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30Y-10Y Yield Curve Predicted Soft ISM, Now Shows Growth

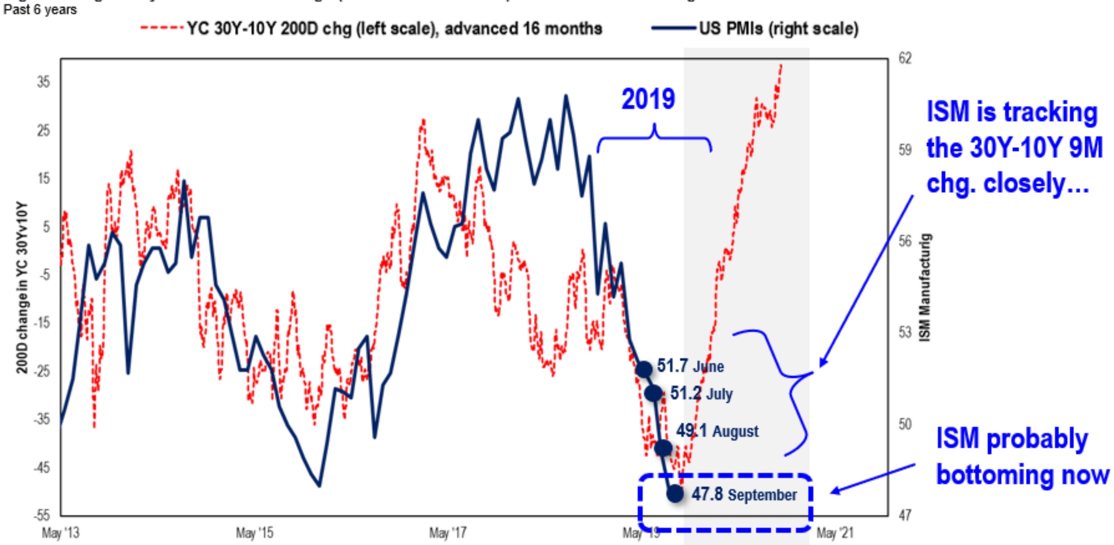
Given the tough week we just endured, and the thick cloud of doom that hangs stagnant over financial markets, I must reiterate a critical data point that is being obscured by this gloom.

The bears are ranting and raving about a recession or a bear market, but investors need to concentrate on something that I've been going on about now for some time. It is worth repeating because in 2020—with hindsight—it will be the kind of thing that you say, "Oh, of course there wasn't going to be a recession. Just look at what the long term yield curve spread was telling us in the fall of 2019."

I have been advising of the probability of a sub-48 print in ISM by September for many months now. That's exactly what happened last week, and it sent markets reeling. The Institute for Supply Management reported its manufacturing index fell to 47.8 in September, the lowest level since June 2009, from 49.1 the prior month. Readings below 50 indicate contraction, while those above signify expansion. The August result marked the first drop in three years.

That's what I said would come to pass. For all the same reasons, which I will illustrate below, it will pay investors to heed the rest of the signal from the long term yield curve spread. I have used the nine months change in the US Treasury 30-year-10-year yield curve because it has a remarkable track record of leading ISM by about 16 months. See the chart below. Thus, while equities sold off sharply on the weak ISM print, the bond market had seen this for the past 1.5 years.

Figure: Long-term yield curve 10M change (advanced 16-months) and ISM Manufacturing
Past 6 years



Source: FS Insight, Bloomberg

Moreover, now it's time for investors to see the second half of what this important signal is saying.

- Why does the long-term yield curve lead the ISM? It is very macro sensitive, much more so than the 10-year-2 year, which gets most of the media's attention because it inverted temporarily and intermittently. The 30Y-10Y, meanwhile, has been flattening throughout 2017 and into mid-2018, reflecting the cumulative headwinds of weak oil (which tanked in 2018), trade tensions, a strong dollar and US government shutdown, along with, of course, the real killer—Fed tightening. As this worked its way through the system, and we saw a progressive breakdown of ISM, which is business confidence.

- *Now* the signal is that the ISM bottom is likely in. The good news is that the 30Y-10Y curve has been sharpening steeply since mid-2018 and has continued to steepen and this suggests that the ISM should be bottoming in September.

- The continued weakness we have seen to date was predicted 16 months ago. More importantly, now if that pattern holds—and I believe it will—the 30Y-10Y yield curve suggests the ISM should be bottoming with an upturn expected as we move into year-end and into 2020.

