



Kristina Hooper
Chief Global Market Strategist

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From the US Treasury yield curve, to stock market volatility, to China's COVID response – I'm getting a lot of questions from clients about what conclusions we can draw from the daily deluge of data that investors have to contend with. This week, I address the latest inquiries.

Is the US Treasury yield curve signaling an impending recession?

The spread between the 10-year and 2-year US Treasury yields has narrowed from about 80 basis points to 20 basis points in a relatively short period of time, leading to much speculation about whether a recession may be imminent.¹ However, it is important to note that the yield spread remains significantly wider than it was in the summer of 2019 when it briefly inverted.

My take on the curve: Recession risks have clearly risen, but a near-term yield curve inversion and subsequent recession is definitely not a "fait accompli." Yes, it's true that historically the bond market has been a more accurate predictor of recessions. And we are seeing multiple parts of the yield curve already inverting – but not all. In fact, the spread between the 10-year and 3-month US Treasury yields has recently widened, suggesting we could avoid a recession. Developed central banks, especially the Federal Reserve, may still be able to engineer a soft landing.

And as my colleague Brian Levitt has pointed out, a yield curve inversion typically signals a recession far out in the future. Over the past six decades, the median amount of time between the initial inversion of the yield curve and the onset of a recession is 18 months.² Further, as Brian has pointed out, a yield curve inversion has not historically been a good sell signal for stocks. In fact, the median return of the S&P 500 Index from the date in each cycle when the yield curve inverts to the market peak is 19%.³

Are longer-term US consumer inflation expectations becoming unanchored?

They don't appear to be. The New York Fed measures one-year and three-year ahead inflation expectations, and both have shown an increase recently. Last week, the University of Michigan released its final Survey of Consumers for March. As with the NY Fed Survey, one-year ahead inflation expectations rose – up to 5.4% from February's final reading of 4.9%. However, Michigan's five-year ahead inflation expectations held steady at 3%.⁴ This suggests that, despite Russia's invasion of Ukraine and the substantial rise in the prices of many commodities, longer-term inflation expectations remain somewhat well-anchored. That doesn't mean that expectations won't change the longer the crisis persists, which is why we will want to follow this metric closely.

How can sentiment be so bad and yet stocks have been rising?

It is true that sentiment is poor. US consumer sentiment, as measured by the University of Michigan, declined further in March and is at a low for the decade, largely driven by concerns about inflation.⁵ However, economic conditions largely remain good in the United States, with a tight labor market, as evidenced by better-than-expected initial jobless claims last week. Leading economic indicators also continue to show solid readings. It is unclear whether the Fed will be able to engineer a soft landing, and while recession risks are increasing, the US stock market is clearly signaling continued optimism while the bond market is signaling some fear. In addition, stocks have generally become more attractive to investors given the significant pullback they recently experienced.

Not all stocks have risen in the past week. European stocks fell last week, and that makes sense given that they are more vulnerable to the impact of Russia-Ukraine in the shorter term. German business sentiment, as measured by the IFO German Business Expectations Index, dropped 13.3 points in March.⁶ This was driven by extreme uncertainty, which also makes sense given how close Germany is to the epicenter of the crisis. However, I believe any progress toward resolution of the Russia-Ukraine crisis would likely benefit European stocks more substantially.

Why has US stock market volatility decreased so much?

Indeed, the VIX has fallen to levels not seen since before Russia's invasion of Ukraine. As I expected, US stocks are becoming acclimated to a "new normal" of ongoing geopolitical conflict in eastern Europe. And as I mentioned above, stocks are clearly indicating more optimism about the US economy. It is interesting to note that the VIX peaked at the same time the 10-year/3-month US Treasury curve began to re-steepen. However, while US stocks could continue to hold up, I expect volatility to increase again given the dual headwinds of Fed tightening and geopolitical risk. This could be a calm before another storm.

Should we be worried about China's economy given continued COVID-19 lockdowns?

We have already seen a number of lockdowns, but the impact on manufacturing has been manageable so far. However, household spending and the services side of the economy could experience further headwinds from this current wave of the virus. And so the Chinese economy's strong start to the year could stall due to recent pandemic disruptions, although we expect policymakers are likely to further ramp up monetary and fiscal policy support in the second quarter. That suggests any downturn could be very brief. We still believe the Chinese economy will re-accelerate in the back half of 2022.

Is globalization dead?

In my view — definitely not. To paraphrase Mark Twain, reports of its death have been greatly exaggerated. Yes, the pandemic and the Russia-Ukraine war have delivered a one-two punch to globalization, and so it has certainly experienced a setback. Simply put, in the short run, geopolitics may dominate business decisions, but in the longer run, economics dictates business decisions. Companies do what is in the best interests of their shareholders and customers, and that

means businesses will continue to embrace the concept of comparative advantage. I believe that means we will likely continue to move toward greater globalization.

Where is there opportunity in this challenging environment?

Some investors like to make tactical allocations, and we believe there are always opportunities even in the most challenging environments. For example, we are currently finding Japanese equities attractive. The Japanese economy faced headwinds in the back half of 2021, as the vaccination rollout was slower than expected, and that weak domestic economy weighed on Japanese equities. However, now Japan's economy is benefiting from a loosening of COVID-19 restrictions, a weaker yen and fiscal stimulus. And while many major central banks are tightening, the Bank of Japan (BOJ) appears poised to remain very accommodative for now, as articulated by BOJ Governor Haruhiko Kuroda in recent comments: "It will be neither necessary nor appropriate to tighten policy because much of the expected inflation will result from higher commodity prices and import costs."⁷ In addition, corporate profitability is being helped by lower wage costs in Japan relative to other developed countries.

Overall, we always advocate being well-diversified both across and within asset classes for the long run, staying the course with your long-term financial plan, and staying calm in the midst of market uncertainty.

With contributions from David Chao and Tomo Kinoshita.

Notes

¹St. Louis Fed, as of March 25, 2022

²National Bureau of Economic Research; Bloomberg, L.P.; Invesco address, March 21, 2022

³Bloomberg, L.P. Past performance does not guarantee future results.

⁴University of Michigan Survey of Consumers, as of March 25, 2022

⁵University of Michigan Survey of Consumers, as of March 25, 2022

⁶Ifo Institute, March 25, 2022

⁷Kyodo News, "BOJ keeps easing policy steady amid low inflation, Ukraine crisis", March 18, 2022

Important information

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Diversification does not guarantee a profit or eliminate the risk of loss.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

A basis point is one hundredth of a percentage point.

The New York Fed's Survey of Consumer Expectations contains information about how consumers expect overall inflation and prices for food, gas, housing, and education to behave. It also provides insight into Americans' views about job prospects and earnings growth and their expectations about future spending and access to credit.

The University of Michigan's Consumer Sentiment Index is published monthly, based on a telephone survey designed to assess US consumer expectations for the economy and their personal spending.

The German Ifo Business Climate Index assesses the current German business climate and measures expectations for the next six months. It is a composite index based on a survey of manufacturers, builders, wholesalers and retailers. The index is compiled by the Ifo Institute for Economic Research.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

The opinions referenced above are those of the author as of March 28, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.