# Weekly Market Summary

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## A Mysterious Curve Flattening Trade That Never Made Sense ! Time for a Reality Check !!

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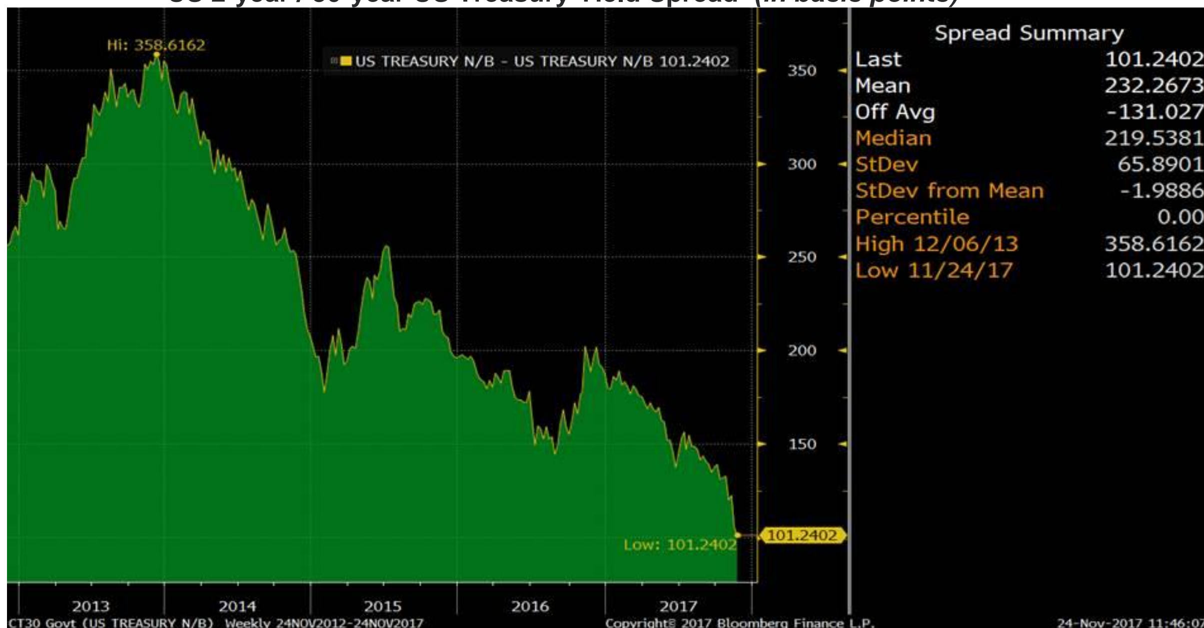
The global economic outlook continues to brighten whilst economists are left playing catch up, continuously revising up their global growth forecasts for this year and next. That is surely applicable to BNP over the past 24 hours, where the bank's chief market economist moved up his growth outlook for 2018 by 0.2% to 3.7%, in line with the latest IMF forecast. Much of this reflects a stronger-than-anticipated end to 2017, and widespread improvements/higher revisions within the advanced economies – including the US, Eurozone and Japan – as well as China. Sooner or later, one would expect such improved economic and financial environment to result in increased commodity prices (energy, grains, industrials and precious metals), further tightness in labour markets, accelerating wages and higher services inflation.

And yet, in the US and elsewhere, there has been a considerable flattening in the yield curve. If you haven't been paying attention to that mysterious phenomena (or possibly too busy with the bitcoin "BUBBLE" story), 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). That 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).

