CANACCORD Genuity
Wealth Management

22nd July 2018

Weekly Note

To us there are no foreign markets.™

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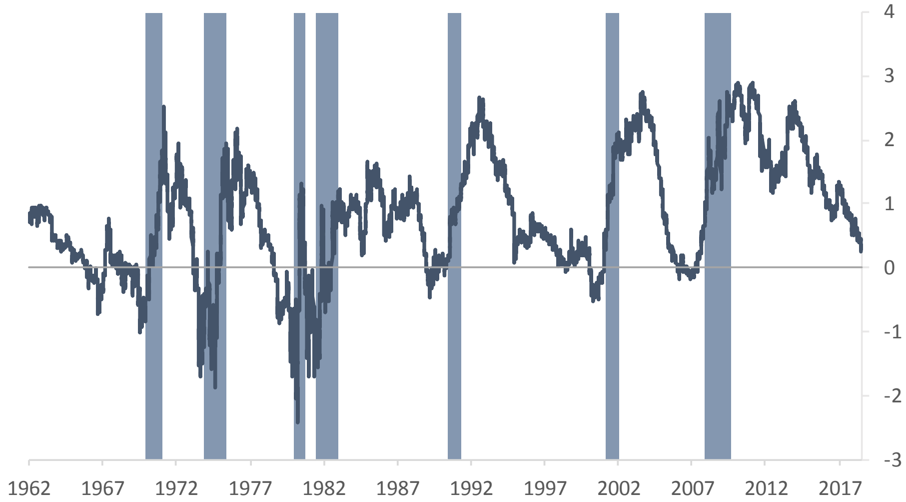
Blind Curve

We could not help noticing a survey from the Daily Mail of the top 40 misheard song lyrics of all time – we just had to share. "We built this city on sausage rolls," scored highly from Starship, as did, "Sweet dreams are made of cheese," from the Eurhythmics, and "It doesn't make a difference if we're naked or not," from the Bon Jovi classic. Our absolute favourite, which didn't score particularly highly, was this priceless Monkeys' mangle, "Then I saw her face, now I'm gonna leave her." Easy mistakes to make? When Blind Curve was released on the "Misplaced Childhood" album it came in a double vinyl format with the lyrics to each song typed on the inside sleeves. Unfortunately, macro strategy inferences on observed economic phenomena don't come with such an easy translation. With the US 2-10's yield curve potentially just one rate hike away from inversion, we take another look at our recession models and reach for the economic Rosetta Stone.

First of all, the yield curve as measured by the difference between the 10 year and the two year yield of US government bonds, has been this close to inversion before (that difference being negative), without being followed by a recession. This last happened in the mid 1990's (Figure 1) and before that, in the late 1960's. In the latter case, the curve inverted briefly, although a recession eventually followed a subsequent inversion a few years later. So, while the yield curve might be one of the best single economic predictors of recession, we are not yet at the point where recession is imminent, but we are getting very close.

Figure 1: US Recessions and the Yield Curve (10 year - 2year)

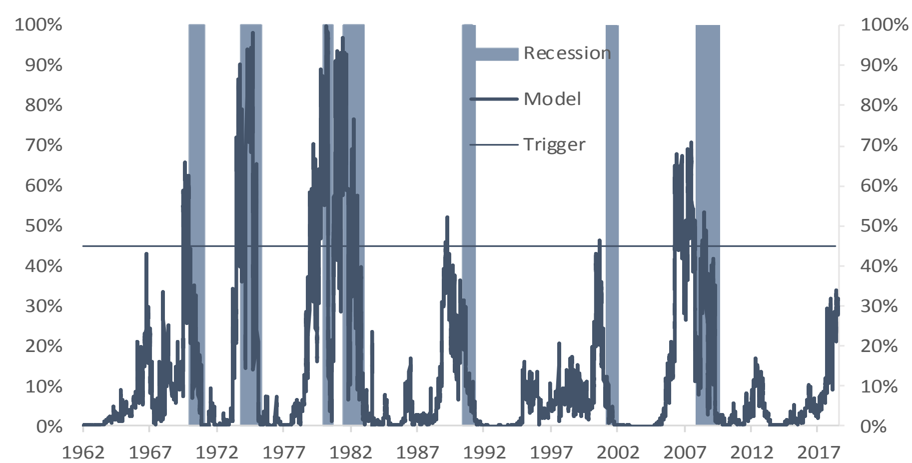


Source: Canaccord Genuity Wealth Management

Using our first model (Figure 2) which predicts the probability of a recession in the next year based on a Probit regression, we see that the odds have certainly risen over the past few weeks. The minimum threshold required is 45% but the highest reading this cycle has been 33% although that has now paired back to 29%. Our machine learning model (Figure 3) which also predicts recession within the next year, is flagging that possibility at 100%. It has been warning this since the yield curve took its latest step down towards inversion a few days ago. These models are not infallible, the yield curve inversion in 1966 generated a false positive, and the last recession was predicted two years before.

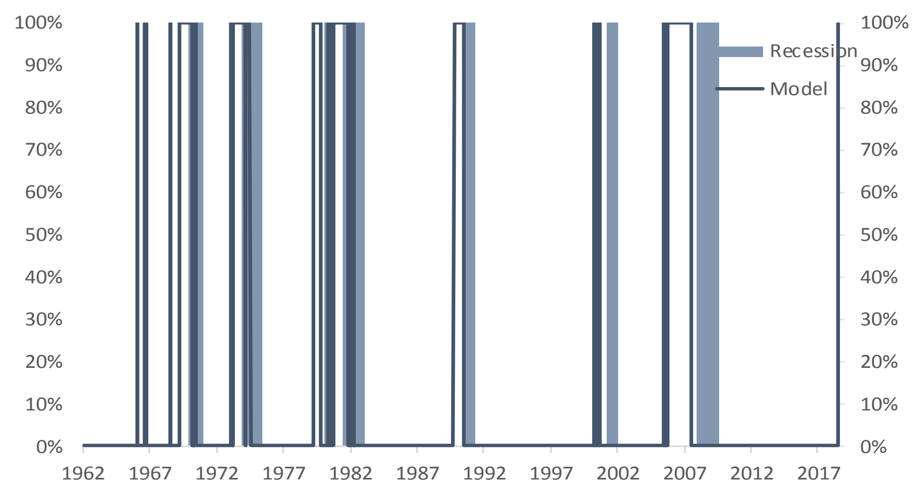
We cannot be absolutely sure if our models “would” or “wouldn’t” predict a recession on the twelve-month horizon, but the odds of a slowdown have certainly risen in recent weeks. With so few recessions in recent history it is impossible to be precise. Our best judgement is that equity returns will remain positive for the remainder of this year, but volatility will also rise. As Dire Straits could have sang, there is no “money for nothin’ and chips for free.” Portfolio returns will need to be earned this year; we recommend investors stay well diversified, and risk aware.

Figure 2: Probit model of US Recessions



Source: Canaccord Genuity Wealth Management

Figure 3: Machine Learning model of US Recessions



Source: Canaccord Genuity Wealth Management

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