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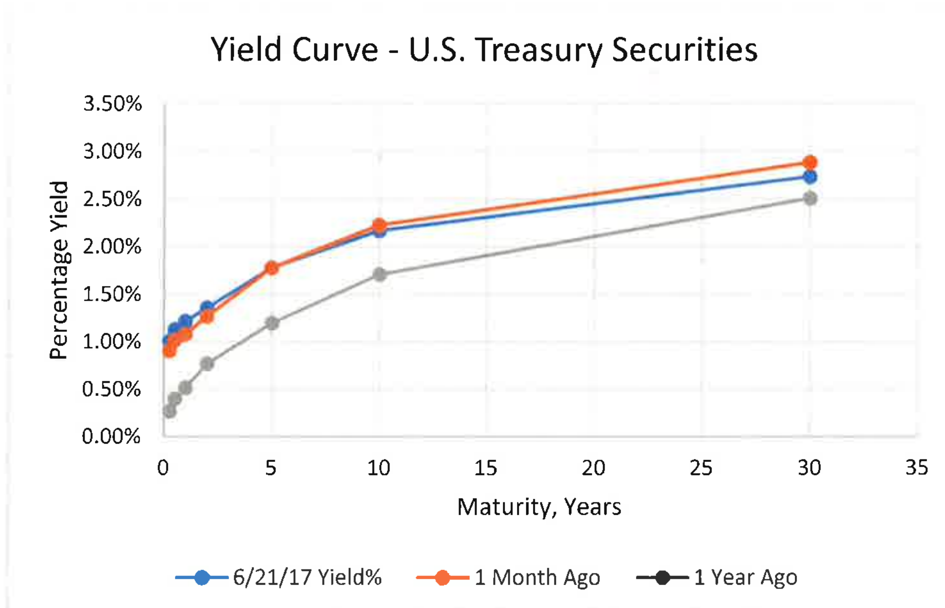
It is time to take a look at what we thought 2017 would be like and compare that with what has happened in the past six months. At the end of December, we thought that the economy would continue growing slowly. Despite a brief flash of excitement over GDP growth at yearend, our slow growth economy has mostly stayed that way. We expected President Trump's new administration and Congress to take up measures to enhance economic growth, and while some steps have been taken to reduce regulation, plans for tax and health care reform have stalled. Corporate earnings for the first quarter were good, increasing about 15% over the first quarter of 2016. Unemployment is even lower than it was at year end. The stock market has moved up nicely, while the bond market has also reversed course and strengthened.

We follow many different economic and market indicators to see if we can read the tea leaves about the economy. While there are perhaps thousands of these indicators, the most significant ones relate to the overall health of the economy and key signals about the markets for stocks and bonds.

Since interest rates play a large role in the economy, it makes sense to follow indicators based on key rates. These can signal potential changes to come. The most watched interest rate signal is the U.S. Treasury Constant Maturity yield curve, which gives us a look at current and past yields on Treasuries from 3 months all the way out to 30 years. The U.S. Treasury yield curve as of June 21st is shown below:



Data courtesy Bloomberg LP

The yield curve shows us the current yield for the 3 month, 6 month, 1, 2, 5, 10 and 30 year Treasuries as of June 21st. We can also compare current yields to the yields from dates in the past, such as one month and one year ago so that we can see what has been happening to yields over time. The above chart shows that yields have increased across the entire range of maturities over the past year. We see that short-term yields have been increasing the most, as the Federal Reserve has been raising short-term rates for the past couple of years and short term yields are largely controlled by this Fed action. We use the term "rate" here to indicate a percentage that is set by the Fed, and the term "yield" to indicate a percentage based on market prices for the bonds.

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The increase in longer term yields is generally in proportion to the increase in short term yields, and this is a signal of a growing economy. This yield curve is referred to as upward sloping. The higher long-term rates are an indication of the higher reward being demanded by investors for the risk of holding a longer term bond, and reflect higher long-term borrowing rates as well as expected inflation. The Fed has a much smaller impact on long term rates and yields, so the market largely determines these.

If the Fed raises short term interest rates to a higher level – one that might cause the economy to slow down – shorter term yields could end up higher than longer term yields. This could be a signal of a coming recession, and it is known as an inverted yield curve. Low long-term rates are a signal of weak demand for borrowing, and this is reflected in the lower yields of longer maturity Treasuries. This can also be known as a "flight to safety" trade, as investors buying the longer dated bonds are driving the yields of longer term Treasuries down below the yields of shorter term Treasuries. Investors might be choosing to sell stocks and riskier bonds, fearing losses in a bad market to come, and believe their money will be safer in U.S. Treasuries. The lower yields also reflect lower expectations for inflation in the future.

Another indicator to watch is the yield spread between high yield bonds and U.S. Treasury bonds. The "spread" is simply the current yield of a basket of high yield bonds minus the yield of the U.S. Treasury of the same maturity, expressed as a percentage. High yield bonds are a good way to look at the health of the economy. Companies with weaker credit issue them in good times when they tend to do well and can make payments on them. When a recession hits, they can flirt with bankruptcy and default on the bonds. Here is a chart of the yield spread as it has varied over the past 10 years:

Source: BofA Merrill Lynch, BofA Merrill Lynch US High Yield Option-Adjusted Spread© [BAMLH0A0HYM2], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLH0A0HYM2, June 13, 2017.

The section of the chart shaded in grey is the most recent recession, and we can immediately see that the spread signaled serious trouble as high yield bonds were sold in a panic. It reached a high of 21.4% in December of 2008, as investors were quite concerned about the survival of the issuers of these bonds. The rise in yield reflects what investors demand for the risk of owning them. Once the recession ended, bond prices rose again and the spread dropped to more normal levels. The average spread over the past ten years is 6.4%, and the current spread at 3.8% is at the low end of the range we have seen since before the recession.

Both of these indicators are currently telling us that the economy is doing OK. While we can't predict with any reliability what these charts will look like tomorrow, let alone in 6 months or a year, we can use these alongside our many other indicators to give us a sense of our current economic health.

Thomas E. Dexter, CFP®

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