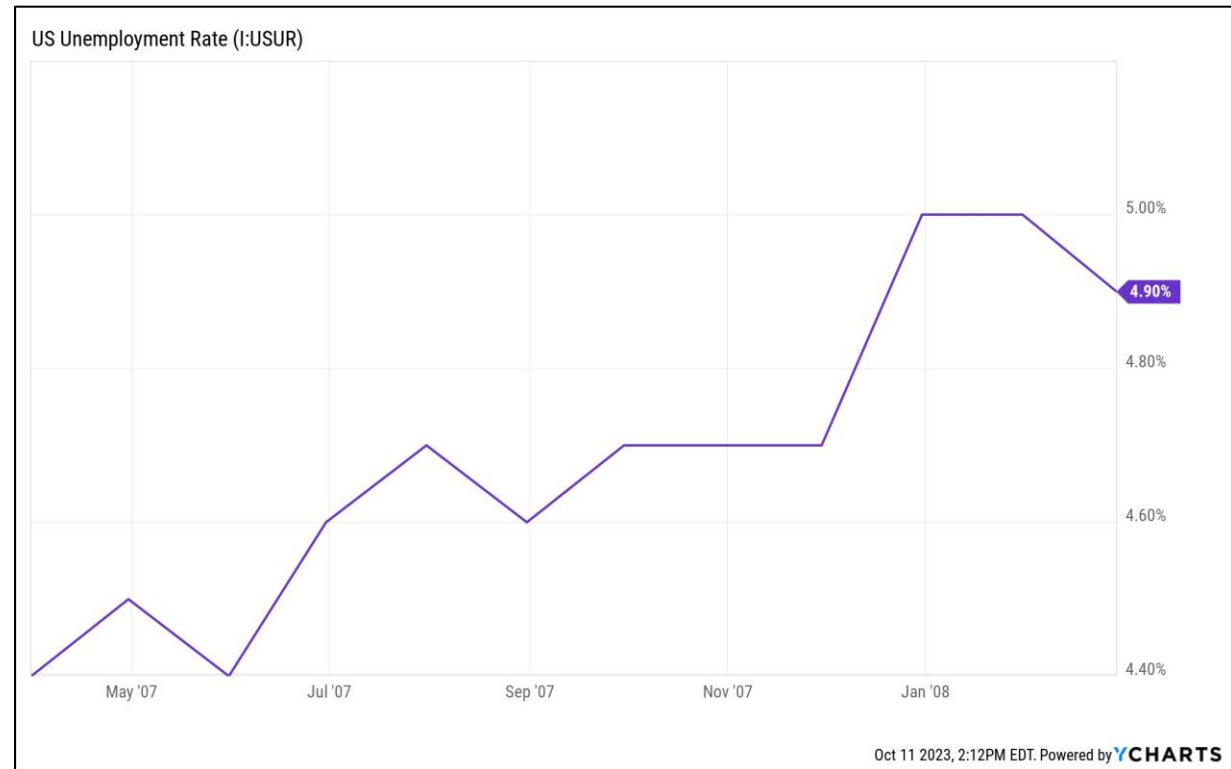


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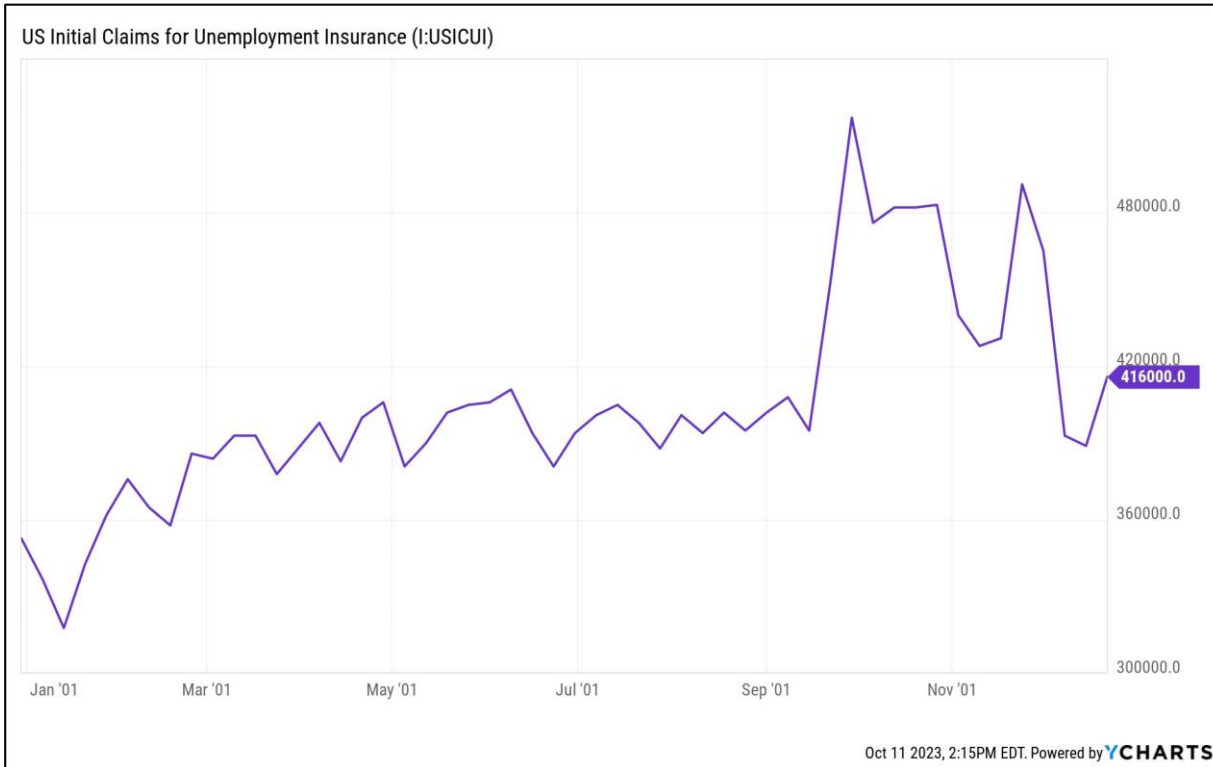


