

ECOWEEK

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The US yield curve: be careful what you wish for

- The flattening of the US treasury curve has received a lot of attention as of late because historically recessions have been preceded by an inversion of the yield curve
- A rather flat curve does not imply that a recession is imminent
- However, historically once the yield curve starts to steepen after having flattened or inverted, a recession follows quite soon thereafter
- Rather than focussing on the slope of the curve, one should wonder when the Fed will stop tightening

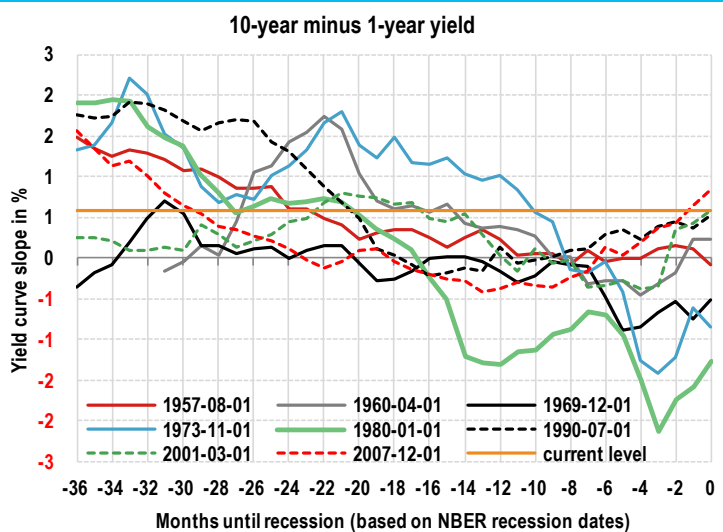
Be careful what you wish for. The concern about the flattening of the US treasury curve suggests people would be relieved if the flattening would stop. However, the historical experience shows this would give even more reason for concern. Past recessions in the US have been preceded by a yield curve flattening followed by an inversion but this knowledge is of little help when producing forecasts or, as an investor, doing market timing. Indeed, the time lag between a flat to negatively sloped curve and the start of a recession is long and variable (see chart). With the historical relationship between the slope and economic downturns in mind, one is inclined to hope that at some point the curve would steepen again. This could happen either because the 10-year yield rises more than the 1-year yield or because the latter would drop more than the former. In the first case, the curve steepens and shifts upwards. Under the assumption that the term premium* does not change, this would require a considerable increase in the long-term growth outlook which would pull upwards the entire path of future short-term interest rates. Given the mature stage of the business cycle, it seems hard to count on such a steepening for a prolonged period, if only because it would force the Federal Reserve to tighten policy much more aggressively. This would weigh on the long-term growth perspectives and cause the curve to flatten again.

In the second case, the entire curve shifts down and steepens because yields at the short end decline more than at the long end of the curve. This would reflect a downward revision in the growth outlook which triggers an anticipation of an ending of policy tightening and an imminent start of monetary easing.

.../...

* The term premium is the extra yield a bond investor receives for taking duration risk, that is for buying a long-dated bond rather than continuously rolling over short-dated paper. In the US this premium has actually been negative most of the time in recent years.

US TREASURY CURVE IN THE RUN-UP TO A RECESSION



Source: FRED(Federal Reserve of St Louis), BNP Paribas

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ECONOMIC RESEARCH DEPARTMENT



