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Charts of the Week: Unyielding

A HAVER ANALYTICS® commentary and podcast

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OCTOBER 6TH, 2023
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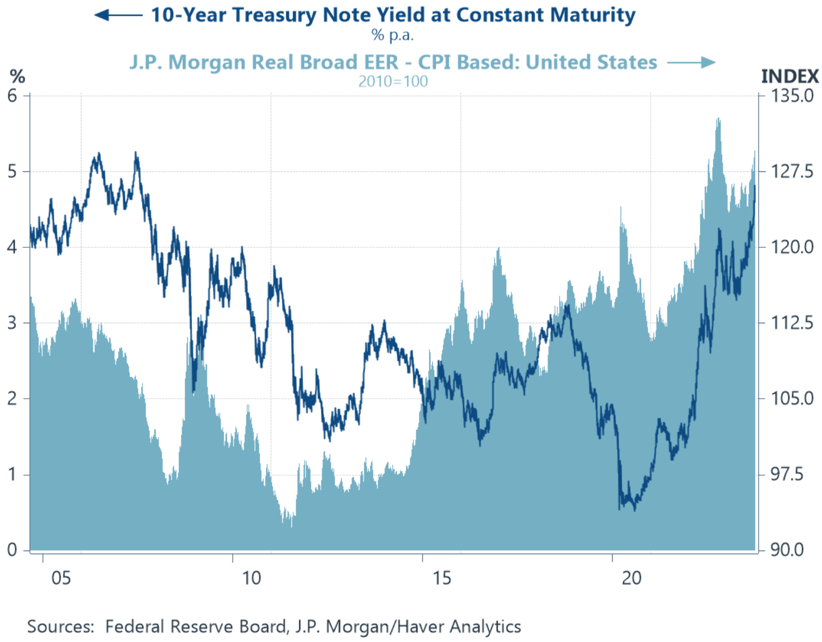
Summary

A further steep climb in US Treasury yields has been in the eye of the storm for financial markets over the past few days. In our charts this week we assess this trend (chart 1) and driving factors. The latter include a tighter-for-longer narrative from the Fed (chart 2), a broader global trend toward quantitative tightening (chart 3), and an oil-related lift in US (and global) inflation expectations (chart 4). We touch too on the potential role that Japan may have played in generating some financial instability in recent weeks (chart 5). We then conclude with some perspective on the implications of these trends for emerging markets (chart 6).

US yields and the dollar

10-year US Treasury yields have climbed relentlessly over the past few weeks to reach their highest levels since mid-2007. Partly for this reason, the real trade-weighted value of the US dollar has been ascending at the same time and presently stands close to a two-decade high. That the US dollar has, on the whole, been climbing at the same time as Treasury yields have been advancing suggests that investors have been more impressed with US fundamentals relative to elsewhere.

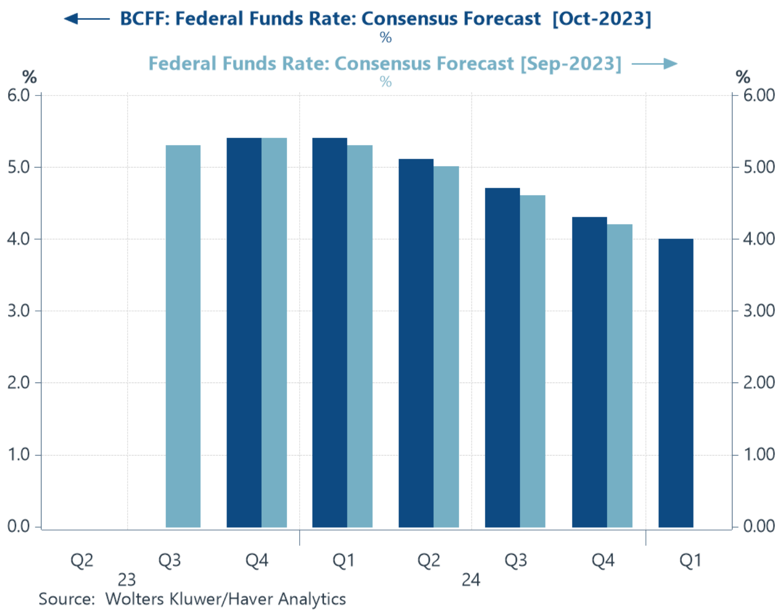
Chart 1: US 10-year Treasury yields versus the real trade weighted value of the US dollar



