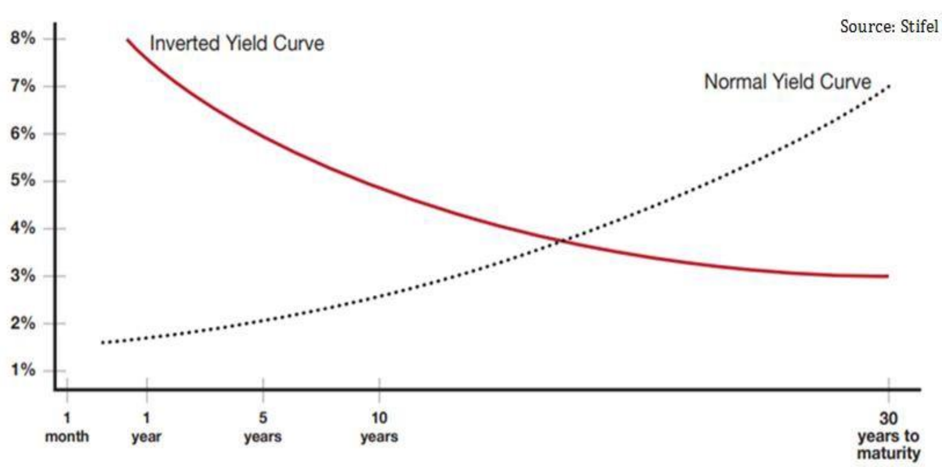
Argent Capital Management LLC

Market Overview – August 2019

When I can watch Jeopardy, invariably I feel ignorant when the categories are ancient history or opera or too many other subjects to name. On the other hand, on the rare occasions when the Jeopardy categories relate to business or the stock market, I feel right at home. Imagine my surprise then as I sat down to watch network news during August and saw the talking heads describing *'The Inverted Yield Curve.'* This happened on more than one occasion, so I knew the topic was top of mind.

For those of you who live in the St. Louis area, every six months, we at Argent hold a client luncheon. At our most recent client luncheon I tried to explain the inverted yield curve and why it was a concern both for the economy and for the stock market (link to the video of our explanation: https://www.youtube.com/watch?v=EvFjL2izKgY).

So what is the inverted yield curve? Let's take a step back and describe the yield curve. Put simply, the yield curve is a graph of the different rates of interest on U.S. Treasury bonds for different maturities. As you would expect, to compensate a bond investor for holding a bond for a longer period, or maturity, longer-term bonds generally have a higher rate of interest. If I am to lock up my money for ten years I want a higher interest rate than if I lock up my money for two years. That creates an upward sloping yield curve; shorter maturities with lower interest rates, longer maturities with higher interest rates. That positive slope is normal and makes sense to investors. An inverted yield curve, as the name implies, is just the opposite. With an inverted yield curve, interest rates on shorter-maturity bonds are *higher* than the interest rate for longer maturities. The graph below shows the difference between the two yield curves.



So why does an inverted yield curve become so important that it takes up precious airtime on prime-time news? The answer is that an inverted yield curve has been a very good predictor of recessions, and recessions are generally bad for stock markets. Part of the reason why an inverted yield curve can cause a recession is because of the change in the behavior of banks. Banks make loans and those loans help drive economic growth. In order to make loans, banks have to borrow money. The borrowed money banks use to make loans is our deposits; savings accounts, checking accounts, money markets, etc. The profit a bank makes is the difference between what the bank can charge for its loans minus what the bank must pay for its deposits. As the normal yield curve indicates, banks generally pay less for deposits, which are short-term in nature, than they charge for loans, which are longer-term in nature. This positive *spread* or profit creates an incentive for banks to make loans. When the yield curve inverts, however, that incentive disappears. During a period of inversion, banks pay more for deposits than they make on loans. In other words, banks lose money every time they make loans, so banks, being for-profit institutions, stop making loans. Without loans, growth slows, and when growth becomes negative, the economy falls into a recession.

That's why the network newscasts ran stories on the inverted yield curve. Whether the U.S. is going into a recession or not remains to be seen. Certainly, investors will closely watch the yield curve and actions by the Federal Reserve to lower short-term interest rates. In the meantime, where we at Argent have been finding the bulk of new ideas that meet our Change-Based[SM] investment process are in cyclical stocks. Cyclical stocks are those companies whose fortunes are most closely tied to the economy, for instance, homebuilders, retailers or banks, to name a few. Many of these companies have depressed valuations because the market is convinced the inverted yield curve will drive our economy into a recession. That outcome-whether the economy will fall into a recession or not-is unknown. What *is* known is that these companies are trading at considerable discounts with the potential to grow.

We have four successful equity strategies – Large Cap, Small Cap, Dividend Select and Mid Cap. If you have questions on any of these options, please call us.

Sincerely,

Ken Crawford
Senior Portfolio Manager