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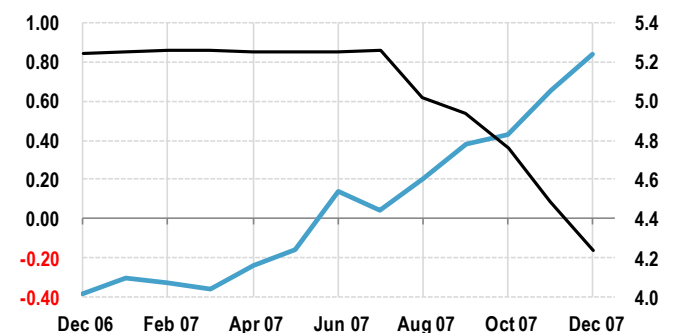
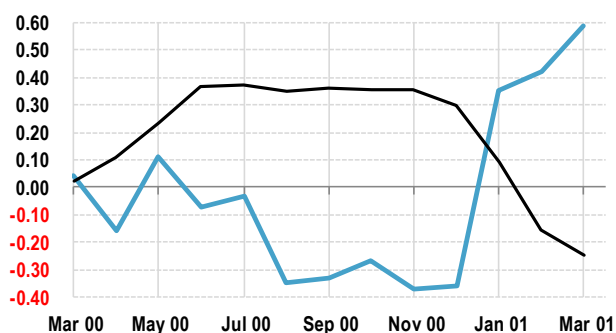
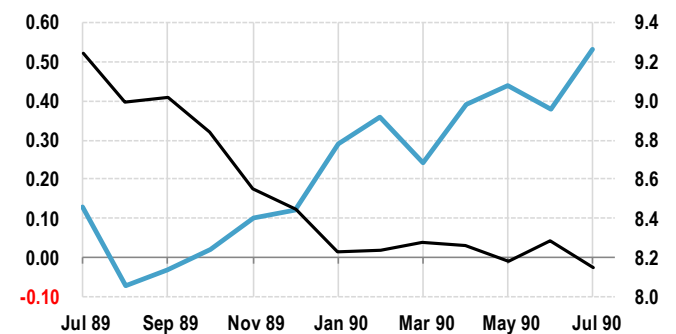
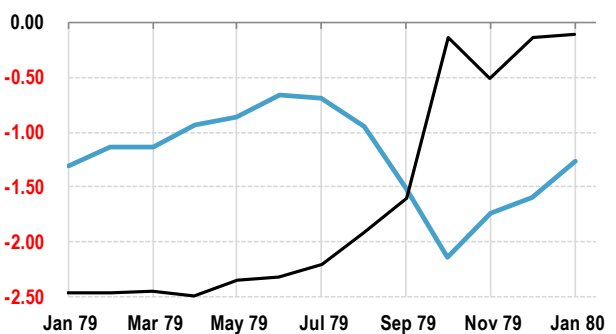
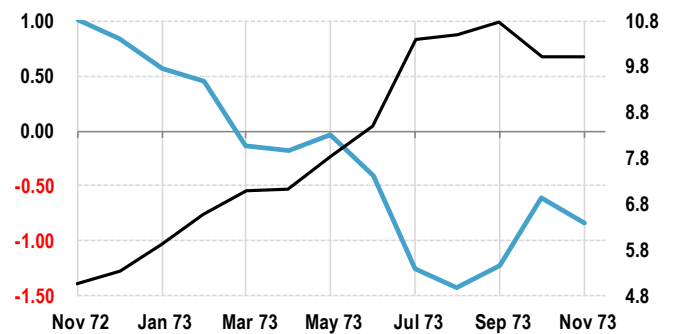
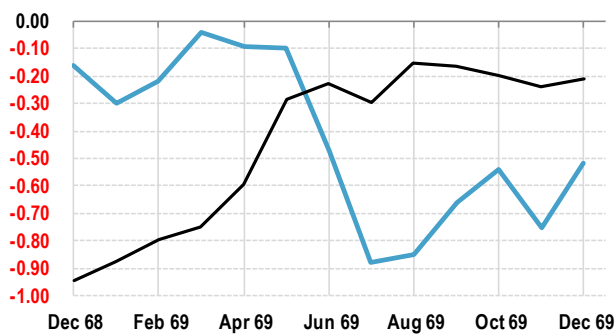
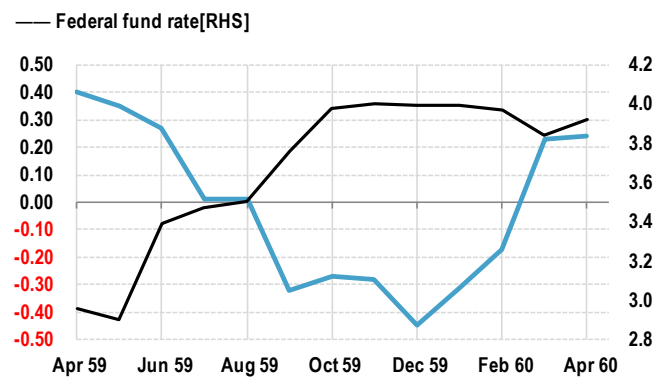
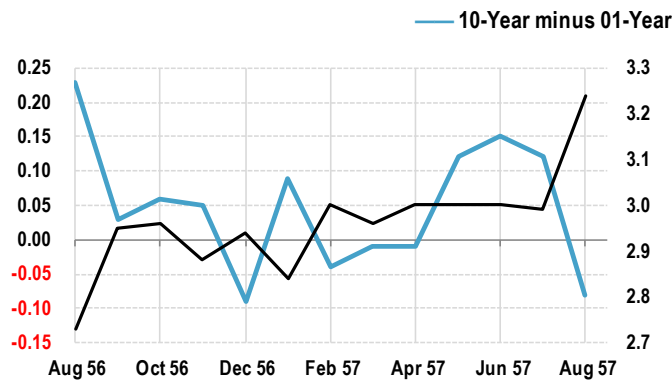
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These charts show the slope of the yield curve and the federal funds rate in the months before a recession (the last month on the horizontal axis corresponds to the start of the recession based on the NBER recession dates; the recession of July 1981 is not shown because the money supply targeting strategy of the Federal Reserve implied a high degree of interest rate volatility). In most cases, when the curve starts to steepen, a recession follows quite soon thereafter. This means that