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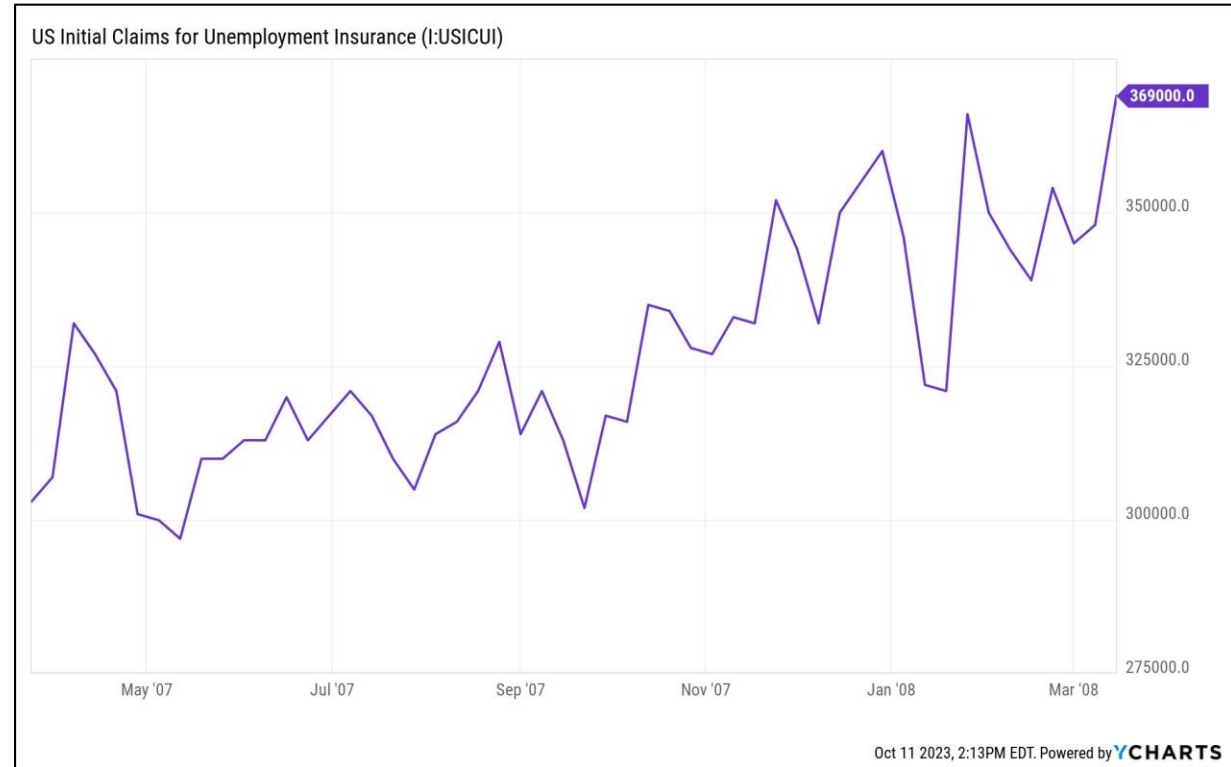


