Predictions

The Yield Curve Flattening in Q4 2018

Japan bought USTs

Excerpts from our Nov and Dec 2018 newsletters, and our T-Leaf Reading whitepaper, 2/26/2019

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Traditional Thinking – Yield Curve Flattening portends Recessions

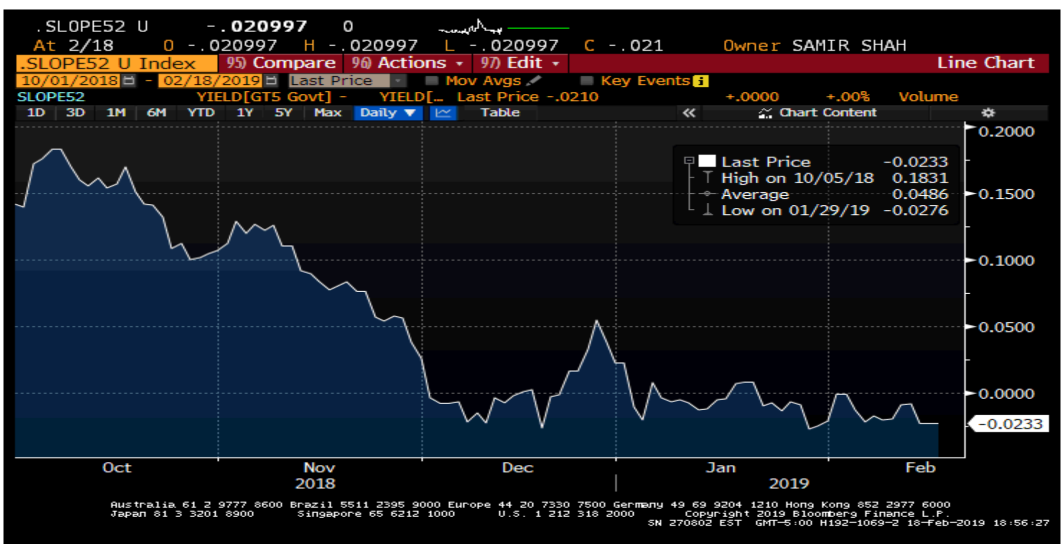
The flattening of the yield curve in November and December 2018 has brought out every Fixed Income research analyst and quotable portfolio manager, who continue to write in newspapers and white papers, and give warnings on TV about the impending recession that the yield curve is signaling, based on their analyses of history.

An example:

https://www.nytimes.com/2018/06/25/business/what-is-yield-curve-recession-prediction.html

> *From this NY Times article: "Every recession of the past 60 years has been preceded by an inverted yield curve, according to research from the San Francisco Fed. Curve inversions have "correctly signaled all nine recessions since 1955 and had only one false positive, in the mid-1960s, when an inversion was followed by an economic slowdown but not an official recession," the bank's researchers wrote in March."*

December 2018: understanding the Yield Curve flattening



In *MBS Mantra's November 2018 newsletter*, (Dec 11, 2018) I wrote the following:

> *There has also been much prognostication from various sources that the flattening, and indeed slight inversion (to 5 years), of the yield curve portends a recession.*
>
> *We disagree. …*
>
> *I fully expect that, in two months' time when the data is released, we will discover that the Bank of Japan purchased a significant amount of US Treasuries in Nov/Dec, to offset the Yen*

strengthening that should have resulted from the equity market selloffs in November and December 2018. …

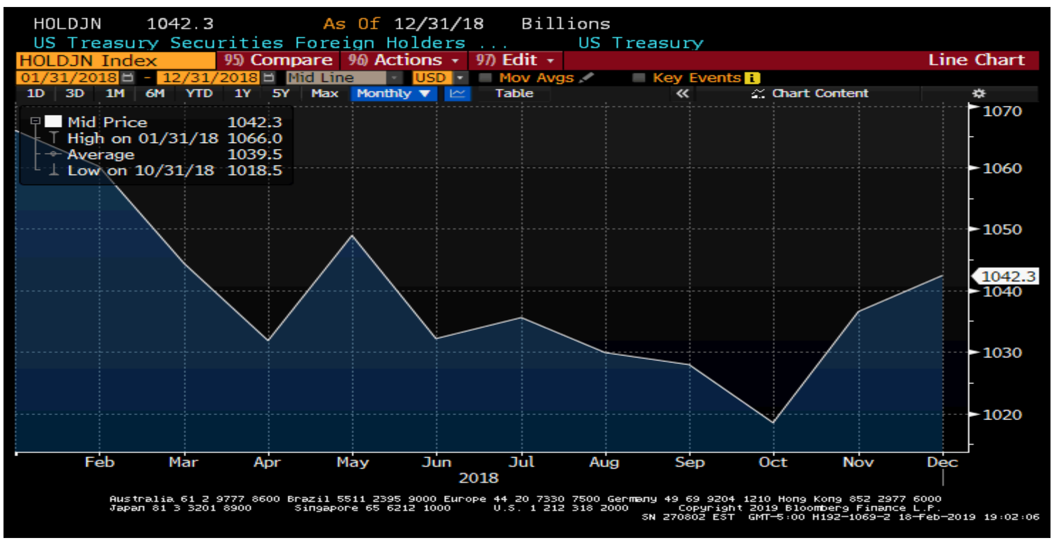
To me, this smells of a Japanese intervention to keep the Yen weak. We last saw this in 2014.