the lead time is shorter and less variable than the time between the curve inversion and the subsequent recession. The charts also show that the steepening of the curve mostly occurred in anticipation of a policy easing. From this perspective, assessing when the Fed will stop tightening in this cycle seems a question of bigger importance than focussing on the slope of the yield curve.

William De Vijlder



Source : FRED(Federal Reserve of St Louis), BNP Paribas



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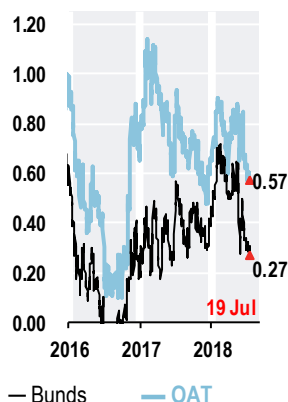
Markets overview

The essentials

Week 13-7 18 > 19-7-18

➤ CAC 40	5 429	➤ 5 417	-0.2 %
➤ S&P 500	2 801	➤ 2 804	+0.1 %
➤ Volatility (VIX)	12.2	➤ 12.9	+0.7 pb
➤ Euribor 3M (%)	-0.32	➤ -0.32	+0.0 bp
➤ Libor \$ 3M (%)	2.34	➤ 2.35	+1.2 bp
➤ OAT 10y (%)	0.57	➤ 0.57	+0.7 bp
➤ Bund 10y (%)	0.28	➤ 0.27	-1.3 bp
➤ US Tr. 10y (%)	2.83	➤ 2.85	+1.6 bp
➤ Euro vs dollar	1.17	➤ 1.16	-0.5 %
➤ Gold (ounce, \$)	1 242	➤ 1 217	-2.0 %
➤ Oil (Brent, \$)	75.5	➤ 73.3	-3.0 %

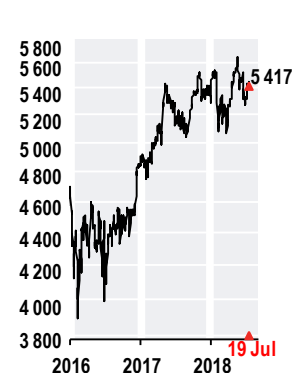
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates	highest' 18	lowest' 18
€ ECB	0.00 at 01/01	0.00 at 01/01
Eonia	-0.37 at 01/01	-0.37 at 18/05
Euribor 3M	-0.32 at 29/05	-0.33 at 01/01
Euribor 12M	-0.18 at 11/07	-0.19 at 19/02
\$ FED	2.00 at 14/06	1.50 at 01/01
Libor 3M	2.35 at 04/05	1.69 at 01/01
Libor 12M	2.80 at 18/07	2.11 at 01/01
£ BoE	0.50 at 01/01	0.50 at 01/01
Libor 3M	0.75 at 19/04	0.52 at 04/01
Libor 12M	1.01 at 17/04	0.76 at 03/01

