# Morning Comment

October 22, 2019

## AFS Insights

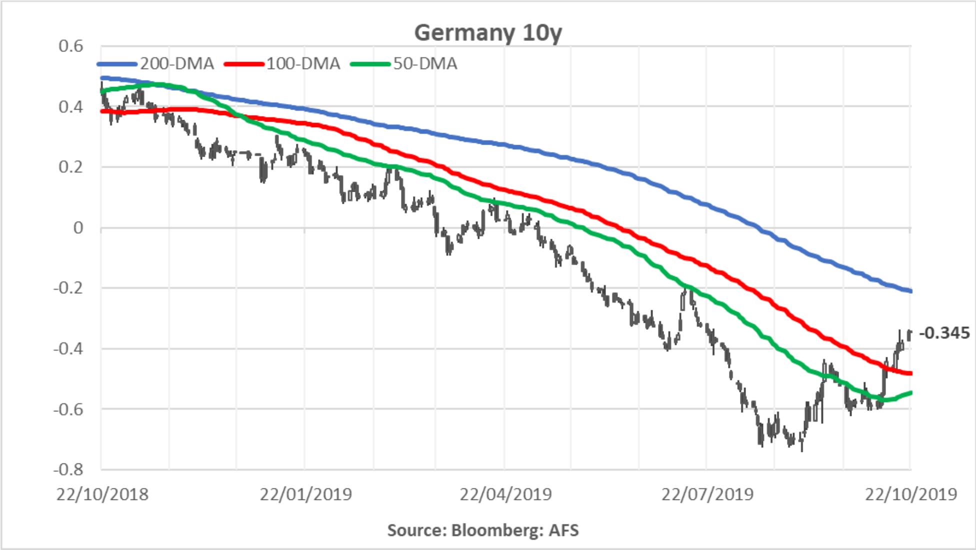
**Arne Petimezas**
**Analyst**
**+31 20 522 0244**
**a.petimezas@afsgroup.nl**

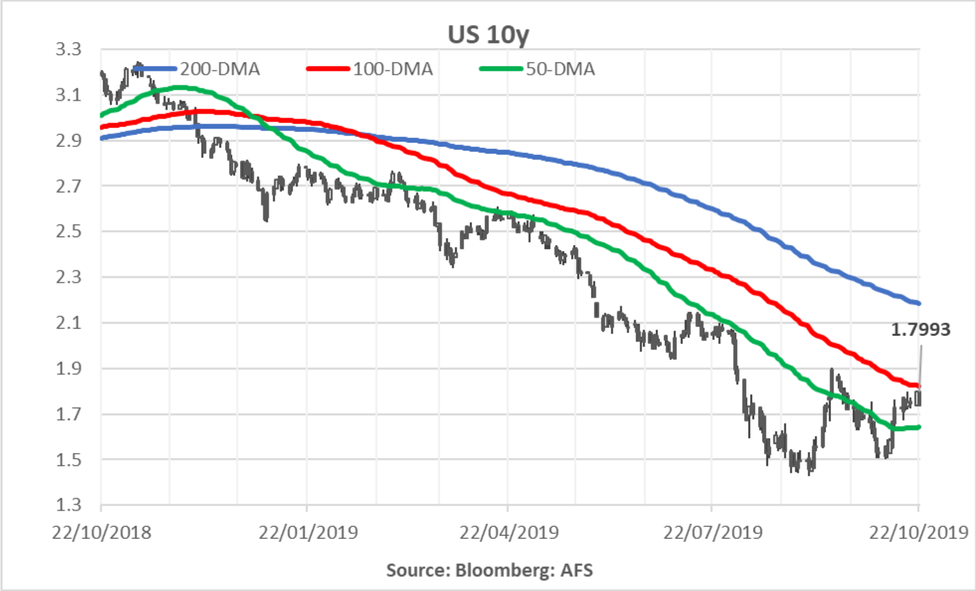
## Headline Sweep

- Brexit: Johnson in last push to get deal through
- Chinese vice foreign minister says progress made in trade talks with U.S.
- Canadian Prime Minister Trudeau Headed to Election Win
- Fosun Is Said to Study Bid for German Tycoons' Private Bank
- SoftBank Seeks Majority Stake in WeWork With Bailout Deal