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Early 2000's

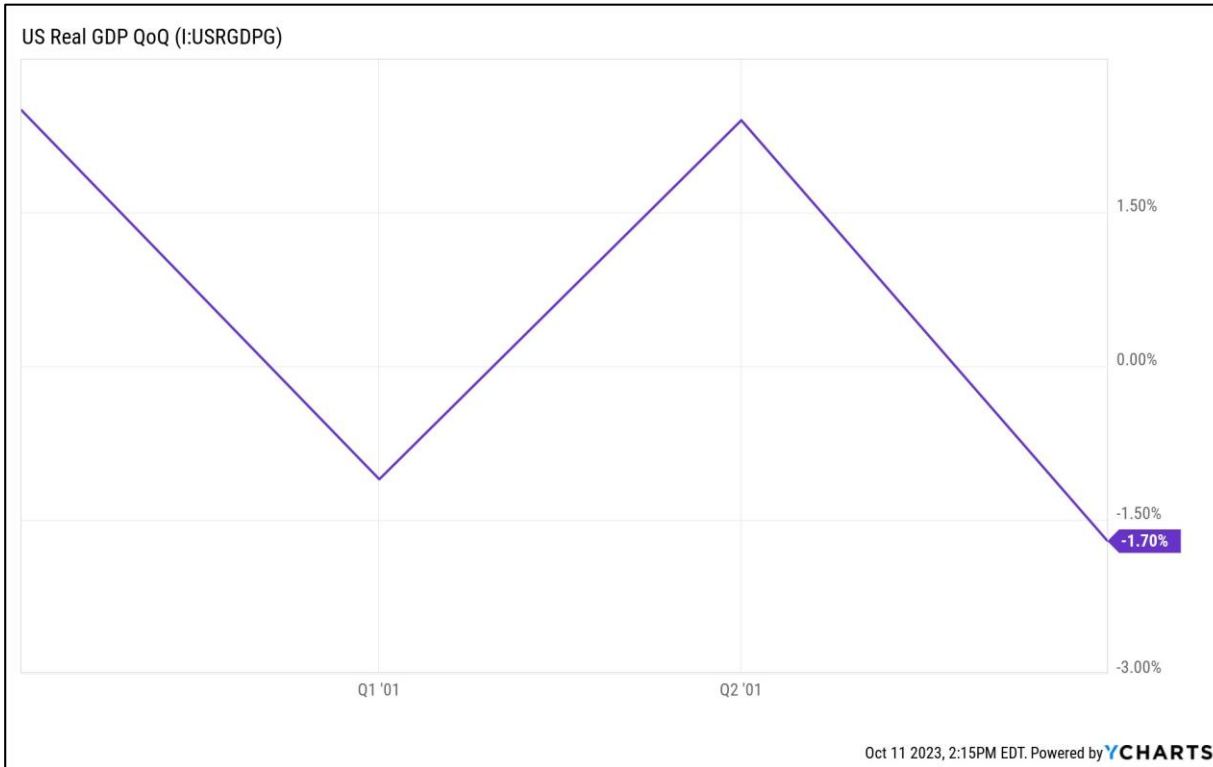


