Dark Grey Monday

A Too Slow Fed Or A Too Slow Economy?

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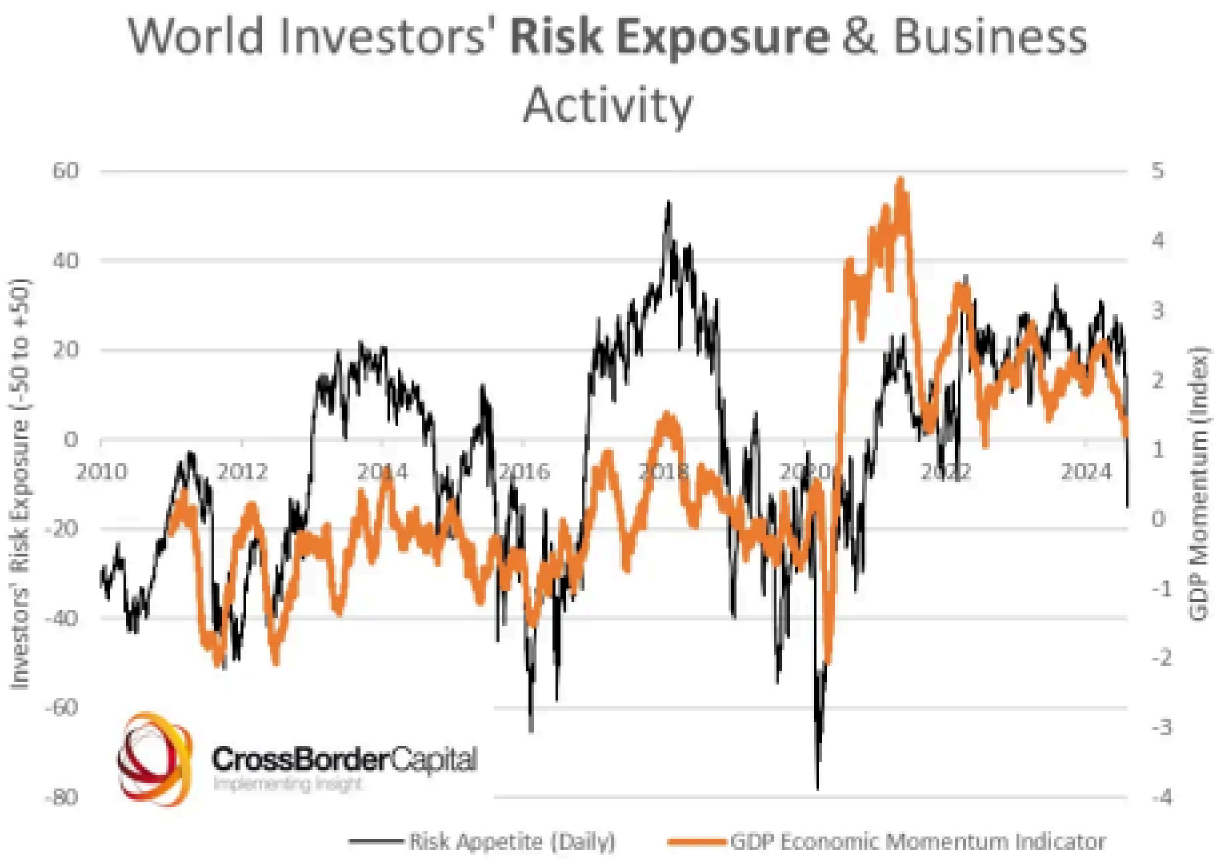
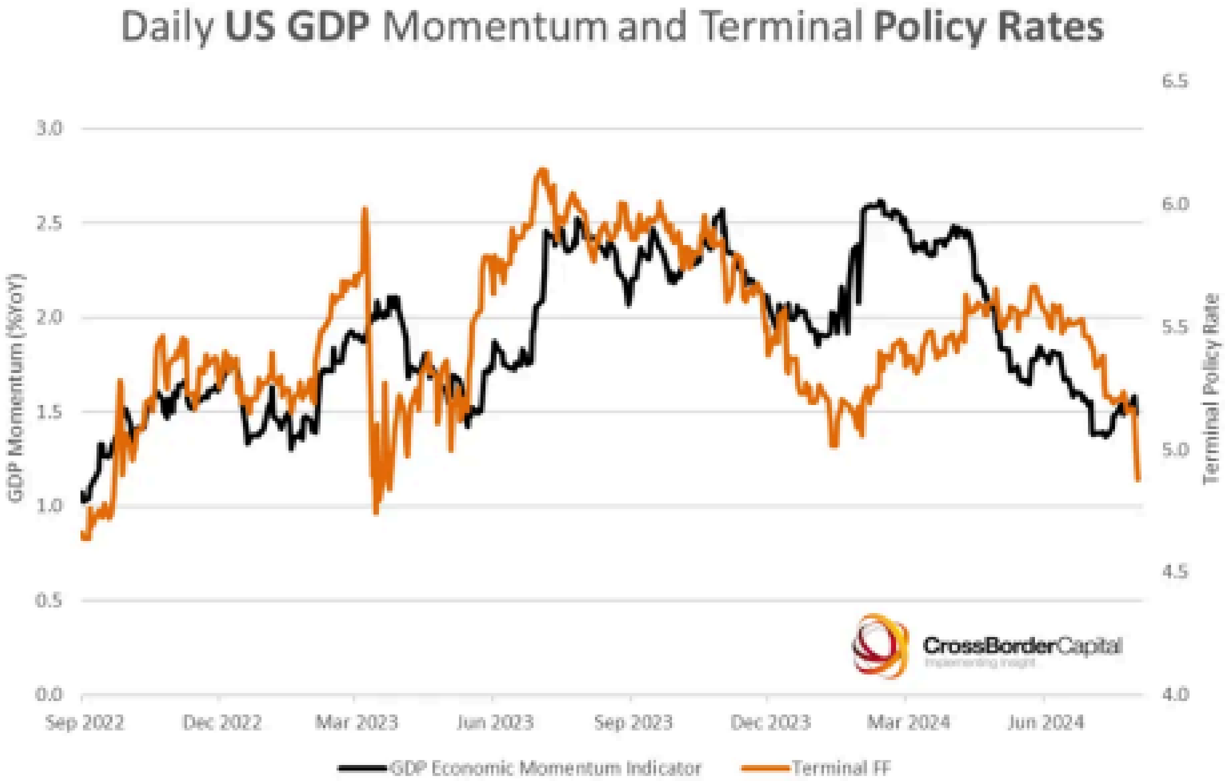
Its always dangerous to catch a falling knife, so let's step back and explore the latest sell-off. Asset prices (P) have two moving parts: a ***liquidity*** component (L) and a ***risk exposure*** component (P/L). These can move independently, but over the long-term they tend to move together. Global Liquidity is seeing a slow, shallow recovery: World investors' risk exposure has lately been elevated. **Major bear markets require a fall in the liquidity trend: this is not yet happening.**