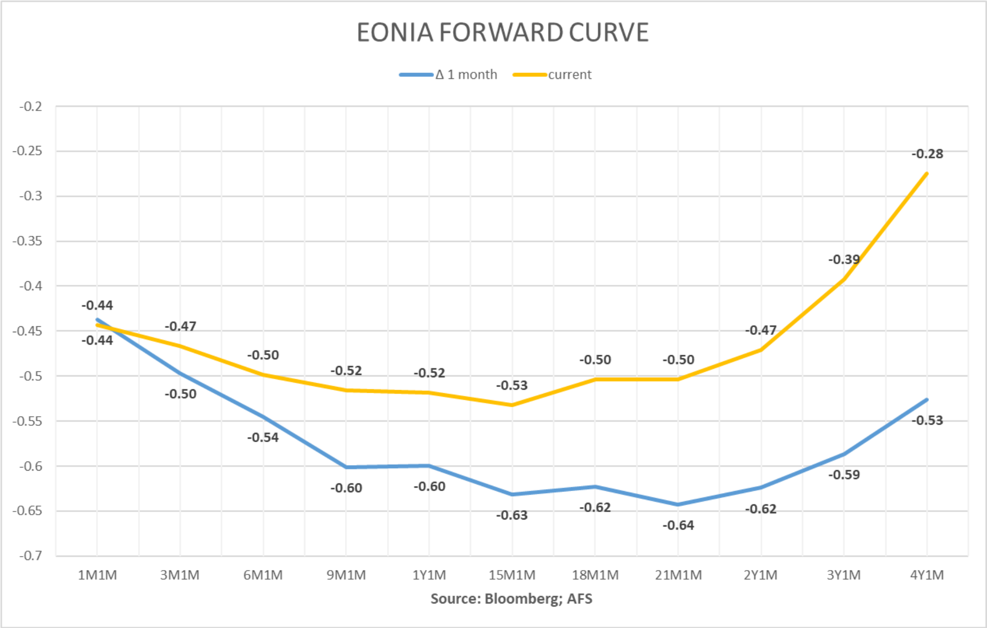
## Overnight Comment/The Day Ahead

- **A clear pattern of rising bond yields has been emerging this month, in particular in case of the Eurozone.** Here are US and German 10y bond yields:

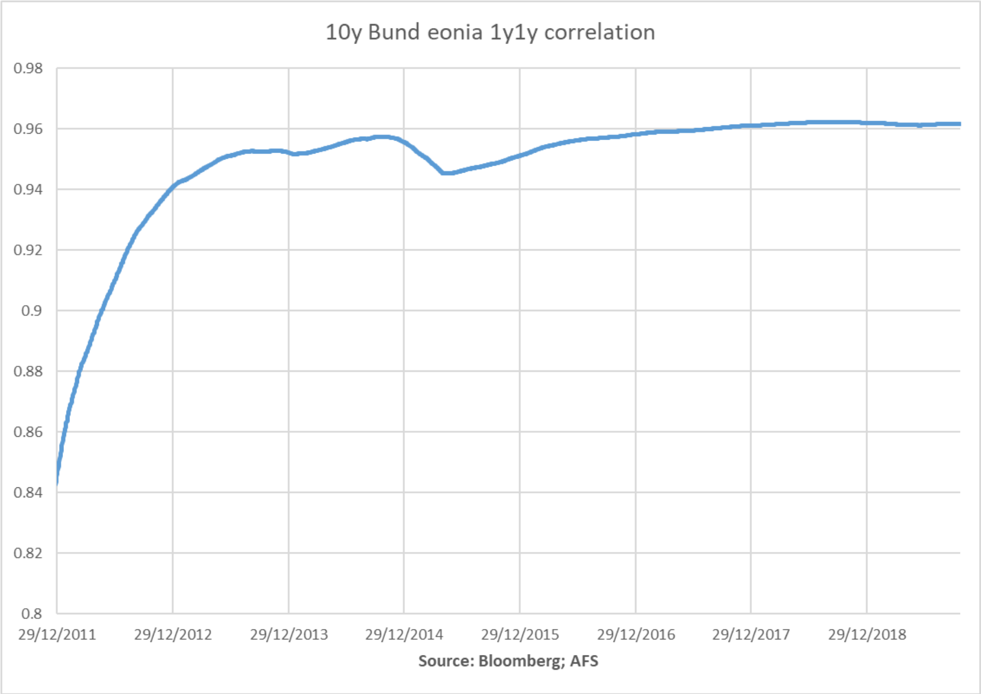




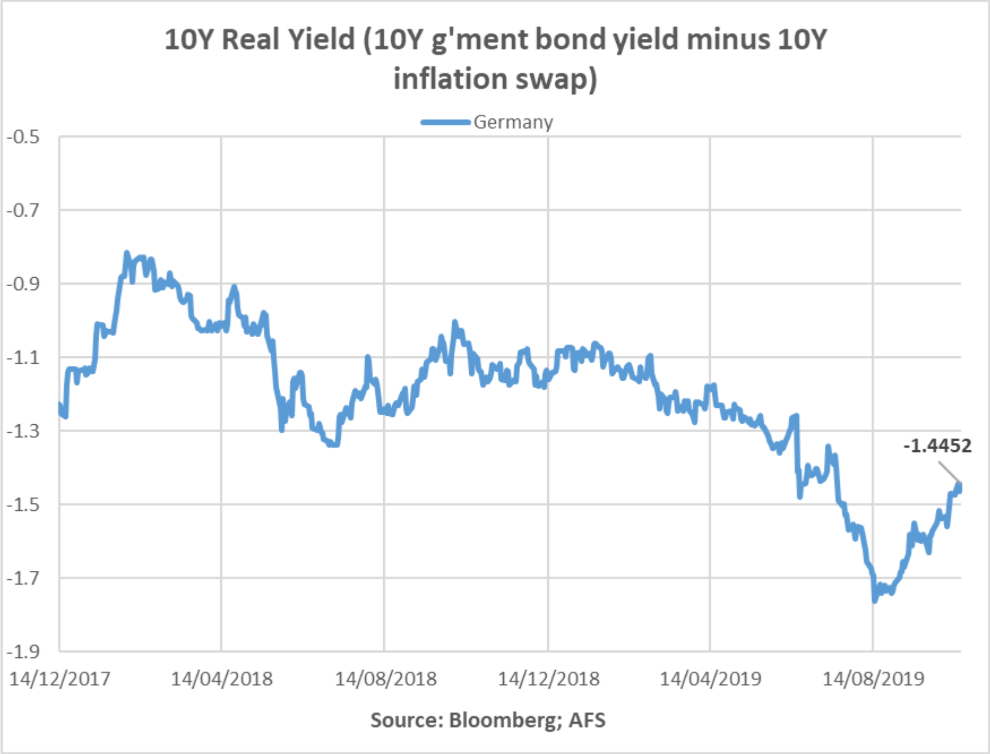

- **In case of the Eurozone the driver has been a reassessment of ECB policy**. The EONIA forward curve has shifted up markedly:




… and expectations of ECB correlate strongly with the 10y Bund yield:




- **And rising real yields are a tell-tale sign of the market dialing back easing bets:**




- **Hawks strongly resisting to the September ECB stimulus package and further easing in the next twelve months is a key driver of higher rates/yields in the Eurozone**. More importantly, what the hawks have made clear is that the hurdles for raising the issue/issuer limit of the QE program to 50% from 33% currently are insurmountable under the present circumstances. That means it's all but assured that QE will end less than a year from now. Furthermore, as we have shown in yesterday's Comment, our favorite early-cyclical indicator for the Eurozone is consistent with growth picking up over the course of 2020. An upturn in growth would make further easing extremely unlikely as the economy of the Euro Area is still operating around full capacity.