Consensus forecasts for the Fed

Those relatively sturdy fundamentals have undeniably had an impact on Fed policy. While the Fed's consensus in the "dot plot" still anticipates one more 25bp-increase in the Fed funds rate (FFR) before year end, it nevertheless now sees monetary policy remaining tighter for longer than previously. Specifically, that consensus now anticipates only two 25bp-rate cuts in 2024 while previously it looked for four. This squares too with the latest Blue Chip Financial Forecasts survey, with FFR forecasts over the forecast horizon six to 14 basis points higher in the October survey compared with the September survey (chart 2). The survey's respondents are also now looking for the first FFR cut later than they had previously.

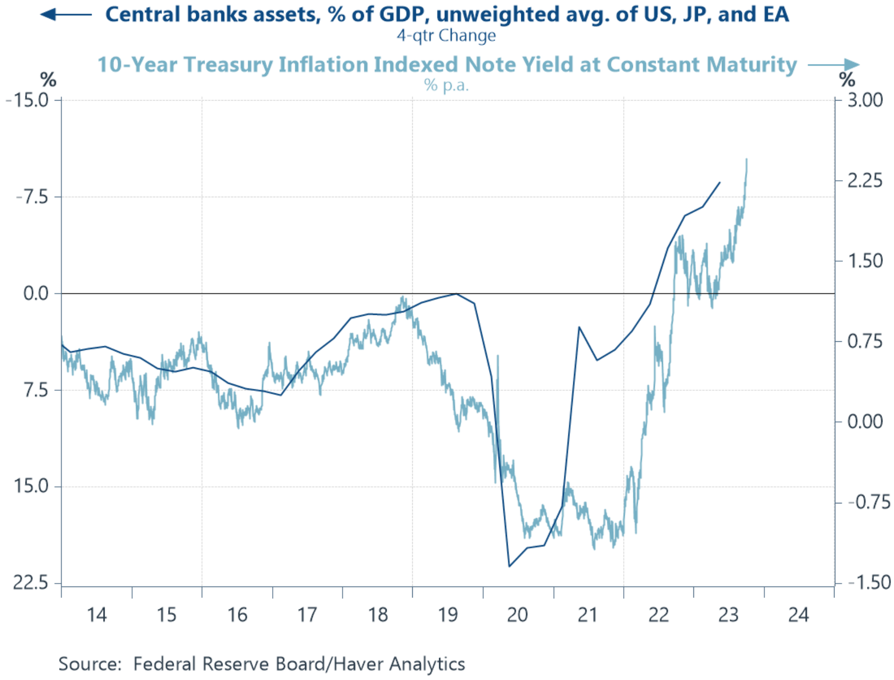
Chart 2: Blue Chip Financial Forecasts: The Fed Funds consensus in October versus September



Quantitative policy and real yields

Another arguably under-appreciated factor, however, that has been driving yields higher, not just in recent weeks, but in recent months, is a global trend toward quantitative tightening. As chart 3 below suggests, it is arguably no surprise that real yields in the US (and elsewhere) have climbed in recent months as the world's major central banks scaled back their purchases of financial assets and of government bonds in particular. That those reduced purchases, moreover, unfolded at the same time as the supply of bonds was increased (thanks to fiscal policy largesse), may have further magnified the upward pressure on yields. After all, US real bond yields were low and often negative when central banks were accumulating these securities on their balance sheets during several phases of quantitative easing. Now that this movie is playing in reverse, as central banks have morphed onto a policy of quantitative tightening, it is little surprise that real yields have been rising.

