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By **Jason Thomas**
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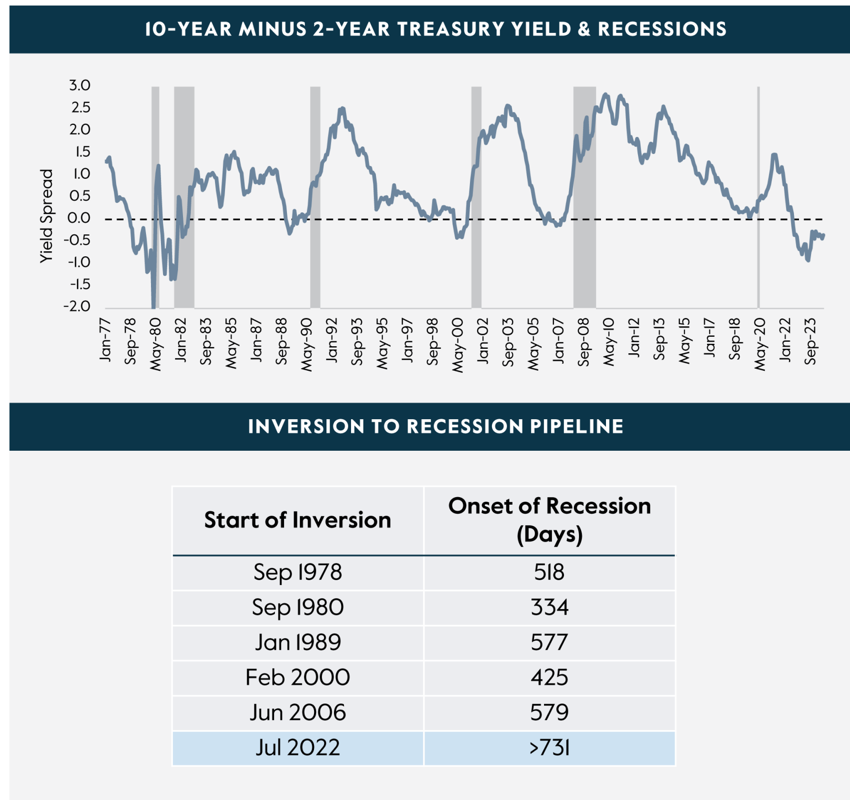
*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. Next week's edition will feature guest author Peter Cornelius, Chief Economist at AlpInvest.*

Last week marks two years since the most reliable of recession indicators – the Treasury yield curve –flashed red. The U.S. Treasury introduced the benchmark two-year note in the mid-1970s. Since then, each time its yield has exceeded that of the 10-year note, recession has followed, typically within 15 months. While "inversion" predicts a *future* downturn, the recession itself tends to be contemporaneous with curve steepening, or normalization (Figure 1).

Figure 1: The Declining Relevance of the Yield Curve as an Indicator?



Start of Inversion	Onset of Recession (Days)
Sep 1978	518
Sep 1980	334
Jan 1989	577
Feb 2000	425
Jun 2006	579
Jul 2022	>731

Source: Carlyle Analysis; Federal Reserve, July 2024. There is no guarantee any trends will continue.

Inversion is the market's way of expressing the view that the current monetary policy is too tight, as it implies cash yields will prove higher than the economy can withstand over time. Likewise, the relative yield on the two-year plunges when market participants believe the Fed will soon take short-term rates below their longer run or "natural" level. Since that tends to occur amidst signs of real economic weakening, the curve often normalizes as recession hits.

