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Rates Strategy

Upside Down Yield Curve

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- US Treasuries yield curve has started to invert and this has raised growth concerns. In addition, UK yield curve and Singapore yield curve have also inverted.
- Global central banks, led by the US Federal Reserve now need to move ahead of the curve and convince global investors that they can ease monetary policies effectively.
- Going forward, the current strength in the US Dollar may be an increasing inconvenience for the US amidst growth slowdown concerns. So far, the traditional money market liquidity indicators have yet to show any stress of US Dollar funding.

In the wake of poor Chinese macroeconomic data in August and the absence of any meaningful breakthrough in the US-China trade conflict, both US and UK government bond yield curves (2Y versus 10Y) have dipped into inversion on the 14th of August. This development has in turn triggered yet another bout of risk aversion because yield curve inversions have historically predated periods of recession. One could even argue that the yield spread between US 3M Libor and US 10 Year Treasuries has already inverted since the beginning of the year.

Chart 1: US 10s2s Yield Curve Started To Invert

Source: Bloomberg, UOB Global Economics & Markets Research

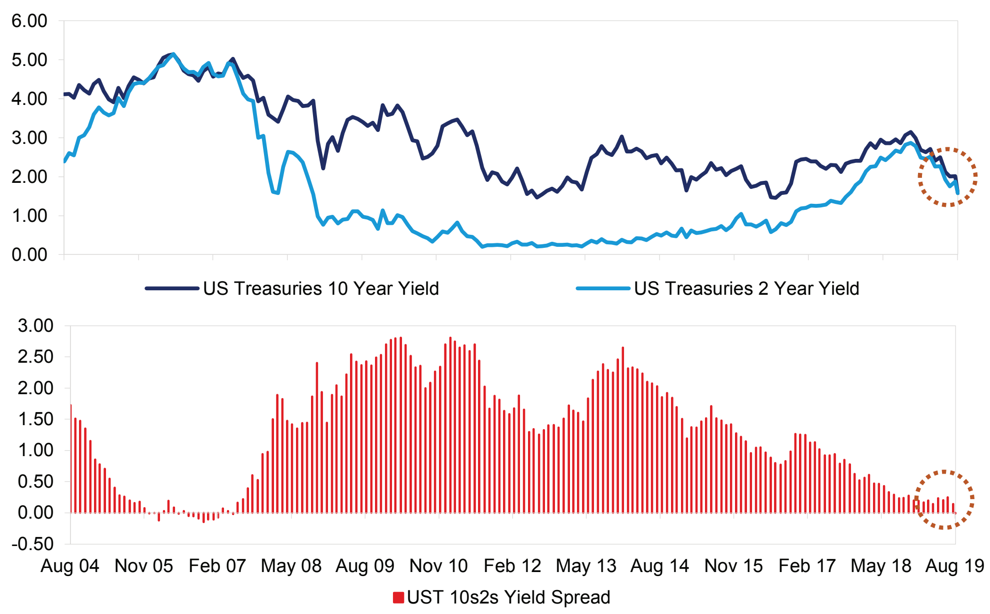
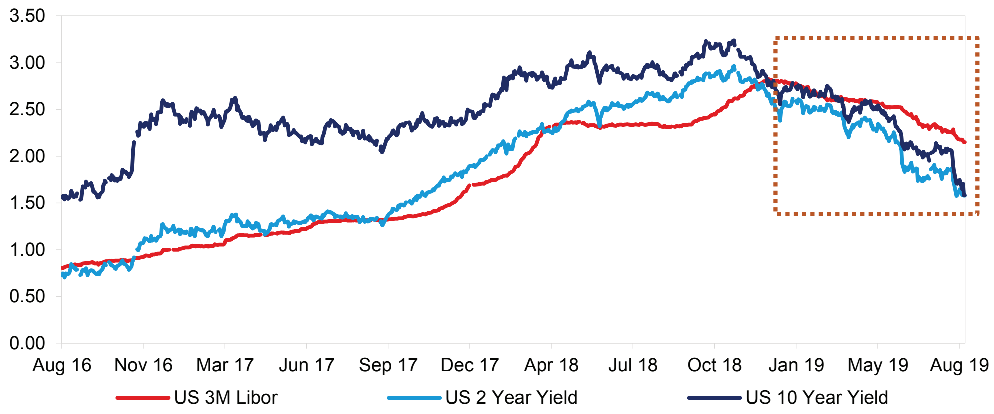


