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THE DUGDALE | HAYES INVESTMENT GROUP
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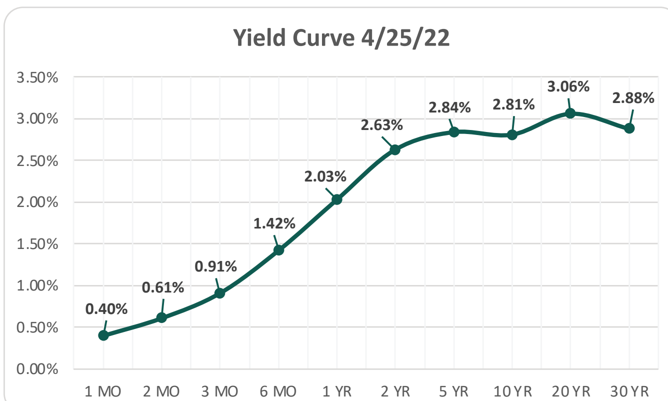
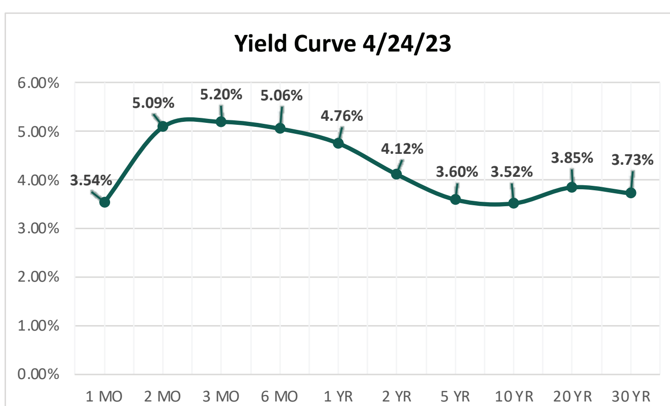
The Yield Curve and What It Might Be Telling Us

The Yield Curve is a simple way to visualize the yield or interest rates of bonds with equal credit quality but different maturities. United States Treasuries provide the best type of security to plot the yield curve since these government obligations have the same credit quality. A normal yield curve will illustrate a line that moves up and to the right, reflecting the fact that there is an opportunity cost to longer maturities so buyers of longer dated bonds would expect to be paid more. Below is a fairly normal yield curve showing rates from about a year ago.



Sometimes the yield curve can become "inverted," in which shorter maturities actually pay a higher interest rate than longer maturities. The yield curve can also "flatten," in which yields are basically the same across all maturities or along a series of maturities such as 2 years to 5 years. This type of flattening is more common than the entire curve being flat. Inverted yield curves are unusual, and it is where we are as of the end of April 2023. See below and compare it to the yield curve of a year ago above.



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Why would investors accept lower yields on longer maturities? Remember that the Federal Reserve really only controls the shortest maturities which is effectively an overnight rate. If a bank needs to borrow money to meet a reserve requirement, they can borrow from the Fed directly or from another bank. Borrowing from the Fed itself is referred to as borrowing from the discount window, and it is a slightly higher rate than what banks might charge each other. Banks almost always prefer to borrow from another bank because the rate is better, and if one bank is willing to lend to another, then it means they are perceived as being a good credit risk. So when we hear that the Fed has raised or lowered interest rates, they are targeting a certain rate by setting the rate at the discount window. All other rates on the curve are determined by the market itself.

Those rates are set by the rules of supply and demand. If there is high demand for a specific maturity, then the yield or interest rate will fall. This is because there are many willing buyers, so the issuer (in this case the government) does not need to offer a higher interest rate to attract money. Likewise, if there is lower demand for a certain maturity, then yields will rise because investors will have to be compensated more to purchase the bond. So the “normal” yield curve that slopes up and to the right makes perfect sense. The longer the maturity, the more uncertainty about what may happen in the interim so an investor demands to be paid more. There is high demand on the short end of the curve from investors who want some yield but don’t want to lock up money for too long so those yields stay lower.

So what’s happening when the yield curve inverts? Quite simply, demand is moving from shorter maturities to longer maturities, and that increase in demand is causing longer rates to be lower than shorter. They are accepting less for longer because they think longer term interest rates are actually going to fall so they are buying up what they can to lock in the current yield. This is typically what happens prior to a recession, and while not a fool-proof indicator, an inverted yield curve has been a fairly accurate predictor of slowing economic activity.

This has implications for both the bond (or CD) investor as well as stock investors. The bond investor faces reinvestment risk. While it is very tempting to place all your money in the 6 month CD paying around 5%, if rates do fall over that period, then you are reinvesting all of that money at a lower rate. For many of our clients, that is an acceptable risk because many use short term bonds, CDs or money market funds for “emergency” savings or short-term goals so having liquidity is more important than the reinvestment risk. For conservative investors who use those instruments primarily for the income they produce, then that risk is real and they are better off spreading that money over many maturities even if that blended yield is lower than a short-term maturity. If rates do start to go down, then at least you have locked up some money at the higher current rates. This strategy is often referred to as “laddering” bonds or CDs.

For stock investors, an inverted yield curve could be a signal to take a slightly more defensive stance. This would mean an increased emphasis on dividend paying stocks, lower P/E stocks and sectors such as Health Care and Consumer Staples.

Yield curve inversions aren’t common and typically don’t last long. Over the last several decades, most have lasted less than 10 months. Recessions tend to lag yield curve inversions by 6 to 18 months. In this latest cycle, the first yield curve inversion occurred in April 2022 but quickly reverted to normal. Then it inverted again in early July 2022 and has essentially been in that state since.

