Macro Strategy

DBS Focus

USD rates: Flat, flatter, inverted

Group Research

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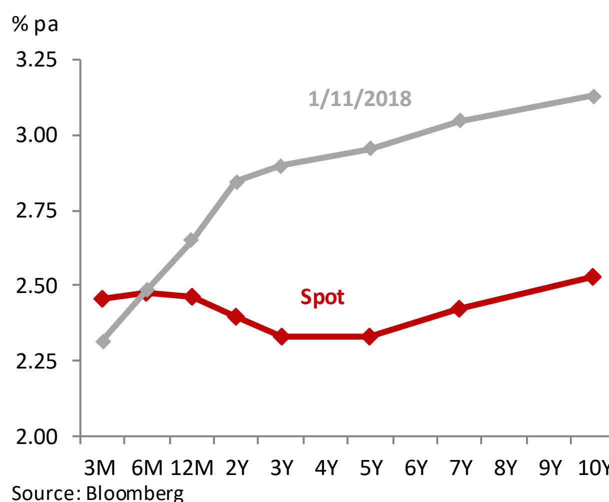
- *The rapid flattening of the US yield curve has sparked recession fears*
- *These fears are warranted, but we think the odds of a recession are probably overstated*
- *The Fed has shifted towards guarding downside risks as opposed to trying to normalize policy further*
- *This appears appropriate given weak Chinese and European data*
- *US rates cannot escape the gravity of lower yields on Germany and Japan*

Flat, flatter, inverted

The 3M/10Y segment of the curve has inverted, triggering recession fears. Over the past few months, inversion has taken place in the lesser-watched portion of the yield curve (2Y/5Y and 3Y/5Y) but this has since spread to the more widely watched 3M/10Y.

Interestingly, the 2Y/10Y (another closely watched metric) is not inverted but this is largely due to the market already pricing in easing over the coming two years. As the economic cycle ages (the current US economic expansion is almost ten years old) and monetary tightening draws to a close (the Fed has been normalising since 2013 when taper was announced), the curve would inevitably flatten. **However, the speed at which the curve has flattened has surprised us.** Notably, the 3M/10Y segment of the curve was above 100bps in early October, but the spread vanished in less than six months as the Fed's terminal rate (current Fed funds rate ceiling is at 2.50%) appears to be lower than originally thought.

UST curve has bull flattened significantly



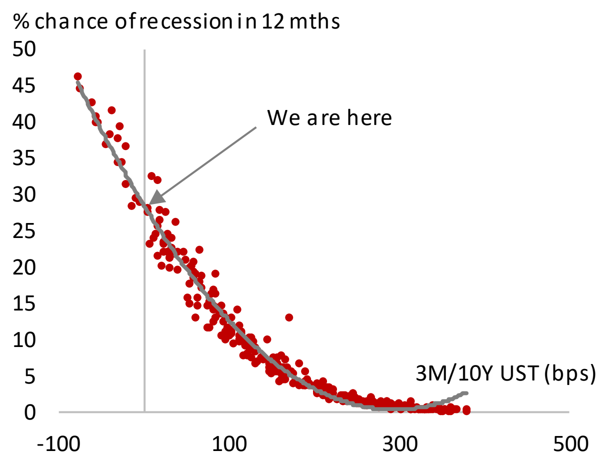
Source: Bloomberg

Recession risks

The probability of a recession/slowdown over the next twelve months is elevated, but probably overstated. Typically, an inverted yield curve foreshadows a recession in the next 6-18 months. **The New York Fed has worked out the probability of recession in the 12 months ahead based on the 3M/10Y spread.** While these numbers are only available on a monthly basis, we transform some of these numbers to tease out the relationship between the shape of the UST curve and recession risks. Noting that the curve is essentially flat,

the model suggests that recession risks are around 30% (high considering that the model puts the probability of a recession stood at around 45% when the 3M/10Y spread was at -80bps).

US recession probabilties & 3M/10Y UST curve



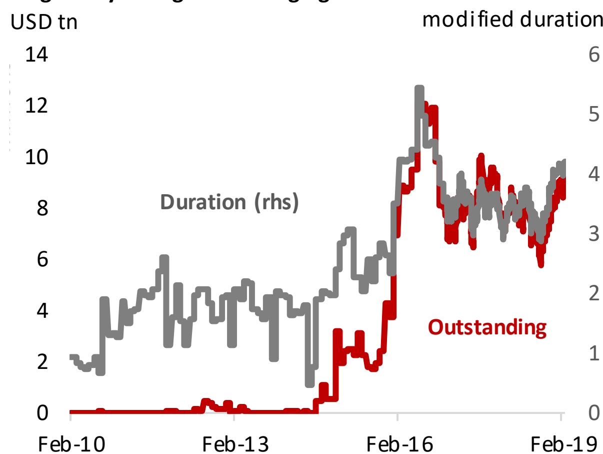
Source: Bloomberg, NY Fed, DBS

We are leaning towards a slowdown, rather than a recession in the US. Notably, a US slowdown over the coming few quarters is probably inevitable as the one-off effects from the tax cuts fade (additional fiscal stimuli appears unlikely in our view). Global challenges have worsened matters. However, **we should be aware that it is much easier for the curve to invert compared to previous cycles.** Bloated central banks' balance sheets and the prospect of an extended period of loose monetary policy (from the ECB, BOJ and other DM central banks) are removing term premium, dragging longer-term DM yields (including USTs) along. This suggests that recession risks (as measured from the 3M/10Y) are probably overestimated. In any case, **the Fed's reaction function has changed. Guarding downside risks is now paramount, as opposed to a bias towards hiking rates.**