Chart 2: US 3M vs 10Y Spread Has Already Inverted Since Start Of The Year

Source: Bloomberg, UOB Global Economics & Markets Research



Whether history repeats remain to be seen

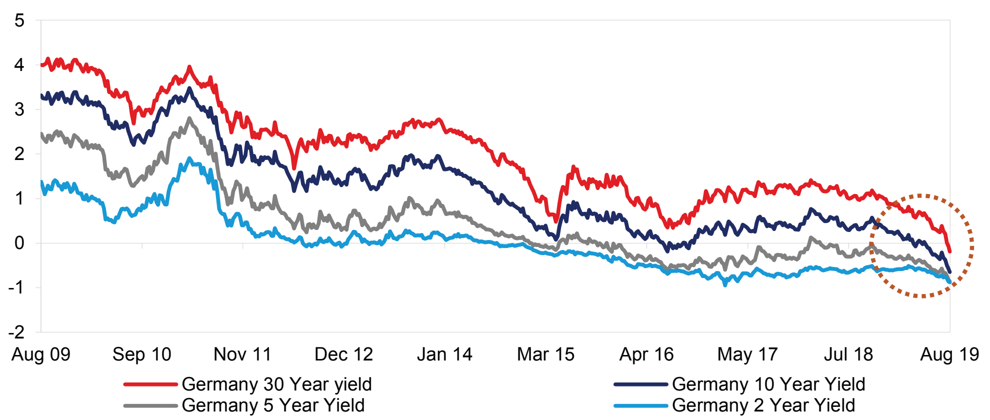
There are indeed grounds for worry because growth outlook for key global economies are souring, with Germany bordering on technical recession and Japan at risk of dipping into recession next year. However, whether history repeats remain to be seen since recessionary periods are coded after the fact.

There is something that is uniquely different in this latest round of yield curve inversion. Investors have been on an insatiable hunt for yield after the shift towards easing by global central banks in 2019, thus the propensity for yield curves to flatten is to some degree magnified. Overnight, former US Federal Reserve Chair Janet Yellen did highlight precisely this point that the lower path for longer term bond yields this time round has exacerbated yield curve inversion.

To an extent flatter yield curves are also consistent with the market value of negative yielding debt globally reaching a new high of around USD 16tn this week. This amount of global negative yield debt more than doubled over the past year. A good example is Germany's bund yield curve. Yield curve inversion for Germany's bund market is a moot point because the entire German bund yield curve is negative, out to 30 years.

Chart 3: German Bund Yield Curve Is Now Entirely Negative

Source: Bloomberg, UOB Global Economics & Markets Research



Nonetheless, it is informative to consider what the upside down yield curve is telling policy makers on both the fiscal and monetary side of the aisle.

UST Market: "US Monetary Response Needs To Get Ahead Of The Curve"

Despite the FED cutting rates by 25bps in July and ending the Balance Sheet reduction program earlier than scheduled, the UST yield curve has continued to flatten rather significantly. A re-escalation of US-China trade conflict since July's FOMC has investors pricing in a more aggressive monetary easing profile, while growth prospects continue to suffer from rising US-China trade tensions.

Further retrenchment in risk appetite will increase the probability of seeing the FED try to get ahead of the narrative in an attempt to prevent a negative feedback loop in financial markets from becoming entrenched.

Experience from QEs 1 ,2, and 3 have shown that the 10Y UST yield can increase rather significantly during periods of FED Balance Sheet expansion

This may involve validating the degree of rate cuts priced by the market or even potentially signaling an even more aggressive profile. Besides getting ahead of the FED rate expectations narrative, Quantitative Easing (QE) which has become a conventional monetary policy tool since 2008's Great Financial Crisis (GFC) may also be floated even before the FED rate hits the zero bound. Experience from QEs 1 ,2, and 3 have shown that the 10Y UST yield can even increase rather significantly during periods of FED Balance Sheet expansion due to reduced tail risk scenarios and stabilizing inflation expectations.

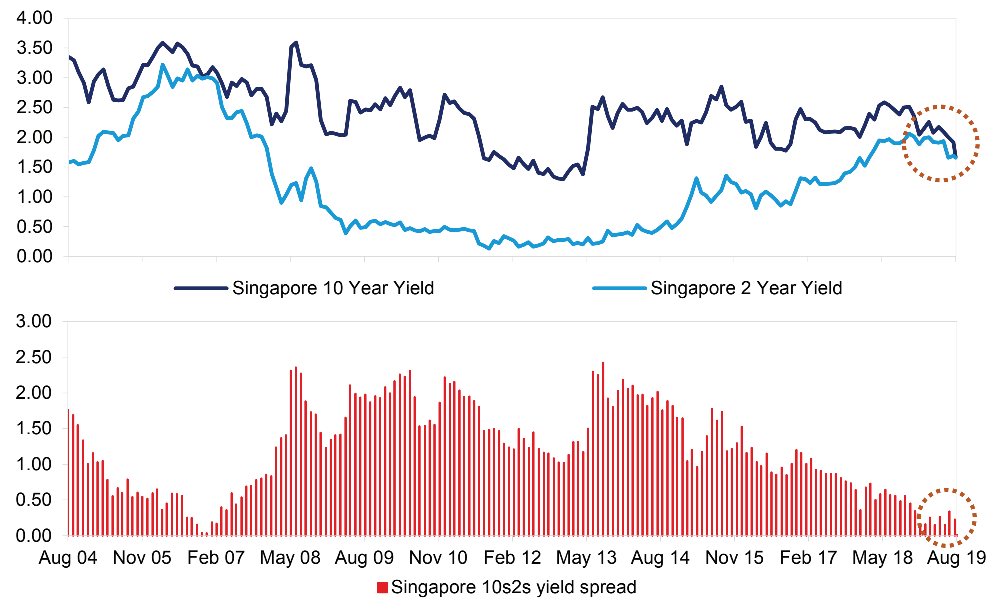
A combination of getting in front of the rate cut narrative and re-deployment of QE will have a significant impact on addressing the yield curve flattening trend. But the journey to a normalized upward sloping yield curve environment will be smoothed immeasurably if government and trade policies were also to be redirected towards a more coherent objective in the background.

