

# MAKING SENSE OF THIS WORLD

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R&R Weekly Column By Brunello Rosa



## **Yield Curve Inversion Does Not Imply U.S. Recession**

Last week, the combination of the minutes of the Fed's June FOMC meeting, the employment report on Friday 6<sup>th</sup> and continued trade tension (with the implementation of tariffs and counter-tariffs between US and China) had the usual flattening impact on the U.S. yield curve, with the 2/10y yield spread now just above 30bps, the lowest level for the last ten years. Mechanically, the twist of the yield curve is easy to understand.

At the short end, a buoyant economy, boosted by a late-cycle fiscal stimulus, with a very tight labour market and rising salaries leading to above-target inflation (with the June figures to be released during this week) imply a central bank continuing its monetary policy normalisation for at least another 18-24 months, and this is reflected in a 2-year yield at its highest level since 2008. Upward pressure on short-term rates derive also from increased issuance of T-bills, to finance the larger budget deficit.

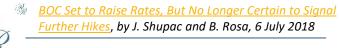
At the longer end, international factors seem to be playing a larger role than domestic ones. As long as the ECB and the BoJ continue to conduct very accommodative monetary policies (they are both still increasing the absolute level of their balance sheets, albeit at a reduced pace) long-dated German bund yields will remain low in historical terms, and JGB yields near zero, given the BoJ's Yield Curve Control policy. In fact, quantitative easing depresses the term premium embedded in long-term yields, which even in the U.S. (where the Fed is reducing its balance sheet and increasing rates), remain very low, if not negative. In such a context, international arbitrage continues to suggest investor to buy US Treasuries any time their yield (at 10y maturity, for example) approaches 3%, in spite of the appreciating dollar (and/or after having taken into account cross-currency hedging). Additionally, increasing trade tensions continue to suggest potentially lower growth potential in the medium term, adding downward pressure to the <u>already low and diminishing real</u> "global" long-term rate, with risk aversion pushing further the safe-haven bid for Treasuries.

So, given the combination of macro-financial and geopolitical phenomena, it is absolutely natural that the U.S. yield curve flattens. The question is: does a flatter - or even inverted - yield curve, necessarily indicate an incoming recession (say, over a 12-month horizon) as the traditional literature suggests? In a speech of a few months ago, former New York Fed President Bill Dudley discussed the several reasons why this wasn't the case. However, his successor John Williams, has more recently suggested that inverted yield curves are still a very powerful signal of incoming recessions. This seems to confirm a recent study by the Federal Reserve of San Francisco, concluding that "while the current environment is somewhat special—with low interest rates and risk premiums—the power of the term spread [i.e. the difference between long-term and short-term interest rates] to predict economic slowdowns appears intact." On the back of this assumptions, the New York Fed continues to publish on a regular basis an estimate of the recession probability based on the slope of the yield curve. Based on the latest data, the probability of a recession in June 2019 would now be around 12.5%.

In our opinion, international factors play such a huge role on the shape of the U.S. yield curve that any estimate of a recession probability in the U.S. based solely on the U.S. term spread is likely to be largely overstated. On the other hand, it is quite likely that the cumulative effects of the Fed's monetary policy normalisation (moving at some point into the neutral/restrictive territory) will eventually be felt by the economy, which will inevitably face a new contraction in coming years.

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### The Week Ahead

In the US and China, inflation is likely to increase. In the US, both headline (c: 2.9% y-o-y; p: 2.8%) and core inflation (c: 2.3% y-o-y; p: 2.2%) are due to rise. In the EZ, German inflation is expected flat (c: 2.1% y-o-y; p: 2.1%). In China, inflation will likely increase mildly (c: 1.9% y-o-y; p: 1.8%).

In Canada, we expect the BOC to increase its policy rate by 25bps to 1.50%.