At 19-7-18

Yield (%)	highest' 18	lowest' 18
€ AVG 5-7y	0.90 at 08/06	0.41 at 18/04
Bund 2y	-0.63 at 07/03	-0.79 at 29/05
Bund 10y	0.27 at 15/02	0.27 at 19/07
OAT 10y	0.91 at 08/02	0.57 at 13/07
Corp. BBB	1.67 at 11/06	1.17 at 08/01
\$ Treas. 2y	2.62 at 17/07	1.89 at 01/01
Treas. 10y	3.13 at 17/05	2.41 at 01/01
Corp. BBB	4.42 at 17/05	3.59 at 01/01
£ Treas. 2y	0.85 at 21/03	0.40 at 01/01
Treas. 10y	1.67 at 15/02	1.23 at 01/01

At 19-7-18

10y bond yield & spreads

4.38%	Greece	410 pb
2.51%	Italy	223 pb
1.74%	Portugal	147 pb
1.29%	Spain	102 pb
0.64%	Belgium	37 pb
0.57%	France	30 pb
0.52%	Austria	25 pb
0.51%	Ireland	24 pb
0.43%	Netherlands	16 pb
0.43%	Finland	15 pb
0.27%	Germany	

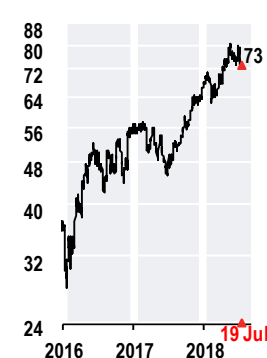
Commodities

Spot price in dollars	lowest' 18	2018(€)
Oil, Brent	73.3 at 13/02	+13.8%
Gold (ounce)	1 217 at 19/07	-3.4%
Metals, LME	2 977 at 17/07	-10.0%
Copper (ton)	6 040 at 19/07	-13.3%
CRB Foods	340 at 04/04	+4.6%
wheat (ton)	189 at 16/01	+22.8%
Corn (ton)	126 at 11/07	+2.4%

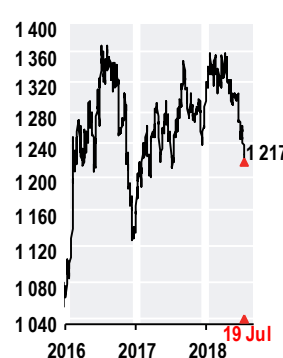
At 19-7-18

Variations

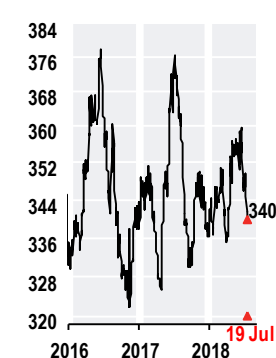
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

€ =	highest' 18	lowest' 18	2018
USD	1.25 at 25/01	1.16 at 29/05	-3.3%
GBP	0.89 at 02/03	0.86 at 17/04	+0.6%
CHF	1.20 at 19/04	1.15 at 31/05	-0.6%
JPY	137.29 at 02/02	125.87 at 29/05	-3.1%
AUD	1.61 at 26/03	1.53 at 09/01	+3.0%
CNY	7.92 at 25/01	7.42 at 29/05	+0.6%
BRL	4.62 at 06/07	3.87 at 08/01	+13.0%
RUB	79.12 at 11/04	68.06 at 09/01	+6.6%
INR	81.39 at 25/04	75.92 at 08/01	+4.5%

At 19-7-18

Variations

Equity indices

Index	highest' 18	lowest' 18	2018	2018(€)
CAC 40	5 640 at 22/05	5 066 at 26/03	+2.0%	+2.0%
S&P500	2 873 at 26/01	2 581 at 08/02	+4.9%	+8.5%
DAX	13 560 at 23/01	11 787 at 26/03	-1.8%	-1.8%
Nikkei	24 124 at 23/01	20 618 at 23/03	-0.0%	+3.2%
China*	83 at 26/01	83 at 19/07	-5.5%	-2.6%
India*	642 at 29/01	547 at 23/05	+0.4%	-4.0%
Brazil*	1 742 at 26/01	1 603 at 27/06	+0.6%	-11.0%
Russia*	707 at 26/02	571 at 16/04	+7.2%	+1.9%