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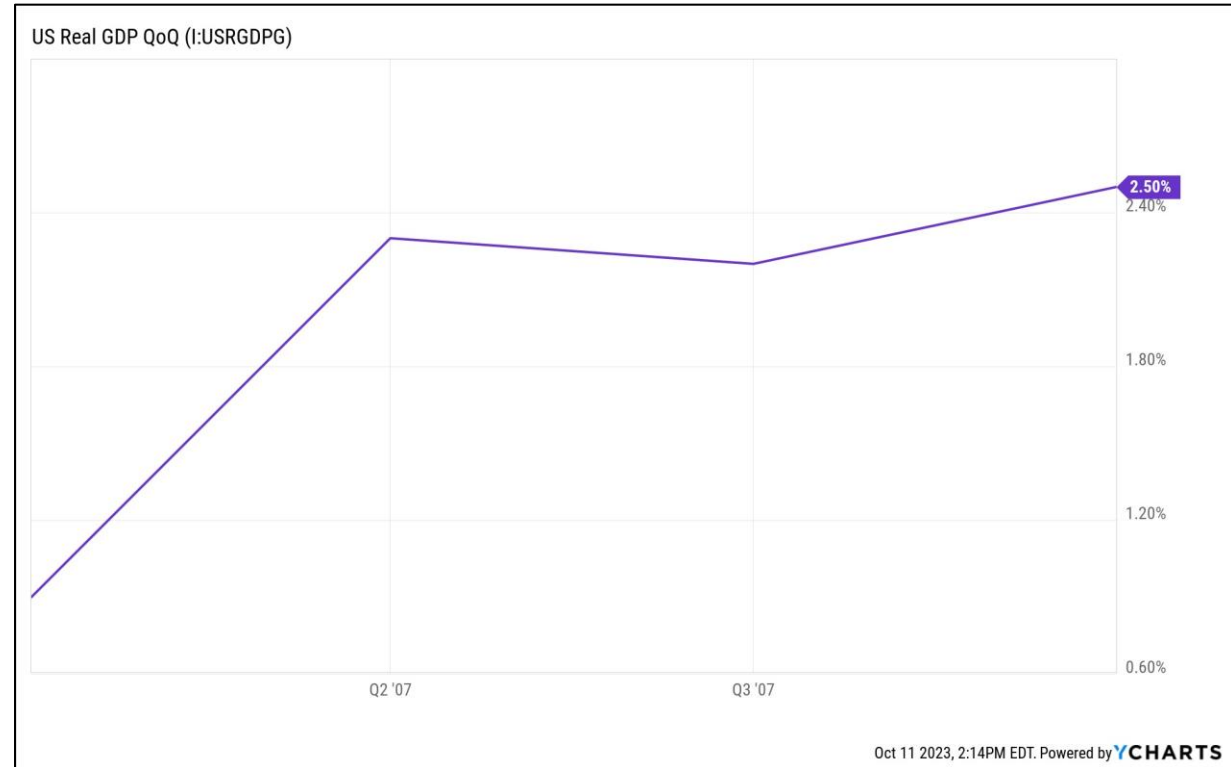