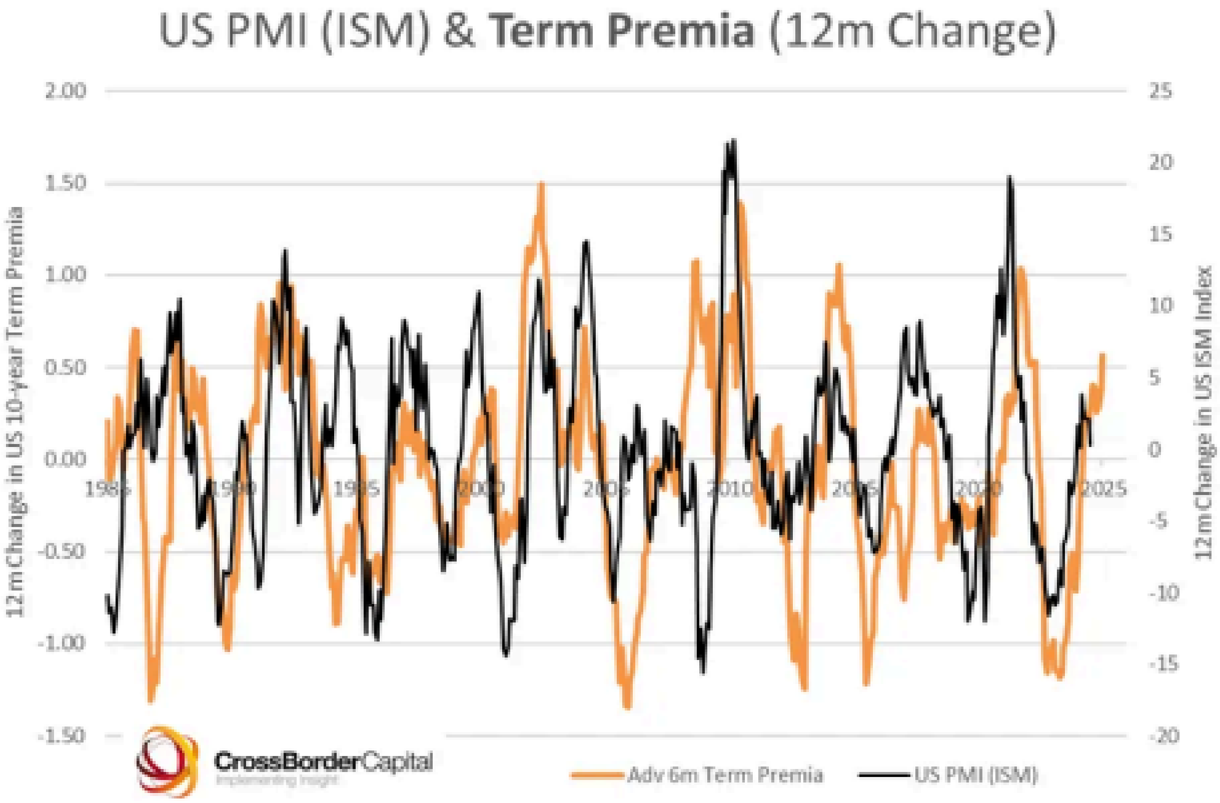
Shorter-term dislocations in risk exposure occur following shocks that unsettle investors and/or warn that they have gotten ahead of what the economy is signalling. We accept that geopolitical tensions are rising and acknowledge that the evolution of this Global Liquidity upturn is painfully slow, but the root of the sell-off is that risk positioning has been high relative to the tempo of World business activity. Latest weak US economic data compound the fear of recession and reinforce concerns that the US Fed is behind the curve. Arguably, the plunge in risk asset prices will help to redress these imbalances. US policy makers really need to ease. Probably, trying hard not to influence the Election, the Fed is inadvertently hurting the economy. However, there will inevitably be negative feedback effects from this sell-off that press down further on the business cycle. The chart below plots our World GDP daily *nowcast* against an index of the risk exposure of World investors (note 'zero' denotes neutral positioning). Typically, the two series move closely together.



