Weekly Market Summary

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What Happens When a Trustworthy Leading Indicator Suddenly "Loses" its Economic Reliability??
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The US bull market is now officially the longest ever! From the depths of the financial crisis in 2008/2009, revived by central bank stimulus, fuelled by technological innovation and finally given a shot of tax cuts by president Trump, the S&P 500 has gone 3,453 days without a drop of 20%, a decline typically associated with a bear market. That edges it past the 1990-2000 Bull Run that culminated in the dotcom boom/bust. The market value of the S&P 500 is up 312% from March 9th, 2009 – the day the index bottomed - an impressive upsurge of US$18.4 trillion. Additionally, growth remains very well supported in the US, Europe and Japan with better-than-expected 2Q2018 GDP releases across all developed nations (as a reminder, US 2Q2018 GDP grew at 4.1%, the fastest reading in four years).

And yet, in the US and elsewhere, there continues to be a considerable and "*alarming*" flattening in the yield curve (last at 21 bps for the 2yr-10yr UST yield spread, the lowest difference since mid-2007). If you haven't been paying attention to that mysterious phenomena (possibly too busy following Trump's persisting scandals), you are way behind it now!

US 2-year / 30-year US Treasury Yield Spread ***(in basis points)***

In the financial media, you will constantly hear the terms "flattening yield curve" and "steepening yield curve." As a reminder, the "yield curve" is simply the yield of each bond along the maturity spectrum plotted on a graph. It typically slopes upward, since investors need to be compensated with higher yields for assuming the added risk of investing in longer-term bonds (also known as "term premium"). The general direction of the yield curve in a given interest-rate environment is typically measured by comparing the yields on the two- and 10-year issues, although the difference between any other 2 points (or tenors) on the curve can be used as well. When the difference between yields on short-term bonds and yields on long-term bonds decreases, the yield curve flattens (or becomes less steep), and that is currently the case. This could be due to an impending recession (where the US Federal Reserve would be required to aggressively lower interest rates in the future), rising market uncertainties or simply falling market inflation expectations. On the rare occasions when a yield curve flattens to the point that short-term rates are higher than long-term rates, the curve is said to be "inverted" (*inverted yield curves have occurred on only eight occasions since 1958. More than two-thirds of the time, the economy has slipped into a recession within two years of an inverted yield curve*).

Previously, the slope of the US yield curve was considered a leading and reliable indicator of growth and a flat to inverted yield curve would have been immediately perceived as a sign of an impending recession (not anymore if you ask me, especially in the era of unrestricted printing of Fiat Currency by various central banks!). Today, what the shape of the yield curve says about investors' economic outlook depends on who you ask: To some (pick me!), long-term Treasuries are "*crazy priced wrong to the expensive side*," along with debt in Europe and Japan (i.e. elevated prices & depressed yields), in part because investors in those regions flock to the U.S. any time debt prices fall; That appetite keeps 10-year Treasury yields in a tight range (most recently that range has been 2.78% to 3.10% for 10s UST yields), even as the Federal Reserve sees economic growth warranting additional interest-rate hikes. Others have a gloomier view and feel that the US central bank is nearly at its limit for raising rates, given rising signs of economic fallouts from president Trump's political and trade policies, persisting political (Italy, Brexit...) & geopolitical tensions (Iran, Syria, North Korea,..), as well as weakening emerging market fundamentals (Venezuela, Brazil, Turkey, South Africa,..). These differing interpretations show how investors are struggling to balance the prospect of further Fed tightening against a backdrop of low but rising inflation, coupled with the lowest jobless rate since 2000 (last at 3.9%) and potential for large US fiscal stimulus to persist in coming months.

Still, with growth moving at a solid clip and the labour market ostensibly at full employment, there is a sense that the market is getting ahead of itself in the aggressiveness of the flattening currently underway (mind you that I did make a similar comment some nine months back when the spread was closer to 80 bps! ☹). After years of balking at tightening monetary policy for fear of disrupting markets, Fed officials finally stuck to their plans in 2017 and 2018, earning bond traders' trust in the process. The two-year Treasury yield is at the highest level since 2008 (last trading at 2.62%, after starting 2017 at 1.19% - a solid 120% jump in less than 2-years!) as investors prepare for a third rate hike this year, scheduled for the September 26th FOMC meeting (*a certainty now that minutes of the US Federal Reserve's August 1st meeting are out, confirming that "many Fed officials saw another hike likely appropriate 'soon'*), and begin to build up expectations for further increases over the coming year. With short-end yields climbing, the curve historically tends to flatten as longer-term rates rise more slowly.