### **The Quarter Ahead**

In the US, the Fed will continue to hike rates and reduce USD global liquidity... In the US: a) the Fed will accelerate the pace of BS reduction to 40bn per month in Q3 and 50bn per month in Q4); b) the government will increase bond issuance; while c) the Fed will keep hiking rates (likely in September and December), to close the year with a Fed funds rate range of 2.25-2.50%.

... putting pressure on EM currencies to weaken further. Over the past week EM currencies stabilized (MSCI EM currency index: -0.1% w-o-w), but EMs remain vulnerable to outflows in Q3 due to: a) declining USD liquidity; b) rising US interest rates; and c) a stronger USD. A number of EM central banks will likely be forced to increase interest rates to pre-empt currency depreciation.

*In Europe, low growth and political uncertainty will increase volatility.* In Germany, the governing coalition is becoming increasingly fragile due to opposite views on immigration policies. EZ retail sales decelerated in May (a: 1.4% y-o-y; c: 1.6%; p: 1.6%), in spite of falling unemployment and rising wages.

In the near term, trade tensions will remain high, but are unlikely to lead to a trade-war. As the US November mid-term elections approach, further tariffs are likely to be imposed. Thereafter, the US government might decide to soften its position.

In a context of rising risks, allocations are turning cautiously defensive. According to a recent BAML survey: a) investors are selling cyclical stocks—banks, EMs and European equities—in favour of defensive sectors; and b) in the fixed income space, US investment-grade corporate debt is increasingly perceived as an opportunity.

*In the GCC, Bahrain has commissioned a study of potential fiscal reforms.* CDS spreads remain high (403bps, -8bps w-o-w), in spite of the recent pledge of support from Kuwait, KSA and the UAE.

Over the next few months, *EM fixed income issuances will remain weak, due to unfavorable market conditions*. In 9 of the past 10 weeks EM bond funds have suffered outflows, with cumulative inflows y-t-d now down to USD20.8bn.

**Brent oil prices will remain above 70 USD/b, in spite of the announced Opec output expansion.** Brent prices declined by 2.6% w-o-w, to 77.1 USD/b, as: *a*) Opec is ramping up production: in June, Saudi Arabia reported a m-o-m increase of 458k bpd; and *b*) in the week to June 29<sup>th</sup>, EIA oil stockpiles unexpectedly increased (*a*: +1.2mb; *c*: -3.5mb; *p*: -9.9mb).

#### Last Week's Review

In the US, the Fed minutes and employment data confirmed market expectations for two additional hikes in 2018 ... The Fed minutes and June labour data—average hourly earnings (a: 2.7% y-o-y; c: 2.8%; p: 2.7%), non-farm payrolls (a: 213k; c: 195k; p: 244k), and the unemployment rate (c: 4.0%; c: 3.8%; p: 3.8%)—signal two further hikes in H2-2018.

... supporting the stock markets. The S&P500 rose by 1.5% w-o-w, and the VIX index declined by 3 points to 13, below its long-term trend of 22.

*However, trade war concerns ...* On July 6<sup>th</sup>, a 25% tariff on USD34bn of Chinese imports to the US came into effect, and China retaliated by imposing similar tariffs

... increased demand for treasuries: the 10y UST yield declined to 2.82% (-4bps w-o-w; -30bps since its mid-May peak), while—lifted by expectations about Fed's hikes—the yields of shorter-term bonds rose. As a result, since February the 2y/10y spread narrowed by 46bps and now stands at just 31bps (the lowest in 10 years). The USD depreciated against a basket of currencies (DXY down by 0.5% w-o-w), and was flat against the EUR at EUR/USD 1.17.

*In Mexico, the opposition leader Lopez Obrador (aka AMLO) won the general election.* His proposal to subsidize agricultural products increases the risk of failure of the ongoing NAFTA negotiation.

In Turkey, inflation rose above expectations (June CPI, a: 15.4%; c: 14.0%; p: 12.2%), driven by TRY depreciation and higher oil prices.