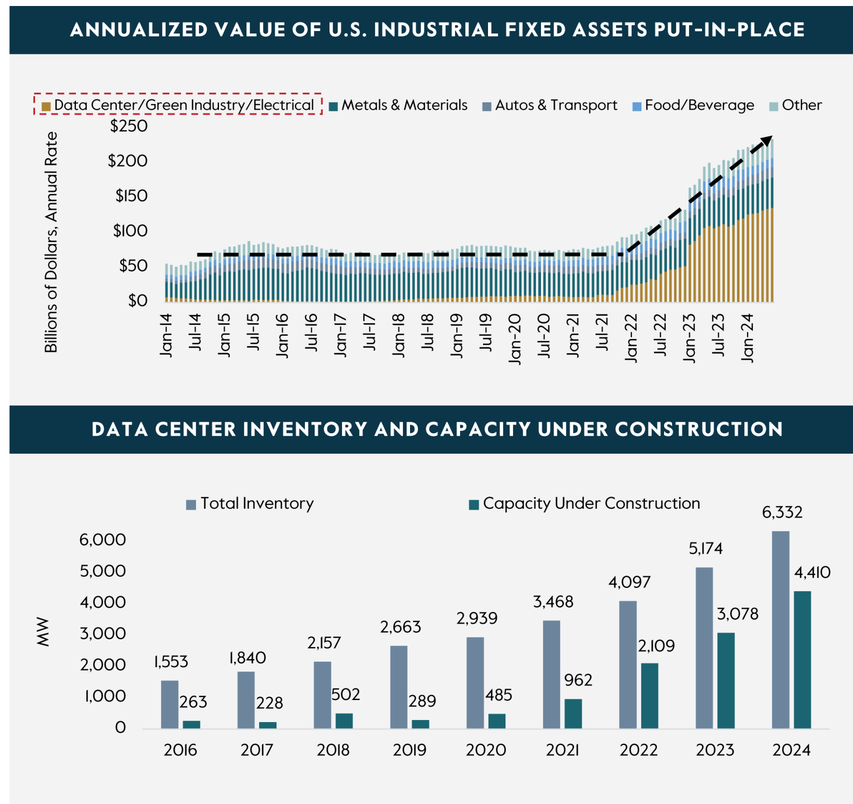
This has been an unusual economic cycle, to put it mildly. In the unlikely event that the start of the next downturn were retrospectively dated to last week, it would still mark the longest ever lag between the curve's inversion and eventual recession. But before disregarding the yield curve altogether, consider that the 45-basis point drop in the two-year yield since April seems commensurate with the softening of economic activity observed over the same period.

Markets entered the year operating under the delusion that rate cuts would be a happy event, enacted to celebrate the economy's resilience in the face of inflation's vanquishment. They may now enter a period of greater circumspection, appropriately wary of what may motivate the rate cuts they've been eyeing.

Second Thoughts About the AI Capex Boom

Nothing eases recession anxiety quite like a look at U.S. capital spending plans. Fixed investment in industrial facilities currently sits at 2.7x pre-pandemic levels, and when including public investment in infrastructure and defense stocks, the backlog of intended capex is roughly 5x larger than the amount put-in-place (Figure 2).

Figure 2: Capex Boom



Source: Carlyle Analysis; Census Bureau, Federal Reserve, Energize Capital, July 2024. There is no guarantee any trends will continue.

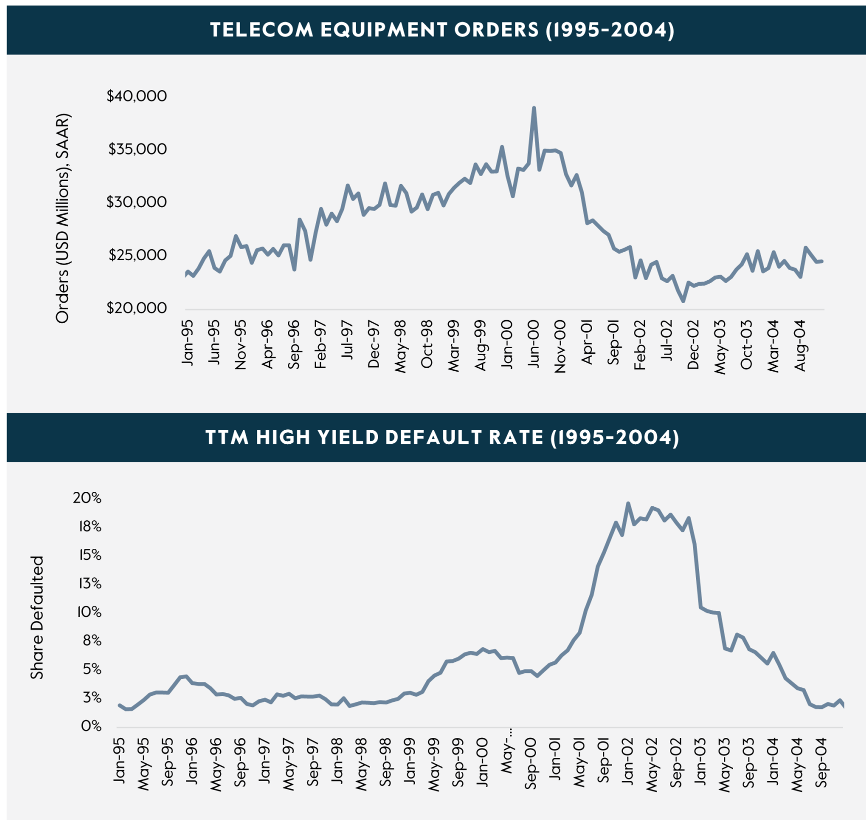
Yet, data centers account for a large share of the increase, and many observers are growing concerned about prospective return on these outlays. Where are the AI-related revenue streams necessary to justify all the spending on depreciating assets? Do the numbers really add up here?