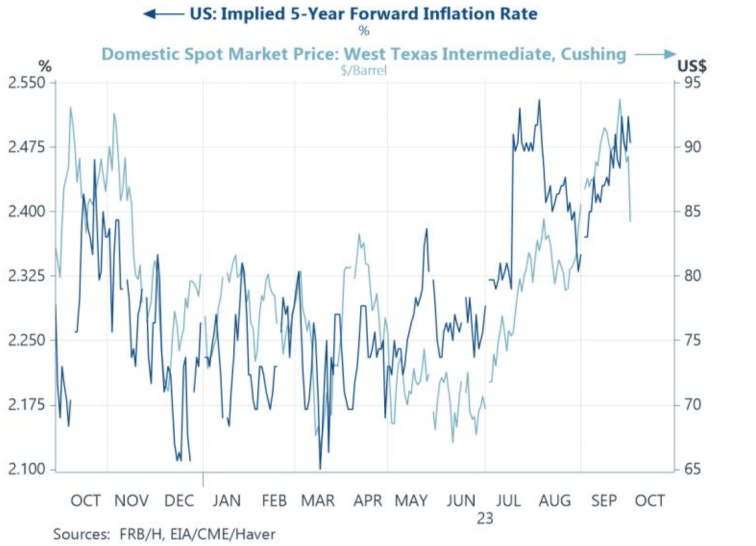
Chart 3: Central banks' balance sheet assets versus 10-year US real yields



Oil prices and inflation expectations

Higher yields can also be traced to a steep climb in the price of oil in recent weeks and the impact of this in re-igniting inflation expectations. Longer-term market-based gauges of US inflation expectations remain closely correlated with the price of oil (see chart 4 below). That the former are presently well above where the Fed would like them to be is a further factor, however, that has fed into a tighter for longer narrative.

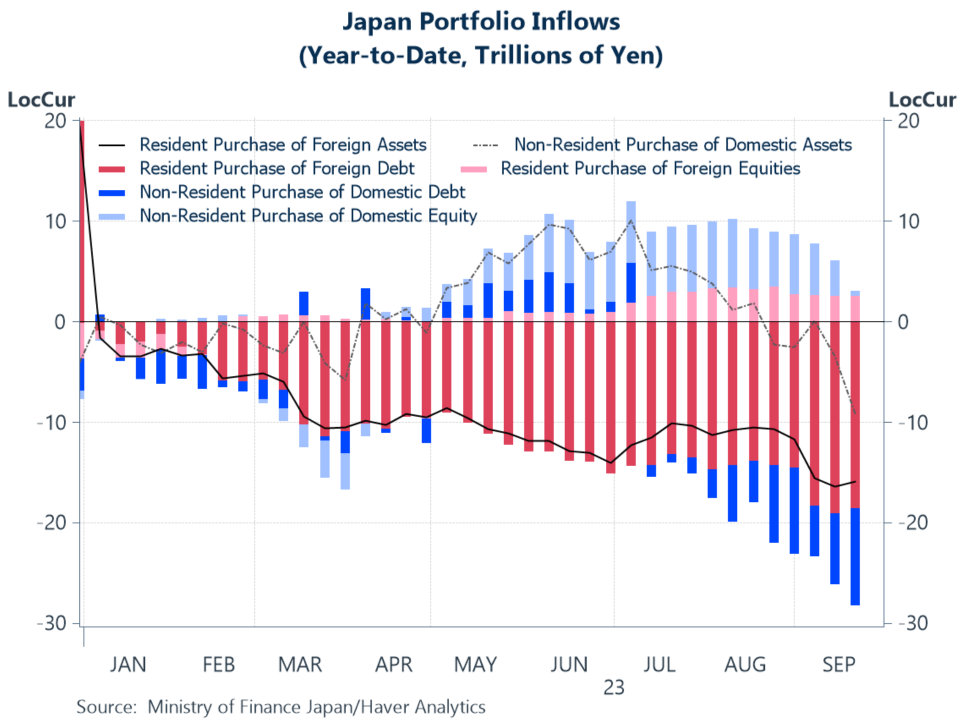
Chart 4: Oil prices and US long-term inflation expectations



Japan’s portfolio flows

Broader global considerations should also be considered in this discussion, including the role of Japan. It may be no coincidence, for example, that US and broader global bond yields have increased more sharply in recent weeks at the same time as JGB yields spiked higher off the heels of some tweaks to the BoJ’s yield curve control policy. With Japanese investors potentially now finding it more profitable to repatriate funds from other asset classes, including US Treasuries, this could have caused global yields to push higher over the last few weeks as well. Digging deeper, however, reveals some flaws in this hypothesis. For Japan’s investors have, in fact, been rebuilding their foreign debt holdings through the year so far. Specifically, Japan’s domestic investors have generated net portfolio cumulative outflows of about ¥15.8 trillion ($110 billion) this year, driven mostly by purchases of foreign debt. Non-resident investors, in the meantime, were cumulative net buyers of Japanese portfolio assets in Q2 this year, but soon became net sellers as their divestments of Japanese debt accelerated.