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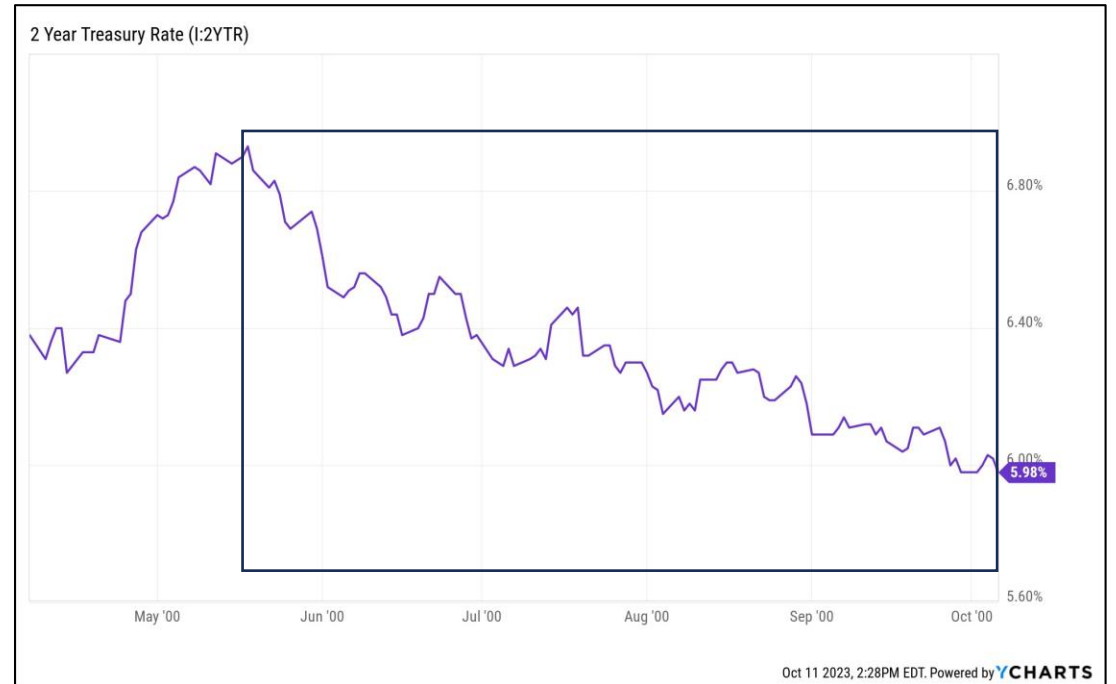
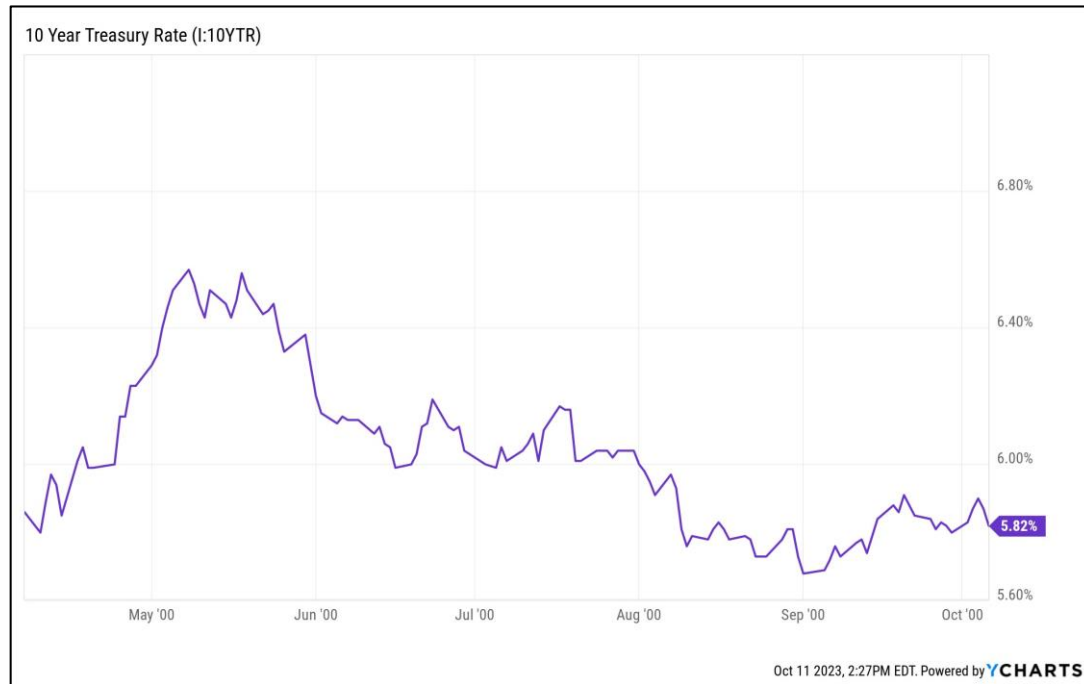