Once again, the recent flattening trend – to my mind – continues to make little sense for the following obvious reasons:

- US growth remains quite solid, with the last few quarters displaying above-potential GDP (3.0 %+). That in turn will assuredly result in further shrinking of the output gap and higher inflation going forward.
- Short term interest rates remain very depressed, despite six "25 bps" rate hikes by the Fed over the past 2 years (historically, the US central bank was comfortable raising rates 8 times per year – 25 bps per scheduled FOMC meeting – following long periods of low rates). Today's real Fed fund rate (subtracting inflation) stands at -0.90% (2.00% FFR - 2.90% CPI) , hardly restrictive, compared to the past 8 cycle's minimum of +2.00% before the economy starts slowing down and the curve begins to flatten.
- Last December's agreement and implementation of a massive US tax cut plan is still expected to result in faster US growth and larger budget deficits over the coming years. Definitely grim news for long bond holders!

As such, and at least for now, flattening of the curve remains attributable to the following factors:

- The global bond market is still awash in central bank purchases, most notably from the Bank of Japan (BOJ) and the European Central Bank (ECB), though the latter is expected to end its bond purchases on December 31st, 2018 (barring any unpleasant economic surprises between now & then). And over the course of the past few years, the yield spread between 10-year Treasuries and German bunds/Japanese JGBs has grown wider, creating an opportunity for overseas investors to add positions in long-term U.S. debt.
- The US Treasury has recently confirmed that it will issue more shorter-term debt, rather than long bonds. With less supply, and constant forced demand, both in the U.S. and elsewhere, from asset-liability managers like insurance companies, pension funds and passive mutual fund giants (like Vanguard and BlackRock), 30-year Treasuries are among the best ways to get it. Hence long bond prices could continue getting squeezed upward.
- U.S. companies have until September 16th, 2018 to claim deductions for pension fund contributions at a 35%, before it drops to 21% as a result of corporate tax cuts passed last December. Front-loading to beat the deadline is said to have fuelled buying in long-dated bonds, further driving the curve flatter.
- A possible shift in asset allocation among money managers, away from expensive equities and in favour of long-dated Treasuries in the context of rising global uncertainties.

That brings me to the final two important observations for the day:

1- **The Economy's Yield Curve:** Whilst the recent rapid flattening of the U.S. Treasury yield curve is raising concern about the economy's prospects, as historically a narrow curve is associated with a slowdown in growth, right now, it should not! It might be a good idea to start shifting focus to the economy's yield curve (the spread between the federal funds rate and nominal gross domestic product). This relationship is most important since it is the ability of the consumer and businesses to carry or afford the higher borrowing costs that could eventually impact economic growth. Based on second-quarter data, the economy's yield curve is close to 500 basis points, which is calculated by taking the 7.00% annualized rate of growth in nominal GDP (4.1% real Growth + 2.9% YoY CPI) less the quarterly average for the federal funds rate of 2.00%. This gap has been expanding from previous years! In a historical perspective, the economy's yield curve is unusually wide, consistent with a positive growth outlook. To be sure, the average spread during the 1990s growth cycle was 150 basis points and in the 2000s it was 200 basis points!

2- **Donald Trump's Final Chapter:** With less than three months before the US mid-terms, the crisis within the White House is rumbling on and president Trump's growing troubles continue unabated! Just in the past few days, former Trump campaign chairman Paul Manafort has been convicted on tax evasion and other charges (8 in total, mostly relating to tax and bank fraud), whilst Trump's long-time lawyer and fixer Michael Cohen's plea deal has implicated the president of the United States in an illegal campaign finance scheme over hush money paid to a porn actress and a former Playboy model. Still more damaging are those claims that Cohen – who previously asserted he would take a bullet for Trump☺ - has "*knowledge*" about computer hacking and collusion that may interest Special Counsel Robert Mueller in his investigation into Russian interference in the 2016 election. The single unfortunate and sad news here is that Donald Trump has in the past repeatedly turned overseas at times of domestic distress. In recent months, the White House has slapped sanctions on countries from Venezuela to Turkey, just as investigations into Russian election meddling and hush-money payments deepened. A tit-for-tat with China on trade also intensified. Yesterday, South Africa's rand led emerging-market losses after Trump leaped into the nation's heated land reform debate. Now that Donald Trump is in even bigger trouble, emerging markets may have to pay a higher cost, according to some of the world's largest money managers. "*Facing an increasingly grim legal and political landscape, the president is likely to double down on his strategy to distract from domestic concerns by fixing his focus abroad*", said John Normand, JPMorgan Chase & Co.'s head of cross-asset fundamental strategy in London. That could escalate his push for higher tariffs on US$200 billion in Chinese imports, among other things. And if that wasn't enough, we have just been reminded – over the past 48 hours - by the president himself that stocks would crash if he was to be kicked out of office, whilst his lunatic lawyer Rudy Giuliani (better known for his recent "Truth isn't Truth" remark on NBC's "Meet the Press") strongly suggested that "*the American people would revolt*" if the president was impeached!

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