These are old questions applied in a novel context. In his *General Theory*, Keynes contraposes "animal spirits" with cool-headed rationality to explain how capital spending can prove "inadequate" if "spontaneous optimism" does not supplement "reasonable calculation."

Here, Keynes references the activities of entrepreneurs and management teams—not investors. Though "investment" is often used interchangeably to describe the capital budgeting of firms and allocation decisions of investors, the two are very different processes. If not for entrepreneurs and management teams' willingness to act on big dreams that often defy rigorous quantification, Keynes argued, "enterprise will fade and die." But it is the job of investors to set the financial terms at which these capex ambitions are realized. In this role, "buying the hype" can prove costly.

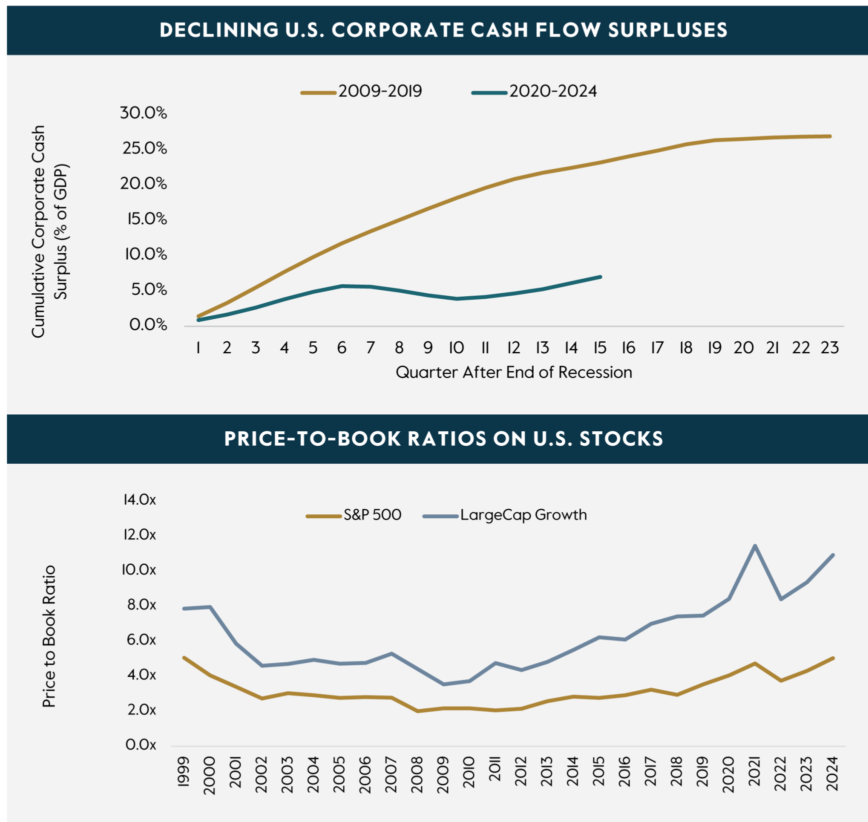
We've analogized the recent capex boom to that of internet and mobile telephony in the late-1990s. In its wake, the annual default rate on high yield bonds nearly reached 20%, with claims used to finance the telecom build-out accounting for half of all defaulted obligations (Figure 3). Today, internally generated cash flow finances most of the spending. But a look at price-to-book ratios—the market value of those assets relative to their acquisition cost—suggests that today's terms may prove even less favorable to investors (Figure 4).

Figure 3: Telecom Capex Boom & its Aftermath



Source: Carlyle Analysis;, Federal Reserve, Bloomberg, BAML, July 2024. There is no guarantee any trends will continue.

Figure 4: Equity-Financed Capex



Source: Carlyle Analysis; Federal Reserve, CRSP Database, July 2024. There is no guarantee any trends will continue.