Mid 2000's



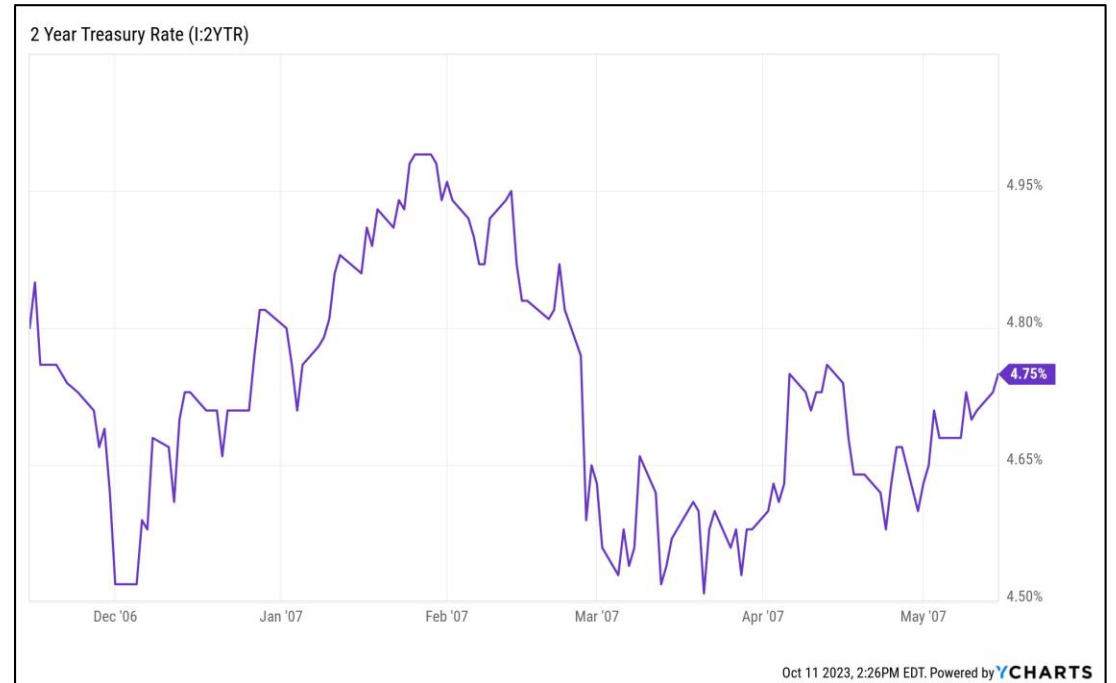
Difference Between Now and Then. 2000.

In 2000, the 10's-2's yield spread began to rise because the two-year yield declined from over 6.80% to below 6.00% as investors priced in future Fed rate cuts. Essentially, the 10's-2's rose because the markets expected the Fed to cut rates as the economy slowed.