In *MBS Mantra's January 2019 newsletter*, (Feb 10, 2019) I wrote the following

The data for November was released on Jan 31, 2018. (Treasury International Capital or TIC data, released by the US Dept. of the Treasury. HOLDJN Index on the Bloomberg.)

As I expected, the BOJ was indeed a net purchaser of US Treasuries in November, by $18.1 Billion, increasing their holdings to $1.036T. This demand for USTs is what flattened the curve, and triggered a lot of business-TV gobbledegook about historical data showing that flattenings usually predicted recessions, etc.

The graph below, from end of month TIC data, shows that Japan added to their UST holdings in November and December 2018, bringing their recent purchases to $23.8b. The Treasury classifies most of Japan's holdings as 'Long-Term' in bond maturity.



In addition, total UST holdings by Major Foreign Holders increased by $65.2b between Oct and Dec 2018. https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/ticsec2.aspx

<u>As an unintended consequence, Japan's (and other Foreign) purchases of USTs amount to QE to the US</u>, and increase our money supply (primarily M3, no longer published), directly manifesting in asset inflation. In today's world, such changes can offset the Fed's QT, or can exacerbate it if foreign holdings are reduced.

This QE injection from foreign UST purchases explains the rally in the S&P in 2019 that is attributed to Chairman Powell 'blinking' on interest rates.

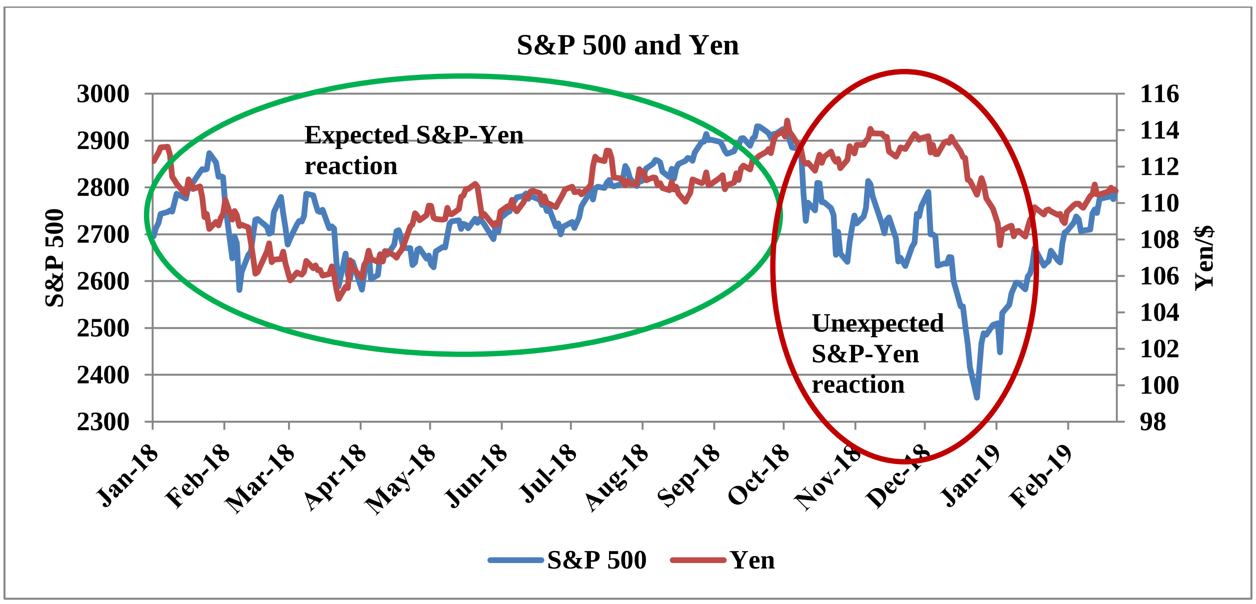
As will be discussed in more detail later, Japan has supplied us with QE before, when they dramatically increased their US Treasury holdings between 2002 and 2004, and implemented US QT as well, when they unwound their holdings. A study of this period gives us a roadmap of what to expect.

