How the inverted yield curve affects Australia

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ince 1968, the US economy has endured seven recessions and Australia has followed suit in six of these, where each was preceded by an inversion of the US government 10-year yield curve.

Yield curve inversion simply refers to the scenario whereby long-term debt instruments – such that US 10-year bonds represent – begin to display a lower yield than short-term debt instruments of the same credit quality, which, for US observers, has often been US three-month or two-year government treasuries.

Prudently, Australian ultra high net worth investors are now asking if such an upending of the link between time and interest is necessary for a recession to occur, given the seismic moves in US treasury markets since February and following an unprecedented era of unconventional global monetary policies.

These moves since February exceed the most inverted yield curve levels last seen during the nadir of the Great Recession, when in 2007 the 10-year to three-month Treasuries spread was inverted by one fifth of a percentage point.

Global pundits say the bond market is telling us that the current US Federal Reserve rate hike cycle is over and that the US Futures market agrees; evidenced by it pricing in an 80 per cent chance of a rate cut this year and zero chance for a rate hike.

Craig Ferguson, director of strategy at Antipodean Capital, says: “The question remains what are the triggers for the Fed to ease and validate bond market pricing? Well low GDP, inflation and softer data are all parts of the story." He adds that this month's European Central Bank (ECB) announcement “provided the ECB an opportunity to embrace the global central banking trend towards easier policy in response to slowing data and geopolitical instability, but instead it looked as though the ECB just didn’t get the memo".

Japanese move

For Australians, this has led to an unusual outcome whereby one of our largest Australian government bond supporters, the Japanese pension system, has redeployed capital away from Australian treasury securities – which are also paying a price thanks to Australia’s dependence on Chinese trade and capital inflows – and towards French and Spanish treasuries, as the struggle to avoid negative yields is being outweighed by the threat of an escalating Pacific Rim trade dispute, with Australia at its epicentre.

Japanese investors have traditionally been significant buyers of French government bonds as France provides them with a positive yield in Europe, significant liquidity and a credit rating close to AAA, according to S&P.

Looking at the yield curve for France, Spain and Germany, Spain clearly offers better value than France, even though Spain is not as liquid as France and does not have the same credit rating.

However, Spain and thus Spanish government bonds have found themselves in a virtuous circle in terms of their rating in 2019, as all three flagship rating houses – S&P, Fitch and Moody's – have elevated French over Spanish sovereign risks.

Subsequently, Japanese investors sold $US7.5 billion in US treasuries while buying $US27.7 billion in French government bonds during March. Roughly $US43.4 billion went into the latter during the first quarter of 2019 alone, which suggests the other $US15.7 billion came from Japanese investors liquidating their Australian bonds, alongside other fixed-income markets affected by the trade war.

French incentive

Remember that bond market movements are as responsive as they are prescient. So if we take the much lower volatility of 20-year Japanese government bonds into account relative to these 10-year French bonds, the incentive for buying French sovereign debt is falling as we head further into 2019, assuming that this shift from US, Australian and trans-Pacific bonds was motivated by a pure carry-trade perspective.

Australian UHNW investors are also well aware that the Japanese suffered lengthy periods when the market rate of interest was stuck above the natural rate, leading to horrible consequences for domestic Japanese economic growth.

In 2019 what this means is that the Japanese may be redeploying away from Australian and towards French bonds in the short term, but would be unwise to do so for any length of time given their previous experience defying the natural rate of interest.

Between 1993 and 2015, long rates stayed stuck above the Japanese economy's structural growth rate and, as the market rate usually equals the government bond rate plus a risk premium, the Japanese market rate stayed above the natural rate for 12 years.

As a result, Japanese firms faced a cost of capital that exceeded the growth in their earnings, with the corollary that their best available investment was just to pay back debt; this led to a collapse in the velocity of money – the yen – and Japanese domestic banks going bankrupt until 2016.

Australians must respect that bond markets play an invaluable signalling role that continues to be responsive and prescient at the same time.

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