- **Turning to the US, our favorite indicator, the Leading Indicators from the Conference Board, are still flashing orange**. The September reading was a disappointment, with the growth rate staying close to zero. Note that sub-zero readings are consistent with recessions (grey bars):

Source: Bloomberg; AFS

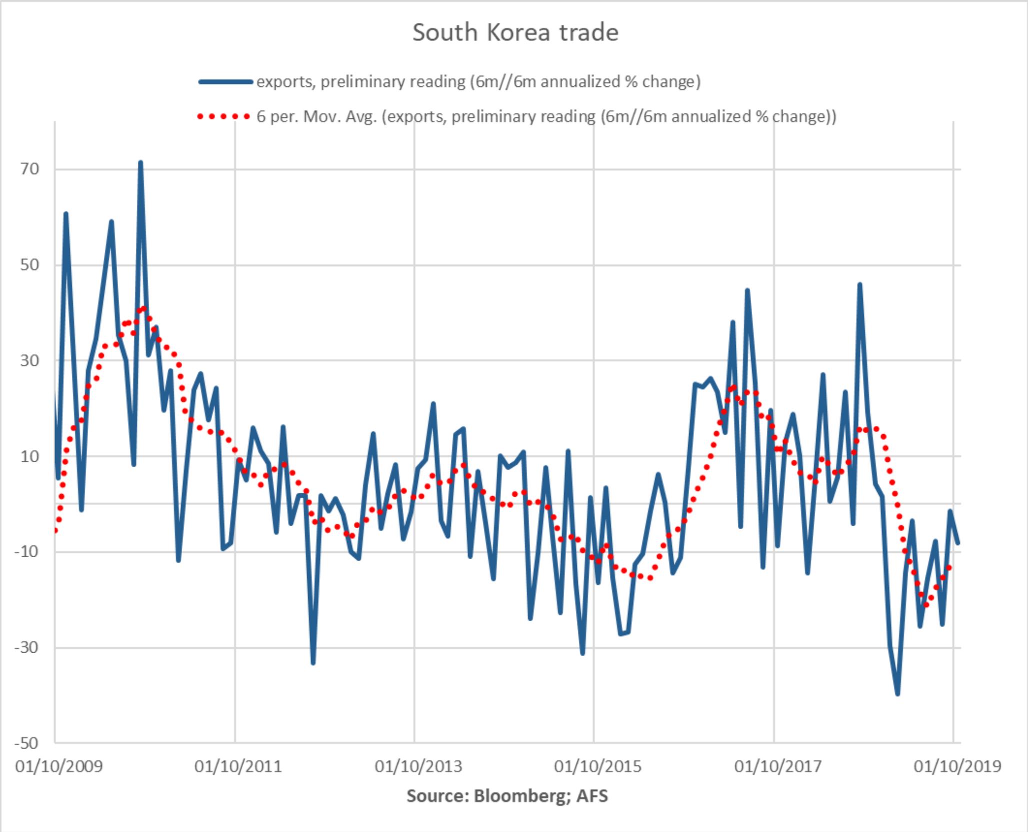
- **Nonetheless the US Treasury yield curve has steepened compared to late August, when long term yields fell the most below short term yields this cycle (i.e. the inversion was the deepest):**

- **The steepening of the yield could herald a recession next year.** Historically, after a sustained inversion the yield curve steepens for a period of up to six months before the last inversion date and the onset of an official NBER recession.[1] Consider the table below, which shows yield curve behavior before the last three recessions:

| | 3m10y inversion<br># of days inverted | First inversion date | Last inversion date | max inversion, in bps | average inversion, in bps |
|---|---|---|---|---|---|
| July 1990-March 1991 recession | 101 | 27/03/1989 | 28/12/1989 | -35 | -12 |
| March 2001-November 2001 recession | 145 | 05/04/2000 | 09/02/2001 | -82 | -44 |
| December 2007-June 2009 recession | 230 | 22/02/2006 | 08/08/2007 | -72 | -29 |
| March 2019 yield curve inversion | 107 | 22/03/2019 | 10/10/2019 | -56 | -18 |

