

Eyebrow-raising flatness of the US yield curve

The sharp flattening of the yield curve suggests investors are pricing in the growing risk of a Fed policy mistake



Source: iStock

USD: Outlook for global asset prices rests on what the Fed chooses to do next

The flatness of the US yield curve has now got to an eyebrow-raising stage – with St. Louis Fed President Jimmy Bullard claiming that the yield curve could become inverted within the next six months. Such a phenomenon would likely be taken by investors as a recessionary signal for the US economy – irrespective of whether that is a true reflection of the underlying economic reality. Equally, it would likely trigger a broader flight-to-safety within global markets – assuming that such dynamics were not already in play during the transition from a flat to inverted yield curve. Thus, the question we need to ask ourselves now is how likely is an inverted US yield curve over the next six months?

The sharp flattening of the curve – and clear lack of interaction between short-term and long-term US rates – leads us to posit that either one of two market dynamics is occurring:

- (a) investors are pricing in growing risks of a Fed policy mistake – such that the narrative of

a growing US economy within the backdrop of short-term policy rate adjustments is no longer credible; or

- (b) the market is completely mispricing the strength of the US economy – as well as the current stage of the economic cycle that we’re in.

Both the economic and financial evidence lends greater support to the former; as we’ve pointed out before, markets have begun to price in the peak for the Fed tightening cycle – with the three-year short-term OIS forward rates lower than their two-year equivalent. Moreover, the extremely low US unemployment rate – and general length of the current economic expansion – would suggest that the cycle is nearing its end (fiscal stimulus is merely a shot of adrenaline to extend the cycle by a year or two). While we have been arguing that the US dollar will take its cue from the US economic cycle – irrespective of what the Fed does – we do believe that the outlook for global asset prices in general now rests on what US monetary officials choose to do next. Tightening into a highly-leveraged late-cycle US economy could be a toxic combination for risky assets – one that should keep global risk appetite on the back-burner should the US curve remain as flat as it is. As a side note, yesterday’s news that Iran will switch from the US dollar to the euro as its official reporting currency makes for interesting US-Iran nuclear deal talks (with President Trump set to make a decision on 12 May).

EUR: Stuck in sideways trading mode as we countdown to April ECB meeting

After managing to shake-off the lower headline Eurozone CPI print (1.3% year-on-year vs. 1.4% flash release), EUR/USD has returned to its fairly directionless state of activity. In Norway, Norges Bank officials (both Governor and Deputy Governor) are due to speak today; we expect the message of a rate hike only “after summer” to be reiterated, which should have little impact on EUR/NOK trading flat around 9.60.

GBP: UK data and politics may see bullish run take a temporary breather

While the softer UK CPI print may have sowed some seeds of doubt over a May BoE rate hike, we think the initial knee-jerk move lower in GBP and UK gilt yields may have been a slight overreaction (though it is good to see that data is once again driving UK markets). Moreover, the government defeat over the Customs Union following the House of Lords is not necessarily GBP negative in our view – in isolation it would not see a pick-up in UK political uncertainty that warrants a risk premium being priced into GBP. We retain a 1.45 target for GBP/USD in 2Q18.