However, this time around the dramatic speed of the flattening has surprised most investors. In the past four tightening cycles, the gap between the 5-year yield and the 30-year yield narrowed on average by roughly 1.00%. But after peaking at 3.02% in November 2010, the same spread has tightened by 2.32% this time around! "*Growth is moving at a solid clip and the labour market is ostensibly at full employment. So why aren't we in an environment with a steeper curve and higher yields?* … *There is a sense that the market is getting ahead of itself in the aggressiveness of the flattening currently underway*," wrote Ian Lyngen and Aaron Kohli, fixed-income strategists at BMO Capital Markets. "*It is the lack of inflation and anaemic term premium that are exaggerating the move.*"

After years of balking at tightening monetary policy for fear of disrupting markets, Fed officials finally stuck to their plan in 2017, earning bond traders' trust in the process. The two-year Treasury yield is at the highest level since 2008 (last trading at 1.74%, after starting 2017 at 1.19%) as investors prepare for a third rate hike in December (almost certain, now that minutes of US Federal Reserve November 1st meeting are out), and begin to build up expectations for further increases next year. With short-end yields climbing, the curve historically tends to flatten as longer-term rates rise more slowly. But since the start of 2017, 10-year and 30-year yields have actually declined (30-year yields last at 2.75%, after a start at 3.05% on January 1st, 2017). And the culprit behind that appears to be stubbornly muted inflation: Even with U.S. jobs growth humming along and unemployment at the lowest level since 2000, US core inflation was running at just 1.8% in October. It briefly rose above the central bank's 2% target at the start of the year (2.3% YoY rise in January 2017), but has since struggled. This has led Janet Yellen, the outgoing Chair of the Federal Reserve, to affirm to an audience at New York University last Tuesday night that she finds this year's low US inflation a mystery(!), adding that she could not say that the Fed clearly understood the causes (though Yellen did point to a much slower increase in healthcare costs than had been expected, and to the introduction of unlimited data plans by cell phone providers which had shown up in the official statistics as a sharp decline in prices). As usual, Yellen's comments were taken as a signal by many in the markets that the Fed's campaign to raise interest rates would peak at a lower rate than previously expected.

To Morgan Stanley's Matthew Hornbach, the flattening Treasury yield curve has a lot in common with the surging price of bitcoin. For both trades, the best option is to simply buy the dips (*seriously? That simple?!J*), Hornbach, global head of interest-rate strategy, wrote in a November 18 note. He recommends adding to bets that the yield spread between two- and 30-year Treasuries will continue to narrow, even though it fell to 100 basis points on Wednesday, the lowest in 10 years. Matthew says the curve could flatten to as low as 80 basis points by year-end, based on Fibonacci projections (time to put aside my 25 years of market analytics skills, and focus instead on this 12th century Fibonacci sequence - built on the reproduction pattern of fictional baby rabbits – to predict the future direction of this spread trade L). "*Trading the flattener should feel very much like trading bitcoin: You are meant to buy every dip, if you see the value proposition, even though you've already missed what seems like a big move*," Hornbach added.

On a fundamental level, the flattening trend makes little sense, despite the U.S. Federal Reserve raising short-term interest rates in the face of stubbornly low inflation (for now!), 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 a shrinking output gap and higher inflation going forward.
- Short term interest rates remain very depressed, despite 4 *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 -0.70%, hardly restrictive, compared to the past 8 cycle's minimum of +2% before the economy starts slowing down and the curve begins to flatten.
- The US House/Senate members are finalizing a massive tax cut plan. Should it be soon passed and implemented, the plan will result in faster US growth and larger budget deficits over the coming years. Definitely grim news for long bond holders and Mr. Horbach analysis!

As such, flattening could mostly be 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). 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. However, ECB purchases are set to expire by September 2018 (truly unwise to replicate Citibank Chuck Prince's "music still playing" proclamation!).
- The US Treasury plans to 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.
- 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 (truly unwise to be purchasing 30-year Treasuries at such depressed levels!).

Which brings me to the final observation for the day: 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 third-quarter data, the economy's yield curve is close to 300 basis points, which is calculated by taking the 4.1% annualized rate of growth in nominal GDP less the quarterly average for the federal funds rate of 1.15%. This gap has expanded by 65 basis points from a year earlier! 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 100 basis points and in the 2000s it was 200 basis points.

And maybe, just maybe, the time has come now to start betting on a big reversal of the current flattening trade (possibly using those Fibonacci retracement levels - namely 23.6%, 38.2%, 50%, 61.8% and 76.4% retracements - to set "take profit" levels).

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