A Tricky 10Y SGS Auction In August

At the moment of writing, Singapore's 10s2s yield curve has just started to invert. Yield curve inversion, historically low yield, and an upturn in both interest rate as well as currency volatility makes for a challenging run up to this month's 10Y SGS re-open auction on 28 August. Auction appetite for 10Y SGS at around 1.67% (14th August close) has been untested since 2013. In addition, the 2Y versus 10Y SGS constant maturity curve is also at its flattest level since 2006, the 10Y is on the rich end of the 5s10s30s SGS butterfly, and the 10Y tenor is also not particularly cheap on the bond versus swap spread curve. Overall, potential for further uptick in volatility, possibly driven by short covering activity, rounds off the reasons for our cautious auction expectation.

Chart 4: Singapore 10s2s Yield Curve Starts To Invert As Well

Source: Bloomberg, UOB Global Economics & Markets Research



Key Implications Going Forward Now That Global Yield Curves Have Started To Invert

1. Global central banks, particularly the FED are under elevated stress to show that they can ease monetary policy effectively and move "ahead of the curve". All eyes will be the upcoming annual Jackson Hole Symposium next week on 22 to 24 August on clues on where global monetary policy goes next.

2. Our existing suite of interest rates, particularly benchmark 10-year yield forecasts are outdated after this month's intense pullback in yield, as well as the latest deterioration in US-China trade relationship. We will be update our rates and yield forecasts at the upcoming Quarterly Report in September.

3. Now that US yield curve has started to invert, the information value going forward is less critical. Focus may shift towards the on-going strength of the US Dollar. Afterall, the US Dollar Index (DXY) remains very strong around 98 and the FED's trade weighted Broad USD Index is at two-decade high of 128 and appears to be targeting the 2002 peak of just under 130.

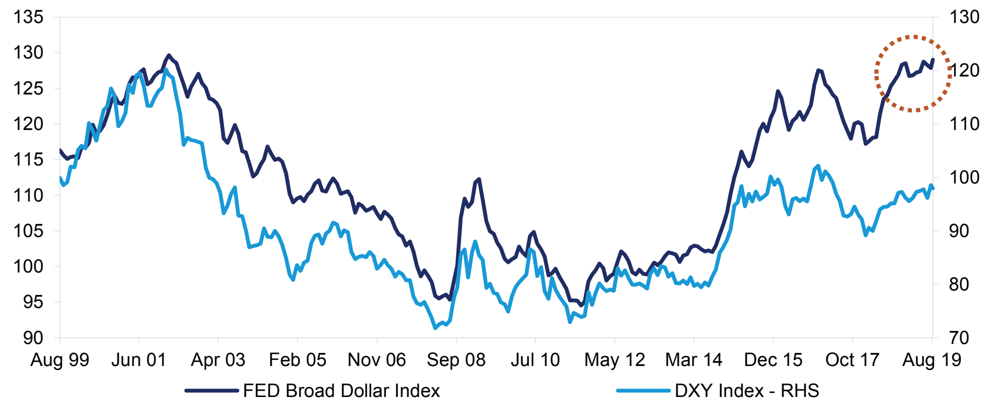
   This on-going US Dollar strength is now an increasing inconvenience amidst growth concerns in the US after yield curve inversion. It may be worth focusing on the money market liquidity indicators for any stress in US Dollar funding going forward. So far, the 3M US Libor vs OIS rate spread has climbed marginally from 10 bps to 20 bps, but is still far from the previous high of 60 bps last seen in 2016.

US Dollar strength with yield curve inversion is now an increasing inconvenience admist rising growth slowdown concerns

4. Needless to say, yield curve inversion reinforces our positive gold call for USD 1,650 by 2Q20.

Chart 5 : FED's Broad Dollar Index Now On The Verge Of Breaking Above 2002 Peak

Source: Bloomberg, UOB Global Economics & Markets Research



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