At 19-7-18

Variations

* MSCI index



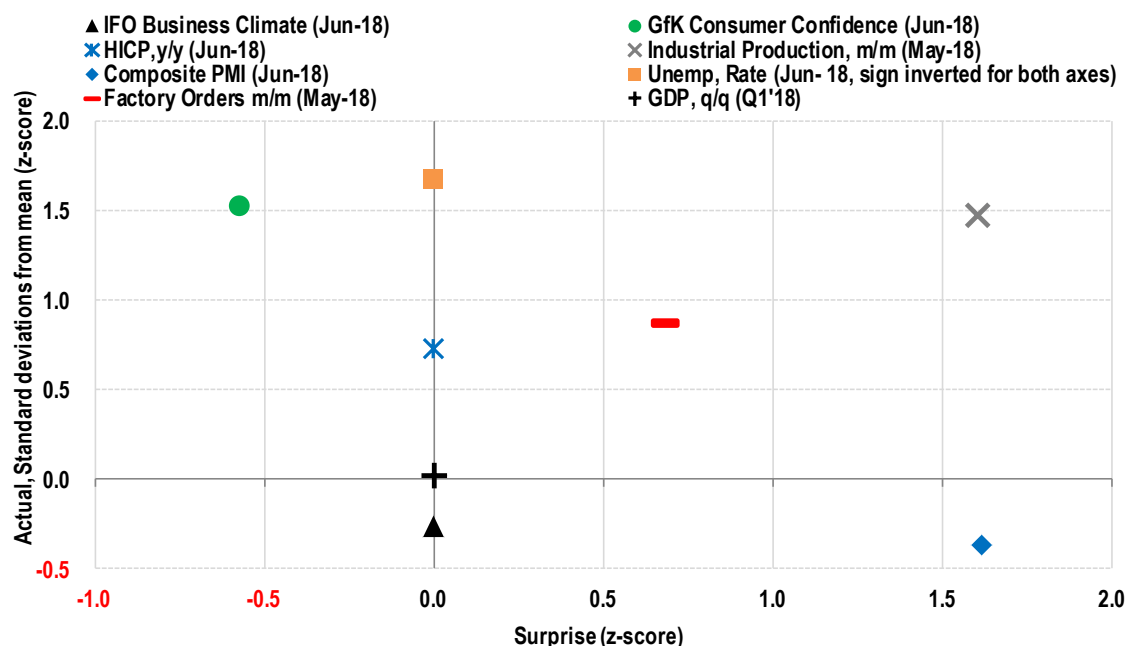
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Pulse

Germany: Slowing growth

In recent months, both survey and hard data have been pointing to slowing growth in Germany. In June, the IFO climate index declined again, as companies reported a further deterioration of the actual business situation. However, signs of stabilisation can be observed. In June, the PMI composite index of manufacturing and services actually strengthened more than expected. Nevertheless, the risks remain elevated as the German car industry is a possible target in the US-EU trade conflict. Consumers are shrugging off these geo-political worries and the strong rise in consumer prices, largely due to petrol prices. They are more concentrating on the good labour market situation and substantial gains in purchasing power following recent generous pay deals.



Note: z-score is a score which indicates how many standard deviations an observation is from the mean: $z = (x - \mu) / \sigma$ where x : observation, μ : mean, σ : standard deviation. On the X-axis, x corresponds at the last known surprise for each indicator represented on the graph, μ and σ corresponds respectively to the mean and the standard deviation of the last 24 value for monthly data and the last 8 quarters for quarterly data. On the Y-axis, x corresponds at the last known value of indicator, μ and σ corresponds respectively to the mean and the standard deviation for this indicator since 2000 (for China since 2011).

Source: Bloomberg, IFO, BNP Paribas

Indicators preview

A busy schedule next week with GDP growth for the second quarter in several countries (US, France, UK) and for the month of July, the Markit PMI surveys, business confidence in France, consumer confidence for the eurozone and the US, the IFO business climate for Germany. The highlight of the week is the ECB meeting followed by the press conference of Mario Draghi.

Date	Country	Event	Period
07/23/18	Eurozone	Consumer Confidence	July
07/24/18	France	Business Confidence	July
07/24/18	France	Markit France Composite PMI	July
07/24/18	Eurozone	Markit Eurozone Composite PMI	July
07/25/18	Germany	IFO Business Climate	July
07/26/18	Germany	GfK Consumer Confidence	August
07/26/18	France	Consumer Confidence	July
07/26/18	United Kingdom	GDP QoQ	2Q
07/26/18	Eurozone	ECB Main Refinancing Rate	July 26
07/26/18	United States	Durable Goods Orders	June
07/27/18	France	GDP QoQ	2Q
07/27/18	United States	GDP Annualized QoQ	2Q
07/27/18	United States	University of Michigan Sentiment	July

Source: Bloomberg, BNP Paribas



Economic scenario

UNITED STATES

■ Despite slow start, economy is expected to expand at a 3% or so in 2018, thanks to tax cuts, booming profits and credit. However, the current weakening in external trade indexes put the risk on the downside.