- Such timing makes sense, if you think about it instead of only watching the headlines. The Fed has been easing and that stimulus takes time to work its way into the system. The U.S. housing market is already responding and the greenback is not soaring any longer. US/China trade tensions, while bad, has not really worsened. Thus, it makes sense that ISM, which is a diffusion index, should start to drift higher.

- I've put together a chart nearby showing industry groups that are positively correlated to ISM. Unsurprisingly, they are all cyclical. These should rise on an upturn in ISM. They are office REITs, trucking, steel, IT consulting & other services, paper packaging, railroads, retail REITs, air freight & logistics, motorcycle manufacturers, construction machinery & heavy trucks, broadcasting, consumer finance, electrical components & equipment, independent power producers and energy, and communications equipment.

Figure: 15 GICS 4 industries with highest correlation with ISM PMI
Correlations are calculated by using monthly change over the past 30 months

		Trailing Correlation:		
	Industry name	30 Months	60 Months	All Period
1	Office REITs	0.54	0.41	0.21
2	Trucking	0.48	0.41	0.12
3	Steel	0.36	0.40	0.14
4	IT Consulting & Other Services	0.50	0.39	0.10
5	Paper Packaging	0.44	0.37	0.17
6	Railroads	0.35	0.36	0.11
7	Retail REITs	0.44	0.36	0.23
8	Air Freight & Logistics	0.37	0.36	0.13
9	Motorcycle Manufacturers	0.35	0.34	0.20
10	Construction Machinery & Heavy Trucks	0.26	0.34	0.16
11	Broadcasting	0.36	0.34	0.16
12	Electrical Components & Equipment	0.30	0.34	0.13
13	Communications Equipment	0.44	0.34	0.11
14	Independent Power Producers & Energy	0.19	0.32	0.33
15	Consumer Finance	0.44	0.32	0.19

Source: FS Insight, Bloomberg

I've also put together 22 individual stock names from these industries with greatest correlation to ISM PMI and which are also in our proprietary quantamental model.

The tickers are ANET, CSCO, IBM, DISCK, HOG, IP, NUE, CAT, CMI, EMR, ROK, KSU, NSC, AXP, COF, SYF, ARE, BXP, VNO, MAC, REG and SPG.

Separately, our senior technical strategist Robert Sluymer also notes that bond yields are turning up. This is consistent with reflation.

What could go wrong? Investor confidence is fragile, which affects business confidence.

Bottom line: We still see a 2H19 rally. Equity markets are understandably glum. But the bond market has suggested the worst may be behind us**.**

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Figure: Comparative matrix of risk/reward drivers in 2019
Per FS Insight