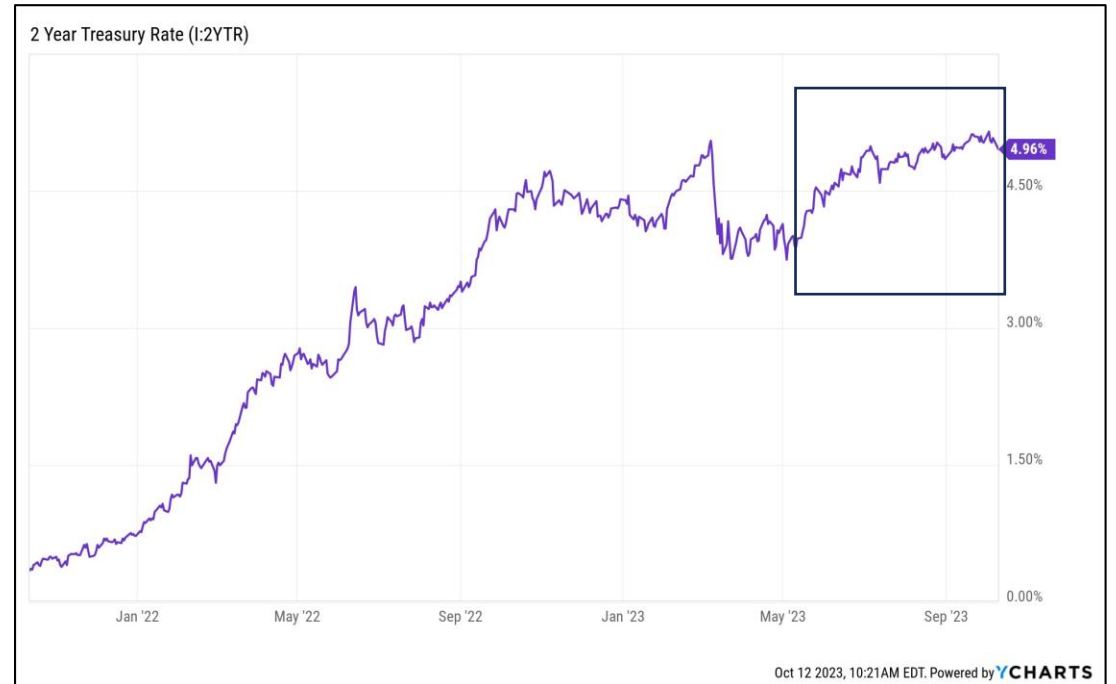
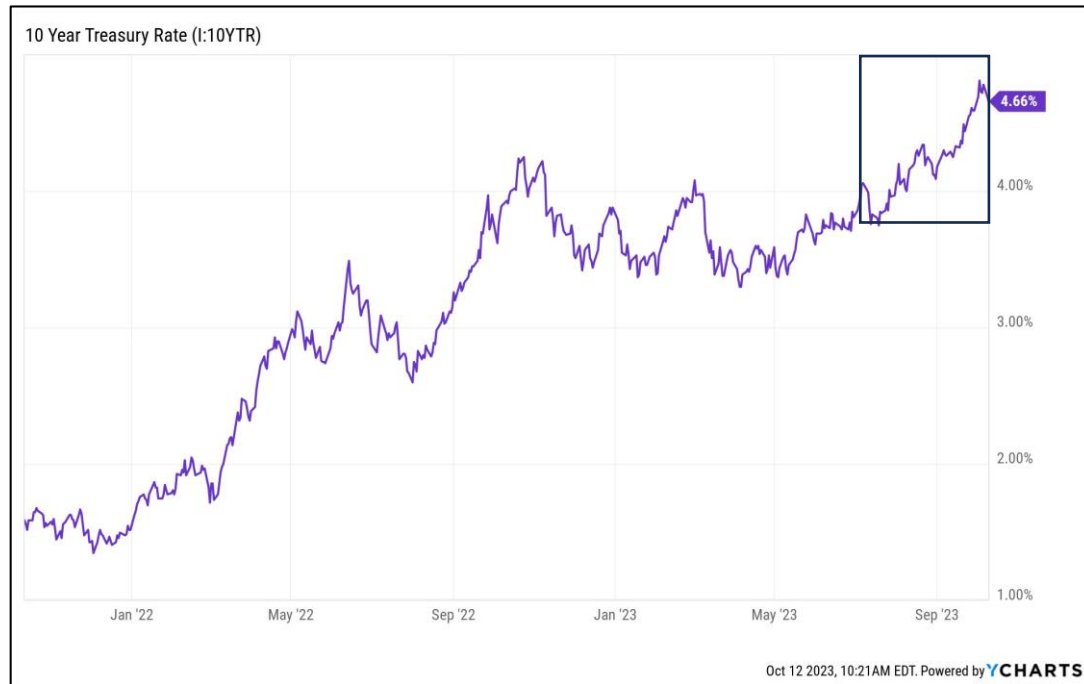
Difference Between Now and Then. 2007.