■ Inflation is accelerating in the wake of higher oil prices and more evident tensions in the labour market.

■ The Fed will keep on normalizing monetary conditions. We forecast the Fed Funds target rate to reach 2.75% by early

CHINA

■ Economic growth will decelerate in 2018. Despite the slowdown, the central bank will have to continue to act to encourage the deleveraging of financial institutions and corporates and reduce financial instability risks. Fiscal policy should remain expansionist.

■ The outlook for exports and household spending is rather favourable in the short term, but the tightening of domestic credit conditions, restructuring measures in the industry and less buoyant property market will weigh on economic activity.

EUROZONE

■ The recovery is continuing, although it has been weaker than expected at the start of the year. Intra-EU trade builds with domestic demand, especially corporate investment.

■ Inflation has rebounded in the wake of higher oil prices, but the core CPI trend remains subdued. Along with renewed tensions over sovereign debt spreads (Italy) this argues for the ECB to keep on buying until year end at least, and to maintain the status quo on key rates thereafter (first hike seen in Q4'19).

FRANCE

■ Growth remains robust but gets back down to a less rapid pace than in 2017. Households' consumption is supported by the jobs recovery but restrained by the upturn in inflation. Investment and exports dynamics remain favourable. Risks are on the downside. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

■ In the US, ongoing strong growth and a very low unemployment rate pave the way for several rate hikes (we expect 4 this year and 1 next). This will put upward pressure on bond yields in 2018. The ECB is expected to stop its QE programme at the end of 2018 and to hike its rates by the middle of 2019. As a consequence, bond yields should follow a rising trend, including in 2019. No change expected in Japan

■ The narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

SUMMARY

%	GDP Growth			Inflation		
	2017	2018 e	2019 e	2017	2018 e	2019 e
Advanced	2.3	2.3	1.5	1.8	2.1	1.9
United-States	2.3	2.9	1.8	2.1	2.5	2.1
Japan	1.7	0.9	0.5	0.5	0.9	0.9
United-Kingdom	1.7	1.4	1.3	2.7	2.8	2.2
Euro Area	2.6	2.2	1.5	1.5	1.8	1.8
Germany	2.5	2.0	1.6	1.7	1.9	2.0
France	2.3	2.0	1.8	1.2	2.0	1.6
Italy	1.6	1.3	1.0	1.3	1.4	1.7
Spain	3.1	2.8	2.0	2.0	1.7	1.7
Netherlands	3.2	2.3	1.7	1.3	1.7	1.8
Emerging	5.9	5.9	5.8	2.4	3.1	3.2
China	6.9	6.4	6.0	1.6	2.3	2.5
India	6.7	7.4	7.6	3.6	4.5	4.4
Brazil	1.0	2.0	3.5	3.4	3.7	3.8
Russia	1.5	1.8	1.6	3.7	3.5	4.4

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

INTEREST RATES & FX RATES

Interest rates, %		2018				2017	2018e	2019e
End of period		Q1	Q2	Q3e	Q4e			
US	Fed Funds	1.75	2.00	2.25	2.50	1.50	2.50	2.75
	Libor 3m \$	2.31	2.34	2.50	2.65	1.69	2.65	2.55
	T-Notes 10y	2.75	2.86	3.20	3.25	2.41	3.25	3.00
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.25
	Euribor 3m	-0.33	-0.32	-0.33	-0.33	-0.33	-0.33	0.07
	Bund 10y	0.50	0.31	0.90	1.10	0.42	1.10	1.50
	OAT 10y	0.60	0.62	1.15	1.35	0.66	1.35	1.75
UK	Base rate	0.50	0.50	0.75	0.75	0.50	0.75	1.25
	Gilt 10y	1.39	1.33	1.60	1.75	1.23	1.75	2.10
Japan	BoJ Rate	-0.07	-0.07	-0.10	-0.10	-0.04	-0.10	-0.10
	JGB 10y	0.04	0.03	0.05	0.05	0.05	0.05	0.00