For all of these reasons, we think there are some short-term challenges for the stock market. A slightly more defensive stance, which we have already adopted in many of our models, may be warranted for the next several months. It is hard to see a clear catalyst for higher prices. We do see some potentially positive developments over the next 12 months, which could set the stage for new market highs. The supply of money is dropping rapidly after the massive Covid stimulus, and this should help bring down inflation. The Fed is likely done raising interest rates or very close to it. Several analysts we follow are suggesting the Fed could actually lower rates before the end of the year. We continue to think that we may be in a period where it is a great time to buy stocks but maybe not so fun to own them. But that in itself is not a reason to abandon a disciplined investment strategy. We believe this is part of the natural business cycle, and we may be stuck in a trading range until earnings begin to grow. Seek to own quality stocks, collect and reinvest dividends, and avoid companies with weak balance sheets. We are very optimistic that innovation and disruption will continue and that will bring economic expansion in the long term.

A Reminder About Titling of Accounts and Named Beneficiaries

In regular conversations with clients, we often hear that someone has created a Trust that we didn't know about. If a Trust has been created or updated, it is important to let us know so that we can re-title accounts in the name of the Trust. Only individual or joint tenant accounts need to be titled in the Trust. IRAs (or any qualified account), which can only be owned by one person, remain titled in an individual's name. But if a Trust or Will has been created or updated, this would be a good time to review named beneficiaries on qualified accounts. If a financial Power of Attorney has been created as part of the Estate Planning process, please make sure we have a copy of that as well.

Left to right: **Kate Absec,** FPQP®, Senior Registered Associate; **Brad Dugdale,** Senior Vice President, Financial Advisor, Portfolio Manager; **Stephanie Brunner,** Client Associate; **Darin Hayes,** CPFA, CWS®, Senior Vice President, Financial Advisor, Portfolio Manager.

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A note about Daryl:

After much discussion, Daryl has decided to work out of our Spokane office. Many of you are probably aware that he lives there and was commuting on a daily basis. Even with current technology and the acceptance of work from home and remote meetings, our business requires a lot of personal face-to-face interaction, not just with clients but within our team. The distance, long winters and two very active teenage boys made all of us realize that commuting wasn't ideal both for business and for family. For this reason, the majority of his time will now be spent in Spokane, and he will be primarily an independent advisor. The firm will retain office space in Coeur d'Alene for those times he does need to come over for meetings. Please reach out if you have any questions about this arrangement.

Team Tidbits

Brad

The days are getting longer and summer is on its way. Shariae and I spent time on Maui in February with close friends and later attended a D.A. Davidson convention on the island. Golf, whale watching and paddling a Hawaiian canoe made for a memorable vacation. In March, Darin and I attended an investment conference in Nashville with some of the nation's top economic leaders. Shariae and I stayed a couple of extra days and took a private swing dance lesson. Nashville is fun! My granddaughter, Bella, had her first birthday on April 19, Easter day. Bella is becoming quite a character, and Shariae and I are cherishing our time with her and her parents. Happy spring!

Darin

Our daughter, Teagan, turned 18 on April 26th. A little hard to believe. She had a great month. She was honored by the local Kiwanis club as their student of the month and was a scholarship recipient at the CDA Chamber Education breakfast. Not only that, she was one of seven students picked to receive a “Strength of Character” award at the breakfast because of the content of her essay. This meant an extra $1,000 in scholarship money and additional recognition. She’s also been quite successful on the tennis court this spring (if you can call it spring here in North Idaho) and is serving as captain in her senior year. Then it’s off to the University of Idaho next fall (Go Vandals!), and Mom and Dad will suddenly be empty nesters. We are thankful she will be close and hopeful she comes home from time to time or at least lets us visit for some fall football games. We do have a big trip planned for the summer. We will be gone for about two weeks at the end of June and will be visiting Germany, Italy and Croatia.

Kate

Happy spring! Those that know me know this is my favorite time of year. Terry and I have just returned from an extraordinary 2 week excursion throughout Italy which was a rescheduled Covid excursion. We were on an idiot-proof tour and it was everything we imagined and more. Our guide was spectacular! And it is true, the wine is better and less expensive than at home. We landed back in the U.S. from Italy and I went directly to Nashville. What better way to shake off some jet lag, right? I celebrated my baby brother’s 50th birthday, my upcoming 60th birthday and my eldest brother’s 70th birthday with other siblings/spouses. A grand time was had by all and officially kicked off the summer. We await the delivery of our dock, the seasonal lake neighbors are returning and the sleepy, long, dark days of winter are behind us. Welcome summer! We have been waiting for you. Until our next newsletter, enjoy everything spring has to offer in your neck of the woods.

Steph

We are finally seeing some signs of spring and couldn’t be more thrilled to wave winter goodbye! I’m almost done with rehabbing my knee for the 2nd time. They weren’t kidding when they told me it was likely to be a 6 month recovery! I’m starting to get back to a few of my favorite activities, and my leg feels stronger than ever right now! My little Dawson has some big changes ahead of summer. She has exited daycare and has started preschool. She is a sponge right now so we’re really eager to witness the growth we will see over the coming months. A big plus is that it will shave one hour a day off my commute! Kiddo has also started swim lessons with her dad to prepare for our dock days. We are starting off summer right out of the gate with a trip back down to San Diego for the first week of June. This time a few of my MT family is joining us (my mom, niece and nephew). My niece and nephew, who are 12 and 13, have never flown or experienced the SoCal sunshine and beaches, so this is a big treat for them. I’m really looking forward to sharing our time together and being part of memories they will carry all their lives. Anywho, get out there and enjoy some fresh air + sunshine! Stay classy.

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