Weak global growth

Weak global growth is the single largest challenge currently. PMI figures in Eurozone, China and Japan have not shown any signs of a turnaround. Export data across Asia have also been lacklustre. Accordingly, major central banks have turned dovish. In particular, the growth outlook for the Eurozone is particularly weak with the European Central Bank (ECB) revising 2019's GDP forecast down to 1.1%. Further policy normalisation is off the cards and another round of Targeted longer-term refinancing operations (TLTROs) have been introduced. Rate hike expectations have also been pushed out beyond 2020. Against this backdrop, 10Y German yields have joined 10Y JGB yields at zero (or below). Chinese stimulus (albeit controlled) should eventually stabilise growth in the region, however, the positive effects may take a while to spill over to the rest of the world. Against this backdrop, the Fed's pivot to guard against downside risks makes sense.

Negative yielding debt rising again

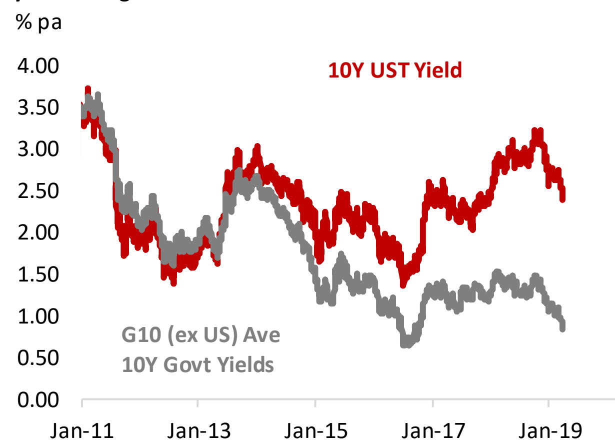


Source: Bloomberg, CEIC, DBS

The gravity of global rates

The global "neutral" rate has drifted much lower on the back of weak global data. We can proxy this by using the average 10Y yields across the G10 economies (excluding the US). This measure is now approaching the all-time low seen in 2016 (when China hardlanding fears, Brexit and easy monetary policies across DM were at play). There has been a similar spike in negative yielding debt. The total outstanding amounts to over USD 9tn, up by USD 1tn since the start of the year. Much like how weak

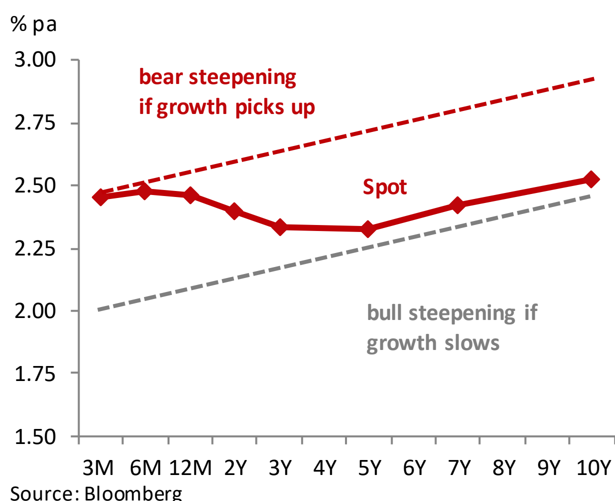
Centre of gravity for DM rates is now lower, dragging US yields along



Source: Bloomberg

global growth can have negative spillover unto the US economy, depressed DM yields will (and have) pull US yields lower. From the experience of 2015/16, it is very difficult for the Fed to run divergent monetary policy from the rest of the world. **With rate hikes ruled out, the market has to price in some risks of the Fed needing to become even more accommodative if the outlook worsens.**

Steepening in the UST curve - bull or bear?



Source: Bloomberg

Steepening, either way?

The UST curve is likely to stay flattish for a while after the end of the hike cycle before steepening inevitably takes place. At the end of the 2004-06 hike cycle, the curve stayed flat (±50bps) for close to 18 months before meaningful steepening took place. For the short 1999/00 cycle, the curve stayed flat (±100bps) for about nine months. **We think that a dovish Fed (relative to economic conditions) should translate into higher inflation expectations in the longer tenors**. Comparatively, a more hawkish Fed should anchor inflation expectations leading to a flatter curve. Unfortunately, the bond forward curve has already factored in further steepening, taking the bet that weakening economic conditions would prompt the Fed to reverse course. For the longer tenors, steepening in the 10Y/30Y segment has been taking place since October. Accordingly, calling for further steepening (than what is priced in the market) in the 2Y/10Y segment may not offer the best risk-to-reward. It may be more attractive to put on fly trades, 2Y/5Y/7Y or 2Y/5Y/10Y to avoid the belly of the curve (which looks rich).

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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