Rosa & Roubini
ASSOCIATES

MAKING SENSE OF *THIS* WORLD — *9 July 2018*

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 6th 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 already low and diminishing real "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.

Our Recent Publications

- *FRANCE: Europe's (Temporary) Bright Spot, by Brunello Rosa and Nouriel Roubini, 4 July 2018*
- *BOC Set to Raise Rates, But No Longer Certain to Signal Further Hikes, by J. Shupac and B. Rosa, 6 July 2018*

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 29th, 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 6th, 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.

Pablo Gallego Cuervo *contributed to this Viewsletter.* *The picture in the front page comes from this website*

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

Abbreviations, Acronyms and Definitions

a	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
BoC	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
c	Consensus	*NATO*	North Atlantic Treaty Organization
C/A	Current account	*NRM*	National Regeneration Movement
CB	Central bank	*OECD*	The Organization for Economic Cooperation and Development
CBK	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	*y-o-y*	Year-on-year
IPO	Initial public offering	*y-t-d*	Year-to-date
IS	Islamic State	*2y*	South African Rand
JPY	Japanese yen	*10y*	10-year