ECOWEEK

No. 18-30, 27 July 2018

Fed: Market considers tightening cycle is well advanced

■ Recent Federal Reserve research shows that the slope of the short end of the yield curve is a more reliable indicator than the commonly used difference between 10-year and 1 or 2-year US Treasury yields ■ In a similar vein, we can look at the difference between the forward 3-month LIBOR rate and the spot rate. This difference has increased as of late ■ However, the level and shape of the entire forward curve show that the market is of the view that the Fed tightening cycle is well advanced

Is the growing media coverage of the US yield curve flattening (see chart) the equivalent of a summer hit on the radio? It is played many times per day, initially you like it but you end up getting bored by it. By now everybody knows that US recessions are generally preceded by a curve inversion so what else is there to be said? Perhaps we should shift our focus a little bit.

One recent interesting contribution came from the Federal Reserve[1] showing that the near-term forward spread does a better job in anticipating downturns than the long-term spread (e.g. 10-year minus 2-year). The former is calculated as the difference between the current implied forward rate (on Treasury bills) six quarters from now and the current yield on a three-month Treasury bills. It reflects market expectations about the near-term monetary policy stance: when it flattens it indicates that the market thinks that the pace of tightening will slow. An inversion would imply an expectation of policy easing over the next 6 quarters. Such an easing, after a tightening cycle, would reflect concern of the central bank about an upcoming slowdown and this makes it also intuitively clear why this indicator provides a better signal than the long-term spread.

Along the same line we can look at the USD LIBOR rates and compare the difference between the 3-month rate in 6-months (so a shorter horizon than in the Fed study) and the 3-month spot rate. Chart 2 (next page) compares the evolution of this difference -the slope of short end segment of the LIBOR curve- to the federal funds rate. The swings in the slope are sometimes considerable. In 2000, the market moved from expecting further tightening to anticipating easing in a matter of months. In 2006 the curve inverted although the economy entered a recession only at the end of 2007.

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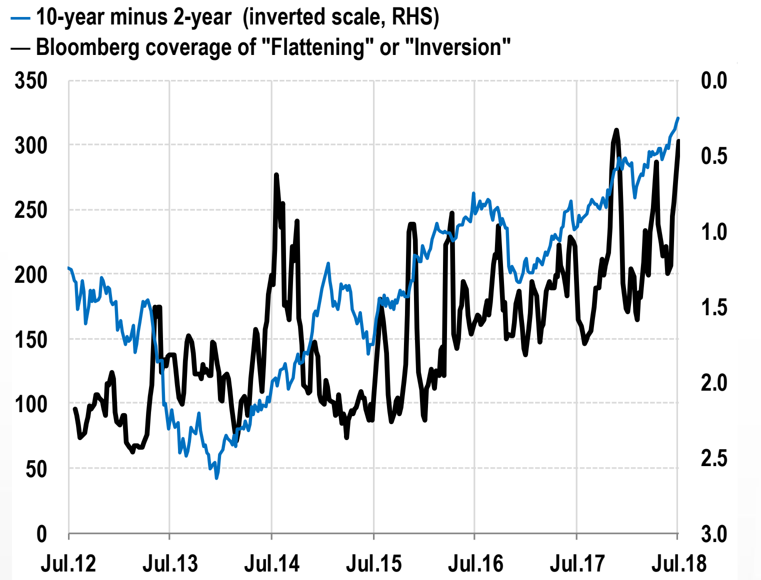
US TREASURY CURVE: EVOLUTION AND MEDIA COVERAGE



Source: Bloomberg, BNP Paribas

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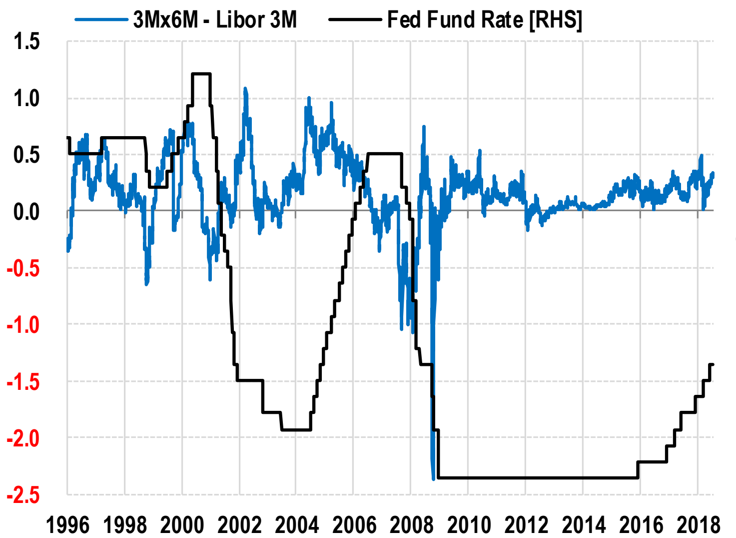
Clearly the slope of the LIBOR curve not only depends on where we are in the business and monetary cycle but also on the level of the policy rate and the forward guidance of the central bank. This helps to understand why the difference between the forward and the spot LIBOR rate was very small in 2012 and 2013. More generally, a low policy rate and a cautious central bank mean that the curve may flatten quite easily based on incoming data, as was the case towards the end of March this year. This could also imply that the spread between the forward and the spot rate is quite volatile, which would reduce its quality as a recession indicator. Nevertheless, against the background of the flattening trend of the long-term spread, the recent steepening of the curve in chart 2 should be welcomed.

Chart 3 shows the evolution since 2015 of the dollar LIBOR forward curve and the observed 3-month LIBOR rate. Until 2017 the curve didn't move much but since then the upward shift has been quite significant, in line with the evolving messages from the Fed. To be noted is that for the most recent observation, the curve is very slightly downward sloping beyond the middle of 2021 which means that the market considers that the peak in Fed funds is not too far away. Going forward we should monitor whether it inverts in a more pronounced way or even earlier than is currently the case because that would spell badly for the economic outlook as seen by the market.

[1] *(Don't) fear the yield curve, Eric Engstrom and Steven Sharpe, FEDS notes, 28 June 2018*

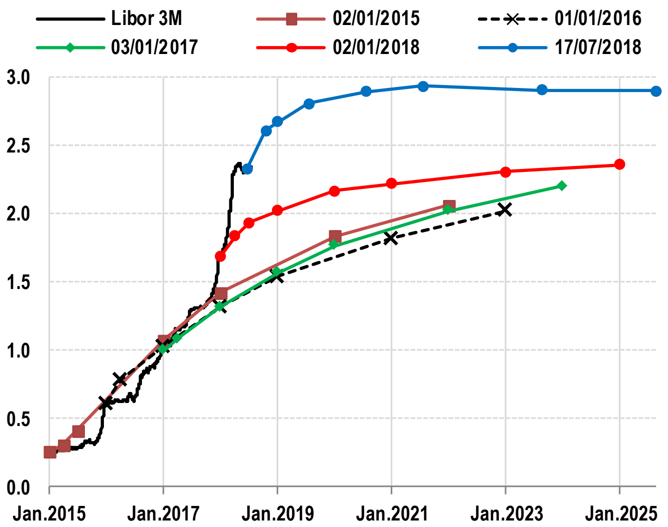
William De Vijlder

CHART 2



Source: Bloomberg, BNP Paribas

CHART 3



Source: Bloomberg, BNP Paribas