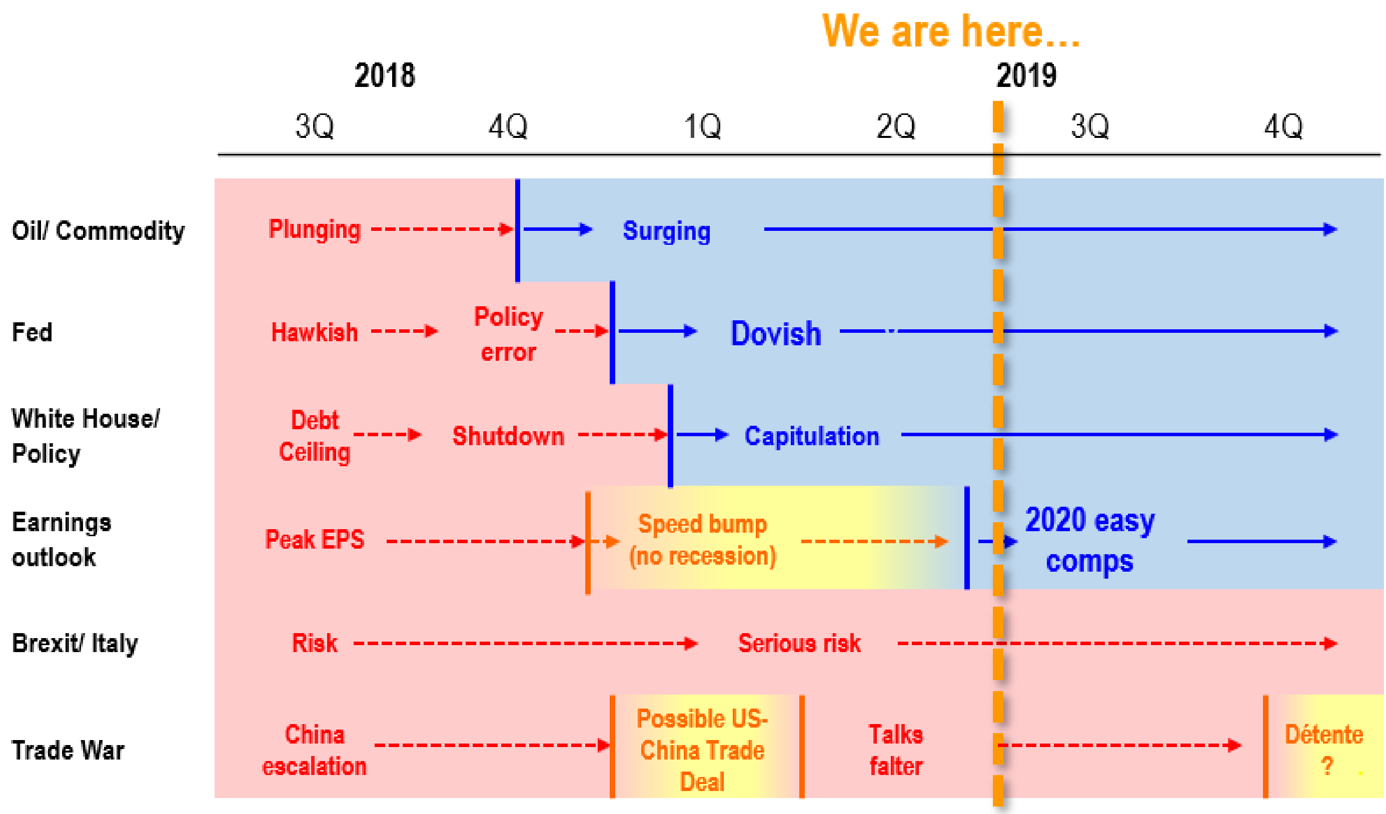

Figure: FS Insight Portfolio Strategy Summary - Relative to S&P 500
** Performance is calculated since strategy introduction, 1/10/2019

Themes	Execution of Strategy	Date added	Last 4 Months: Jul	Aug	Sep	Oct	1Q19* (since 1/10)	2Q19	3Q19	4Q19	2019** Portfolio Rel. Return
S&P 500	S&P 500 Price Index		1.3%	(1.8%)	1.7%	(2.2%)	9.2%	3.8%	1.2%	(2.2%)	12.1%
			Performance relative to S&P 500…								
Tactical — 6-12M											
1 Value / Growth Tilt	Market re-discovered valuation risk. • Quality - Defensive • Growth - Quality	1/10/19	0.5%	(0.0%)	(0.0%)	(0.1%)	1.3%	(2.5%)	0.4%	(0.1%)	(1.0%)
2 Seasons the *NEW* Seasonality	Overweight groups with good seasonals. CURRENT: Online & Electronics Retail, Healthcare Tech, Tech Hardware, Home Ent, Tobacco, Semis, Biotech	1/10/19	(2.2%)	2.2%	(2.0%)	(0.1%)	0.5%	(3.2%)	(2.0%)	(0.1%)	(5.1%)
3 FANG in odd years	FANG works in "odd" years. • FANG-plus.	1/10/19	0.8%	(2.2%)	(0.9%)	2.0%	1.0%	(4.0%)	(2.3%)	2.0%	(3.8%)
Thematic — 3-5 years											
4 Millennials prime years	Millennials driving >50% GDP growth. • Millennial transformation. • Millennial accelerates growth.	1/10/19	0.9%	(3.1%)	2.0%	0.1%	1.9%	(0.5%)	(0.4%)	0.1%	1.0%
5 Labor shortage— AI/ automation	World is short 78 million workers. • Automation/ AI suppliers. • Beneficiaries of Automation/ AI	1/10/19	(0.5%)	(0.5%)	1.9%	(0.6%)	1.6%	(1.8%)	0.9%	(0.6%)	0.0%
6 Higher inflation— Assets vs OpEx	Inflation trending higher long term. • Assets over OpEx.	1/10/19	0.7%	(1.3%)	(0.0%)	(0.9%)	2.8%	(0.7%)	(0.7%)	(0.9%)	0.2%

Source: FS Insight, Bloomberg