We prefer to follow Japan's UST holdings to draw conclusions about movements in Treasury yields, as they tend to be the largest marginal foreign actor in the UST markets. In addition, their motivations can be understood, as I will describe below.

Yen strengthened to 75 Y/$ during the Crisis, and would have gone to 50 Y/$ had Prime Minister Abe not been re-elected. Since 2012, there appears to be a strong policy to keep the Yen weak. **In essence, what Japan is doing now is providing the US with 'Plunge Protection', by injecting US money supply when it is needed.**

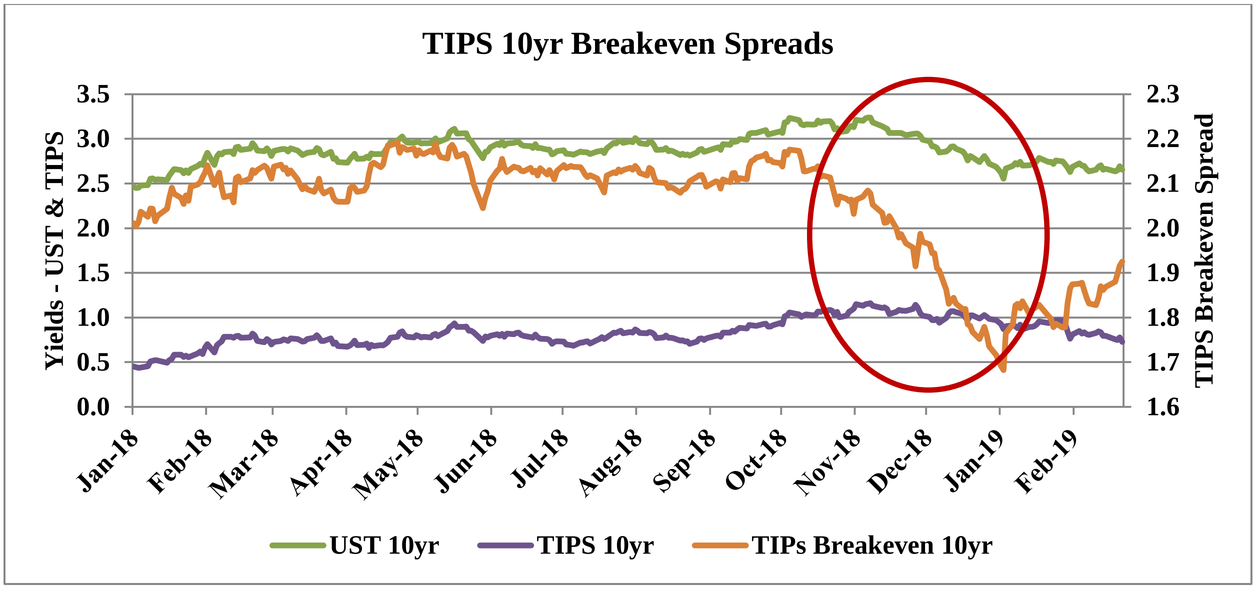
How did we anticipate this:

In December 2018, the S&P declined from 2790 to 2351, a 15% move! However, the Yen only strengthened from 113.8 to 112.7, barely responding. **This lack of Yen response, to me, smelled of an intervention by the BOJ, who probably bought USTs to keep the Yen weak (selling Yen).**



We verified the purchase of USTs by looking at TIPS breakeven spreads.

External demand for USTs should tighten TIPS spreads (since USTs always yield more than TIPS). 10yr USTs went from 2.65% yield to 2.55% yield, while 5yr USTs declined by 75 bps from Nov to the end of Dec. 10yr TIPS breakevens started declining from over 2% to 1.68% at the end of December as UST yields declined.



<u>The outsized tightening in "inflation expectations" in November/December 2018 corroborated the information from the S&P/Yen moves, leading to my conclusion.</u>

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