If corporate managers believe in the transformative potential of foundational AI models (and the monopoly rents that may flow from them), they're behaving as they should. The same may not be true of the investors indulging them.

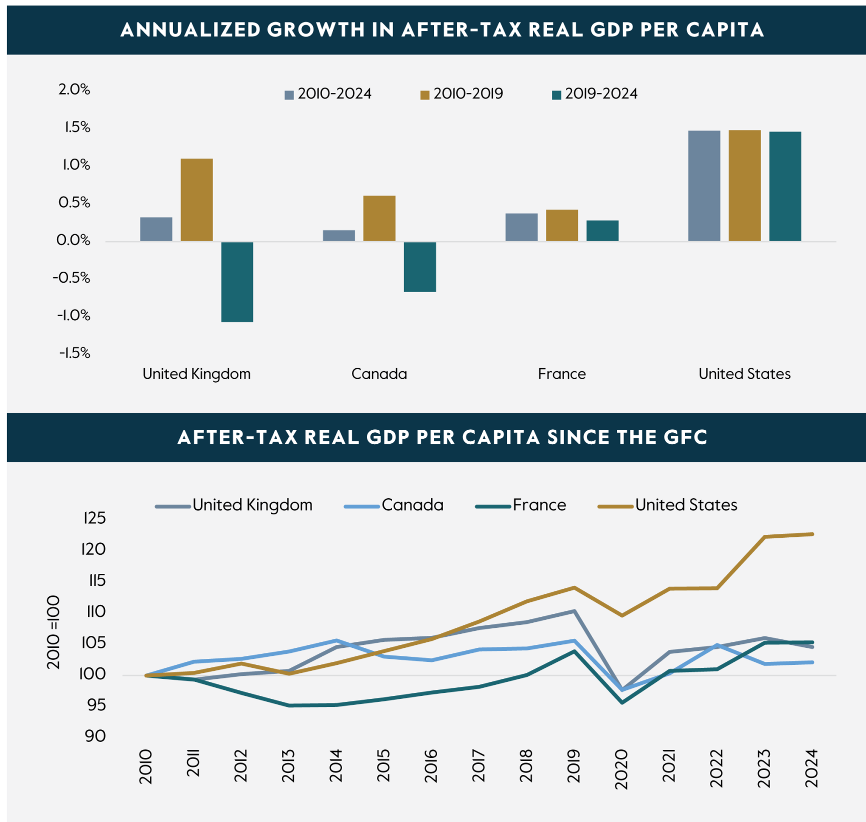
Labour [sic] Takes the Helm

Opinion polls suggest that nearly two-thirds of U.K. voters now regret their country's departure from the European Union. In retrospect, one can say that a plurality of voters wanted to remain in the EU at the time of the 2016 referendum; unfortunately for them, a majority preferred a multiplicity of different versions of Brexit.

Some imagined a dynamic "Singapore on the Thames," with low taxes, light regulations, and free trade. Others believed Brexit would result in a more self-sufficient Britain, insulated from the free movement of labor stipulated by the EU's single market. Still others hoped eliminating EU budget contributions would translate to increased domestic social spending. These visions proved difficult to reconcile, if not mutually exclusive.