Exchange Rates		2018				2017	2018e	2019e
End of period		Q1	Q2	Q3e	Q4e			
USD	EUR / USD	1.23	1.17	1.15	1.24	1.20	1.24	1.34
	USD / JPY	106	111	107	104	113	104	98
	GBP / USD	1.40	1.32	1.29	1.41	1.35	1.41	1.52
	USD / CHF	0.96	0.99	1.03	0.97	0.97	0.97	0.93
EUR	EUR / GBP	0.88	0.88	0.89	0.88	0.89	0.88	0.88
	EUR / CHF	1.18	1.16	1.19	1.20	1.17	1.20	1.25
	EUR / JPY	131	129	123	129	135	129	131

Source: GlobalMarkets BNP Paribas (e: estimates & forecasts)



GROUP ECONOMIC RESEARCH

■ **William DE VIJDER**
Chief Economist

+33.(0)1 55 77 47 31

william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

■ **Jean-Luc PROUTAT**
Head

+33.(0)1.58.16.73.32

jean-luc.proutat@bnpparibas.com

■ **Alexandra ESTIOT**

Works coordination - United States - United Kingdom - Globalisation

+33.(0)1.58.16.81.69

alexandra.estiot@bnpparibas.com

■ **Hélène BAUDCHON**

France (short-term outlook and forecasts) - Labour markets

+33.(0)1.58.16.03.63

helene.baudchon@bnpparibas.com

■ **Frédérique CERISIER**

Euro Area (European governance and public finances), Spain, Portugal

+33.(0)1.43.16.95.52

frederique.cerisier@bnpparibas.com

■ **Thibault MERCIER**

Euro Area (short-term outlook and monetary policy), France (structural reforms)

+33.(0)1.57.43.02.91

thibault.mercier@bnpparibas.com

■ **Catherine STEPHAN**

Nordic countries - World trade - Education, health, social conditions

+33.(0)1.55.77.71.89

catherine.stephan@bnpparibas.com

■ **Raymond VAN DER PUTTEN**

Germany, Netherlands, Austria, Switzerland - Energy, climate - Long-term projections

+33.(0)1.42.98.53.99

raymond.vanderputten@bnpparibas.com

■ **Tarik RHARRAB**

Statistics and Modelling

+33.(0)1.43.16.95.56

tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

■ **Laurent QUIGNON**
Head

+33.(0)1.42.98.56.54

laurent.quignon@bnpparibas.com

■ **Céline CHOLET**

+33.(0)1.43.16.95.54

celine.cholet@bnpparibas.com

■ **Thomas HUMBLLOT**

+33.(0)1.40.14.30.77

thomas.humbloit@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

■ **François FAURE**

Head - Argentina, Central European countries

+33.(0)1 42 98 79 82

francois.faure@bnpparibas.com

■ **Christine PELTIER**

Deputy Head - Greater China, Vietnam, other North Asian countries, South Africa

+33.(0)1.42.98.56.27

christine.peltier@bnpparibas.com

■ **Stéphane ALBY**

Africa (French-speaking countries)

+33.(0)1.42.98.02.04

stephane.alby@bnpparibas.com

■ **Sylvain BELLEFONTAINE**

Turkey, Central European countries

+33.(0)1.42.98.26.77

sylvain.bellefontaine@bnpparibas.com

■ **Sara CONFALONIERI**

Africa (Portuguese & English-speaking countries)

+33.(0)1.42.98.43.86

sara.confalonieri@bnpparibas.com

■ **Pascal DEVAUX**

Middle East, Balkan countries

+33.(0)1.43.16.95.51

pascal.devaux@bnpparibas.com

■ **Hélène DROUOT**

Korea, Thailand, Philippines, Mexico, Andean countries

+33.(0)1.42.98.33.00

helene.drouot@bnpparibas.com

■ **Salim HAMMAD**

Latin America

+33.(0)1.42.98.74.26

salim.hammad@bnpparibas.com

■ **Johanna MELKA**

India, South Asia, Russia, Kazakhstan, CIS

+33.(0)1.58.16.05.84

johanna.melka@bnpparibas.com

■ **Michel BERNARDINI**
Contact Média

+33.(0)1.42.98.05.71

michel.bernardini@bnpparibas.com



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