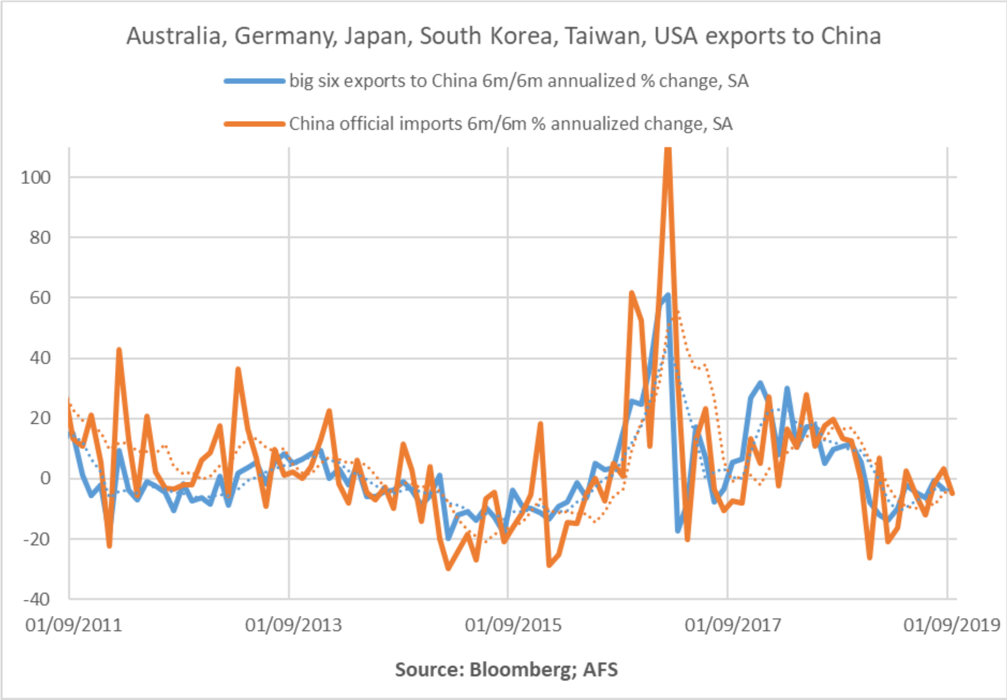
| | 2y10y inversion<br># of days inverted | First inversion date | Last inversion date | max inversion, in bps | average inversion, in bps |
|---|---|---|---|---|---|
| July 1990-March 1991 recession | 185 | 14/12/1988 | 29/03/1990 | -44 | -15 |
| March 2001-November 2001 recession | 233 | 03/02/2000 | 02/01/2001 | -56 | -26 |
| December 2007-June 2009 recession | 245 | 27/12/2005 | 05/06/2007 | -20 | -19 |
| March 2019 yield curve inversion | 8 | 14/08/2019 | 02/09/2019 | -5.3 | -1.8 |

- **Another explanation for the steeper curve is receding global risks**. The US-China trade truce is still holding, and the EU and UK have been as close to a Brexit deal as they have ever been. More importantly, several of the leading global indicators that we track appear to be bottoming out. The table below shows South Korean exports. Note the improving trend of less strong declines:

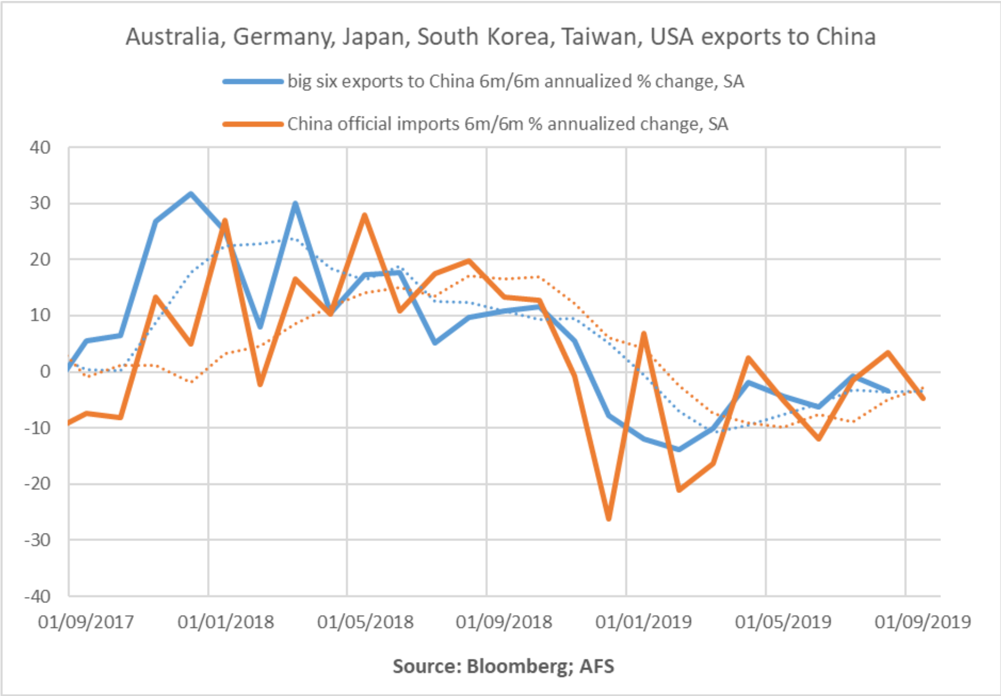



[1] The National Bureau of Economic Research (NBER) is responsible for recession dating.

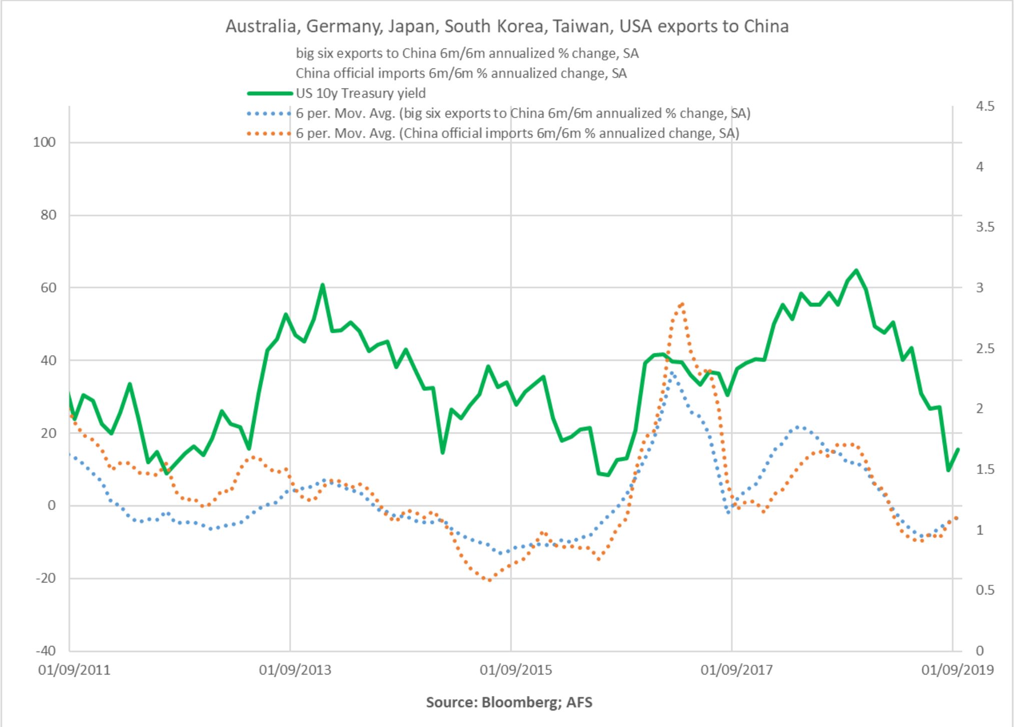
- **An improvement in the sense that declines are becoming less strong is also visible in trade data of China, the world second biggest economy**. We track both official imports and our own measure of Chinese foreign trade: exports of the biggest six exporters to China:



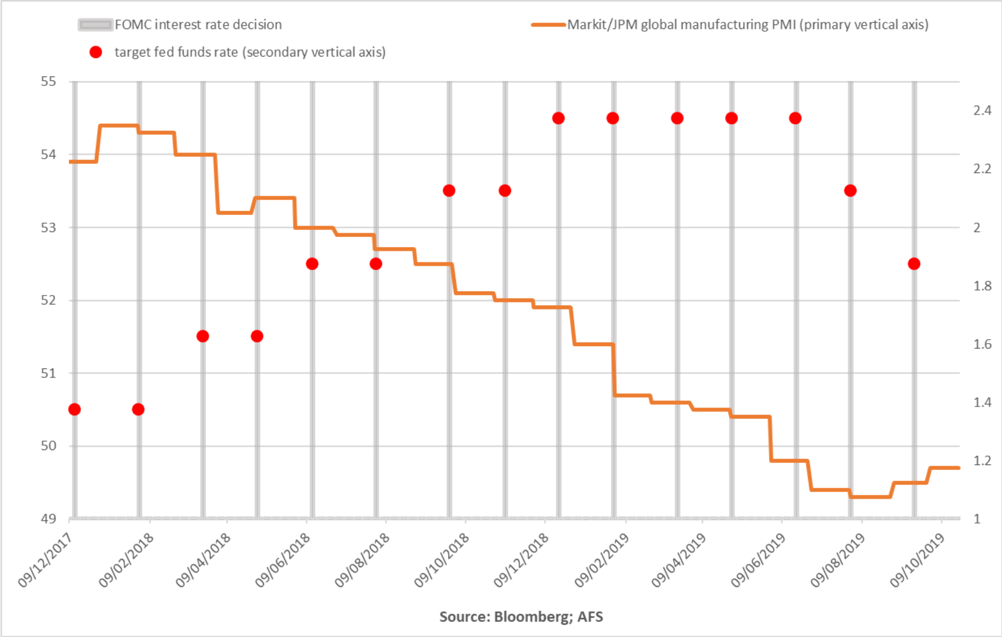

And here's only data for the past two years:




- **While US Treasury yields certainly do not correlate with exports to China, turning points in our Chinese export measure have preceded turning points in the direction of Treasury yields**




- **With charts the truth is in the eye of the beholder so to speak.** However, our exports measure does suggest long end bond yields should rise further from here, barring the US-China trade truce holding.
- **The widely followed Markit global manufacturing PMI has also been bottoming out. We've charted it below.** Note that the grey bars represent FOMC meetings and the red dots the target federal funds rate:




- **The bottom line is that there's light at the end of the tunnel for the global economy.** Global growth has been slowing since the start of 2018. But we could now be witnessing the growth slowdown bottoming out, setting the stage for an upturn next year. This should translate in a further bear-steepening of yield curves. However, the cycle will end in a recession at one point and global debt levels continue to rise while inflation is contained. This suggest a secular rise in long end bond yields is not in the cards.

## Calendar

| TIME | REGION | EVENT | PERIOD | CONSENSUS | PRIOR |
|---|---|---|---|---|---|
| **11:30** | | ECB Main Refinancing Operation Result | | | |
| **11:30** | Malta | Sells 28-day; 91-day Bills | | | |
| **16:00** | US | Richmond Fed Manufact. Index | Oct | -- | -9 |
| **16:00** | US | Existing Home Sales | Sep | 5.45m | 5.49m |
| **16:00** | US | Existing Home Sales MoM | Sep | -0.70% | 1.30% |
| **19:00** | US | Sells USD40 Bln 2-Year Notes | | | |
| | | Brexit Votes in Commons (expected) | | | |
| | | Hungary Central Bank Interest Rate Decision | | | |

**Consensus data: Bloomberg News; All Times Are in Central European Time**