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#### **Abbreviations, Acronyms and Definitions**

| а     | Actual                                 | k      | thousand  |
|-------|--|--------|---|
| AKP   | Justice and Development Party          | KSA    | Kingdom of Saudi Arabia                                   |
| ann.  | annualized                             | LN     | Northern League   |
| ARS   | Argentinian Peso                       | M5S    | Five Star Movement  |
| bn    | Billion                                | m-o-m  | Month-on-month  |
| ВоС   | Bank of Canada                         | mb     | Million barrels   |
| BoE   | Bank of England                        | mb/d   | Million barrels per day                                   |
| BoJ   | Bank of Japan                          | MENA   | Middle East and North Africa                              |
| bpd   | Barrels per day                        | MHP    | Nationalist Movement Party                                |
| bps   | Basis points                           | mn     | Million   |
| BS    | Balance sheet                          | NAFTA  | North-American Free Trade Agreement                       |
| С     | Consensus                              | NATO   | North Atlantic Treaty Organization                        |
| C/A   | Current account                        | NRM    | National Regeneration Movement                            |
| ĊB    | Central bank                           | OECD   | The Organization for Economic Cooperation and Development |
| СВК   | Central Bank of Kuwait                 | Opec   | Organization of Petroleum Exporting Countries             |
| CBR   | Central Bank of Russia                 | p      | Previous  |
| CBT   | Central Bank of the Republic of Turkey | pw     | Previous week   |
| CDU   | Christian Democratic Union of Germany  | PCE    | Personal Consumption Expenditures                         |
| CNY   | Chinese Yuan                           | PE     | Price to earnings ratio                                   |
| CBT   | Central Bank of the Republic of Turkey | PM     | Prime minister  |
| CPI   | Consumer Price Index                   | PMI    | Purchasing managers' index                                |
| DJIA  | Dow Jones Industrial Average Index     | pps    | Percentage points   |
| d-o-d | Day-on-day                             | QCB    | Qatar Central Bank  |
| DXY   | US Dollar Index                        | QAR    | Qatari Riyal  |
| EC    | European Council                       | QE     | Quantitative easing                                       |
| ECB   | European Central Bank                  | q-o-q  | Quarter-on-quarter  |
| EIA   | US Energy Information Agency           | RBA    | Reserve Bank of Australia                                 |
| EM    | Emerging Markets                       | RRR    | Reserve Requirement Ratio                                 |
| EP    | European Parliament                    | RUB    | Russian Rouble  |
| EPS   | Earnings per share                     | SHCOMP | Shanghai Stock Exchange Composite Index                   |
| EU    | European Union                         | tb/d   | Thousand barrels per day                                  |
| EUR   | Euro                                   | tn     | Trillion  |
| EZ    | Eurozone                               | TPP    | Trans Pacific Partnership                                 |
| Fed   | US Federal Reserve                     | TRY    | Turkish Lira  |
| FM    | Future Movement                        | UAE    | United Arab Emirates                                      |
| FOMC  | US Federal Open Market Committee       | UK     | United Kingdom  |
| FRB   | US Federal Reserve Board               | US     | United States   |
| FX    | Foreign exchange                       | USD    | United States Dollar                                      |
| FY    | Fiscal Year                            | USD/b  | USD per barrel  |
| GCC   | Gulf Cooperation Council               | UST    | US Treasury bills/bonds                                   |
| GBP   | British pound                          | VAT    | Value added tax   |
| GDP   | Gross domestic product                 | VIX    | Chicago Board Options Exchange Volatility Index           |
| GOP   | Grand Old Party (US Republican Party)  | WTI    | West Texas Intermediate                                   |
| IMF   | International Monetary Fund            | W-O-W  | Week-on-week  |
| INR   | Indian Rupee                           | V-O-V  | Year-on-year  |
| IPO   | Initial public offering                | y-t-d  | Year-to-date  |
| IS    | Islamic State                          | 2y     | South African Rand  |
| JPY   | Japanese yen                           | 10v    | 10-year   |
| '     | sapanese yen                           | 10,    | 20 ,000   |
|       |  |        |   |

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