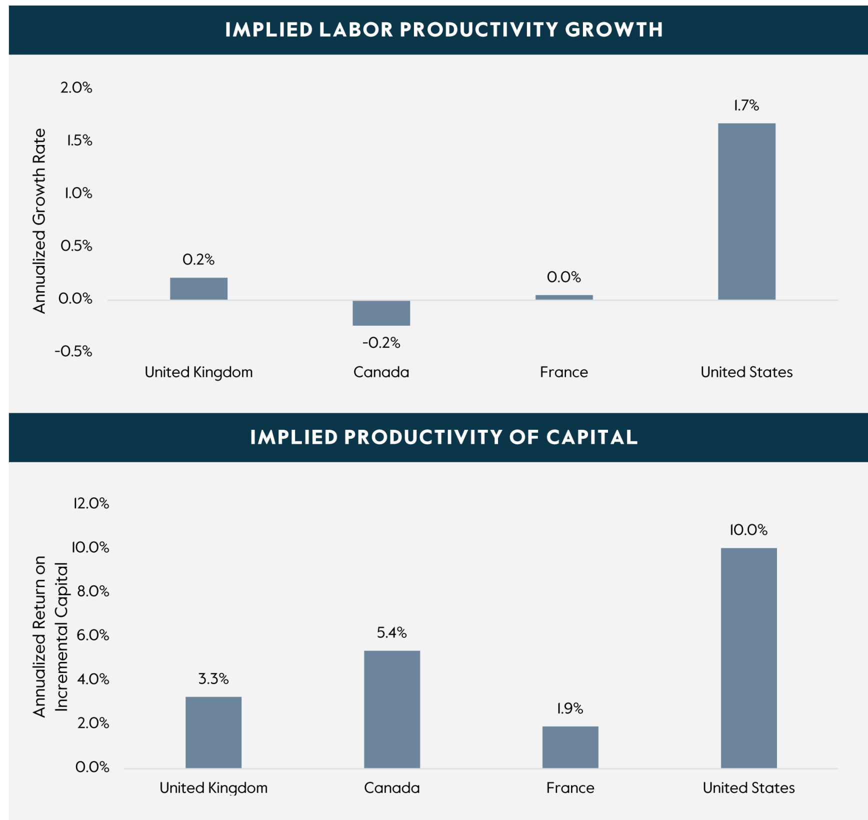
Rather than try to square this circle, Sir Keir Starmer's first task is simply to rebuild faith in government. While Brexit deserves some blame for the deterioration in British living standards, similar trends have been observed in economies that experienced a similar electoral upheaval, like France, or appear due for one, like Canada (Figures 5 and 6).

Figure 5: Evolution of Living Standards Over the Past 15 Years



Source: Carlyle Analysis; IMF WEO Database, July 2024. There is no guarantee any trends will continue.

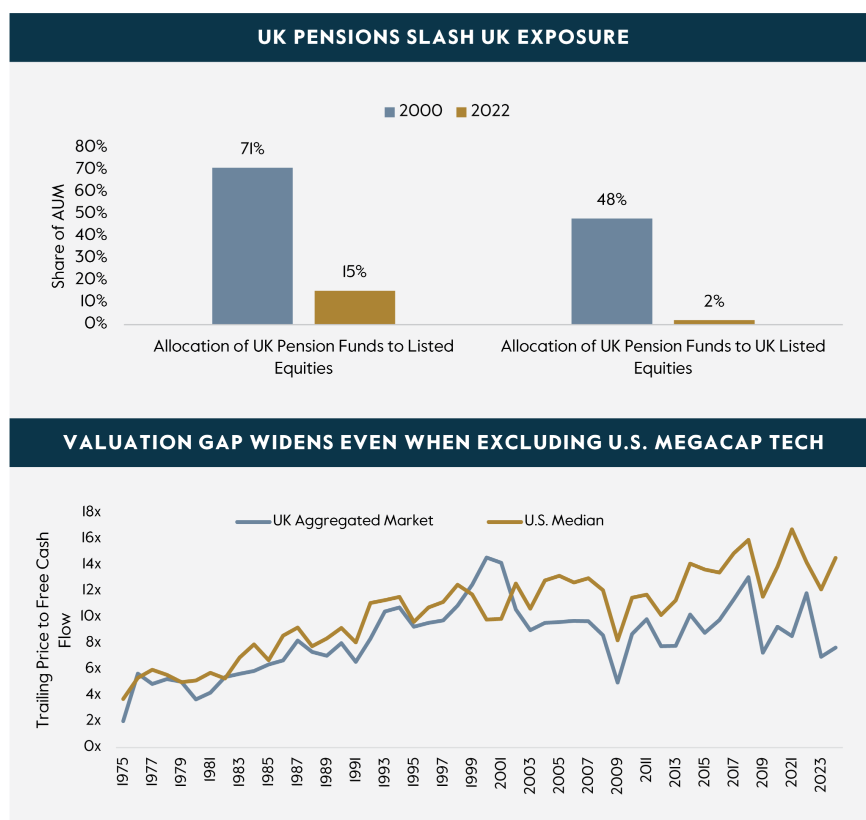
Figure 6: Productivity Differentials



Source: Carlyle Analysis; IMF WEO Database, July 2024. There is no guarantee any trends will continue.

Even modest success could prove a boon to UK asset prices, which have suffered from the same crisis of confidence reflected in the election result (Figure 7).

Figure 7: Asset Allocators Share Concerns with Electorate



Source: Carlyle Analysis; Schroders, New Financial, March 2023; CRSP Database, July 2024. There is no guarantee any trends will continue.

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