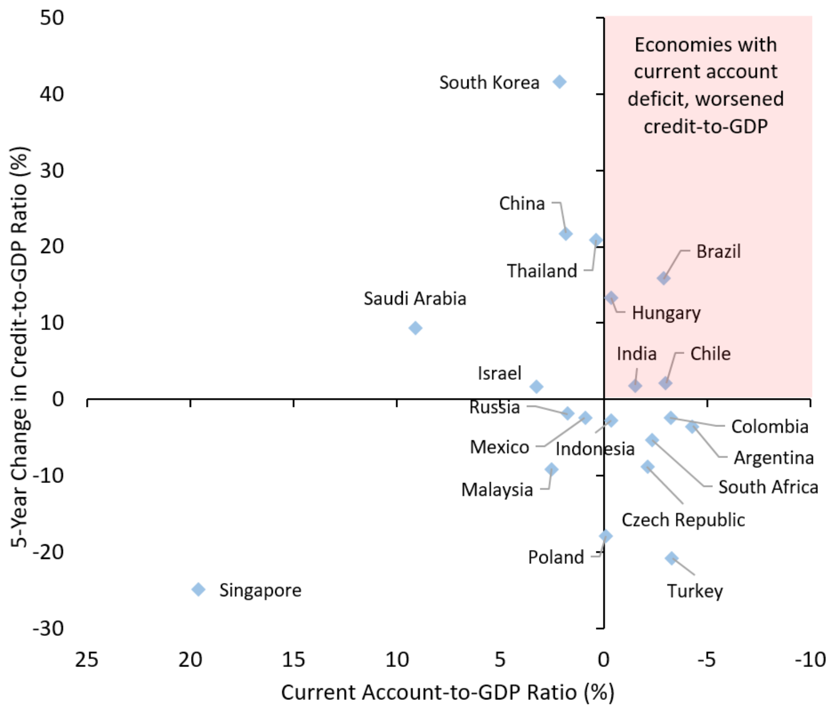
Chart 5: Japan’s portfolio inflows



Emerging market vulnerabilities

Turning finally to some of the broader implications from this, emerging market economies (EM) are likely to now come under the spotlight. A stronger dollar and weaker EM equity markets, after all, suggest that global risk aversion – and an exodus of capital from EM – could have been in the ascendancy in recent weeks. In chart 6 below we attempt to offer some colour on the underlying EM vulnerabilities by comparing the latest data for a country’s current account balance with its build-up (or drawdown) of domestic leverage (measured by the 5-year change in its credit-to-GDP ratio). Those economies in the north-east corner of the chart are – in this straightforward analysis –vulnerable to any further financial strains inasmuch as rising domestic indebtedness have combined with a current account deficit. In short, they are more dependent on capital inflows from overseas to maintain the status quo. Those economies, for the record, include India, Hungary, Chile and Brazil.

Chart 6: Latest current account positions and changes in credit to GDP ratios in selected Ems



Source: BIS, IMF, National Sources, Haver Analytics

ABOUT THE AUTHOR

Haver Analytics is pleased to bring [Andrew Cates's] commentaries on the state of the global economy to its clients.

Andy Cates has more than 25 years of experience forecasting the global economic outlook and in assessing the implications for policy settings and financial markets. He has held various senior positions in London in a number of Investment Banks including as Head of Developed Markets Economics at Nomura and as Chief Eurozone Economist at RBS. These followed a spell of 21 years as Senior International Economist at UBS, 5 of which were spent in Singapore. Prior to his time in financial services Andy was a UK economist at HM Treasury in London holding positions in the domestic forecasting and macroeconomic modelling units.

He has a BA in Economics from the University of York and an MSc in Economics and Econometrics from the University of Southampton.