Roosters typically crow in advance of the sunrise, but that knowledge does not provide much insight on the movement of the heavens. Similarly, the U.S. Treasury yield curve may typically invert in advance of recessions, but that knowledge does not provide much insight into when a recession will likely start, how deeply the economy may entrench or how negative the equity market response will be to economic deterioration. The first quarter of 2019 witnessed the yield on the 10-Year U.S. Treasury Note (10-Year) dip below the yield on the 3-month U.S. Treasury Bill for the first time since 2007, therefore, some investors looking for higher definition forecasts from market seers have likely been left wanting.

Should investors alter their long-term plans given current economic and capital market conditions? While a true long-term investment plan should have the ability to remain intact through a recession and/or bear market, investors may be understandably nervous about a test of their long-term mettle seeming to grow more imminent by the day.

The combination of current conditions creates unique challenges for long-term investors intent on maintaining their strategic risk profile. The strong rally in the beginning of the year has returned equity market valuations to the upper end of their historical range. This may be an indicator of increased downside risk – a risk that could be realized in the near to intermediate future, given where we are in the economic cycle. But what if the robust trends of an expanding economy with record-low unemployment, benign inflation and corporate earnings growth continue? How much return would investors leave on the table by reducing exposure to the equity market?

Despite positive returns from the Bloomberg Barclays U.S. Aggregate Bond Index (the Aggregate) over the last two quarters, there is evidence that the bond market has become a less attractive safe haven. When yields were higher, it was possible for investors to garner a decent return while waiting for disaster to strike in the equity market. But, as the chart below shows, as the bellwether 10-Year yield has trended downward, so has the return potential of the bond market.

10-Year U.S. Treasury Note Yield vs.
Bloomberg Barclays U.S. Aggregate Bond Index Returns
January 1, 1990 – March 31, 2019

For more information and access to additional insights from Gateway Investment Advisers, LLC, please visit www.gia.com/insights.

Bloomberg Barclays U.S. Aggregate Bond Index Returns (2012 – 2019)					
	Q1	Q2	Q3	Q4	Year
2012	0.30%	2.06%	1.59%	0.21%	4.22%
2013	-0.12%	-2.33%	0.57%	-0.14%	-2.02%
2014	1.84%	2.04%	0.17%	1.79%	5.97%
2015	1.61%	-1.68%	1.23%	-0.57%	0.55%
2016	3.03%	2.21%	0.46%	-2.98%	2.65%
2017	0.82%	1.45%	0.85%	0.39%	3.54%
2018	-1.46%	-0.16%	0.02%	1.64%	0.01%
2019	2.94%				Source: Bloomberg

Moreover, the strong first-quarter return for the Aggregate is consistent with a pattern in recent years (beginning in 2012) when brief periods of falling interest rates have helped generate quarterly returns for the Aggregate that were well above yields on the 10-Year, while calendar year and multi-year annualized returns for the Aggregate have rarely exceeded 3.5%. If longer-term yields remain range-bound, investors could expect this pattern to continue.

The combination of elevated equity valuations, which may be an indicator of increased downside risk, and a flattened yield curve in the bond market, which may limit a continuation of bond market gains fueled by the downtrend in longer-term yields, creates new challenges for long-term investors. In this environment, investors may benefit from increasing allocations to low volatility equity strategies that can provide consistent participation in equity market advances and a reliable source of protection during equity market declines. Delivering this profile has been the sole focus of Gateway's risk-first approach to long-term investing for over 40 years.

For more information and access to additional insights from Gateway Investment Advisers, LLC, please visit www.gia.com/insights.