The sudden adverse reaction of investors to weak US economic data has hard hit US small caps and economy-sensitive technology names. Skittish Asian investors have cratered the Nikkei index in Japan. There have been rallies in rival paper currencies, namely the Yen and Euro, and even the fragile Chinese Yuan has briefly strengthened. **Capital is likely shifting away from the US dollar and not towards the US dollar, as might be expected in a genuine rush to 'safety' or concerted 'risk off' move.** In fact, US Treasury term premia edged slightly higher last week, with all the action in fixed income markets driven by a collapse in policy rate expectations: 27bp in just three days. The following chart reports our estimates of the US terminal policy rate (risk adjusted) embedded in the term structure. These are plotted alongside our daily US GDP *nowcast*.



Prospective lower policy rates will trigger the usual rally at the front-end of the term structure and add pressure for a steeper yield curve. Yet, a number of commentators argue that this renewed steepening is a further recession signal. There are circumstances when this may be true, but what happens to Treasury bond term premia often decides the economic outcome. Term premia are the extra yields demanded by investors to hold interest rate risk. **Rising term premia are not consistent with economic recession because they indicate a reduced net demand for 'safe' asset bonds.** Interest rates are often slashed in recessions. Hence, investors want more duration risk. The chart below shows the correlation between changes in US term premia and subsequent changes (6 months later) in the US ISM manufacturing survey. Term premia move pro-cyclically with the business cycle.



A clear recession signal would involve both falling rate expectations and falling term premia. This would imply a 'bullish' yield curve steepening with bond yields consistently dropping across the curve. Apart from briefly during these latest panic days, we are not yet convinced this is underway. **It will pay to watch more closely, once the dust has settled.**