Similarly, but to a lesser extent, the rise in the 10's-2's was again driven by a steep drop in the two-year yield (this time from above 5.00% to 4.50%) as markets again anticipated some Fed rate cuts in response to expectations for a slowing economy. It's important to note, however, that the bond market had no idea such a large financial crisis was looming at this point.



Difference Between Now and Then. 2023.

This time is different. The 10's-2's spread is rising because the 10-year yield has surged higher and that is an important change.



Why Is This Time Different?

- Typically, the 10's-2's spread inverts (becomes negative) when markets expect the Fed to hike short term rates so high that it will cause an economic slowdown. That expectation of higher rates drives the two-year Treasury yield higher while investors “reach” for yield in long dated securities, pushing those yields lower. That is what happened during this inversion.
- Typically, when this reverses, it's because the two-year yield falls as investors anticipate the Fed cutting rates as the economy slows.
- This time, we are seeing the 10-year yield rise quickly - why?

What Does It Mean?

- Possible signal #1: Inflation isn't dead. The surge in the 10-year yield could be driven by bond investors thinking the Fed hasn't gone far enough and that the Fed won't kill the economy or inflation.
 - Investment implications: Resilient growth (no landing) but still above average inflation and higher for longer interest rates. Sectors that would benefit are 1) Cash, 2) Cyclical sectors (energy, materials, financials), and 3) Junk debt.
- Deteriorating U.S. fiscal state. It's not just a coincidence that the 10-year yield started to accelerate higher when Fitch downgraded the U.S. debt ratings. The dysfunction in Washington is extremely high right now with high deficits and existing years of extreme spending, the "Bond Vigilantes" have returned and could be pushing Treasury yields higher.
 - Investment implications: Sectors that would benefit are 1) Hard assets (commodities, gold, HAP, energy, resources), 2) Super cap tech (FDN, "Magnificent Seven"), 3) Large multi-nationals (think Dow Industrials), and 4) Foreign exposure.
- QE aftermath and bond market dynamics. The supply of Treasuries for sale has surged following 1) The unprecedented spending of the pandemic era and 2) Government shutdown. At the same time, that surge in supply has occurred when a huge buyer of Treasuries, the Fed, has suspended QE and is actively reducing its balance sheet.
 - Investment implications: Higher yields for longer. This would almost "decouple" Treasury yields from economic dynamics and the result could be a greater chance of an economic slowdown. Sectors that would benefit: Cash.

Takeaways and What Comes Next

- First, the facts:
 - The past two times 10's-2's went from inverted to back positive, one year after turning positive the S&P 500 was solidly lower.
 - The past two times 10's-2's went from inverted to back positive, one year later the unemployment rate was higher, jobless claims were higher and the economy was either outright slowing or losing momentum.
- But, this is different.
 - So, what do we watch: The two-year yield. If the market becomes concerned a growth slowdown is coming, then the two-year yield will begin to drop as the market anticipates the Fed cutting rates – and this will happen regardless of what the Fed says.
 - If we see 10's-2's begin to spike higher like we saw in '00 and '07, it'll likely occur because the two-year yield is plunging and that will be decidedly negative signal because the bond market will be warning of a major growth slowdown (and almost certainly will hit stocks).