

# ECOWEEK

No. 18-30, 27 July 2018

## Fed: Market considers tightening cycle is well advanced

■ Recent Federal Reserve research shows that the slope of the short end of the yield curve is a more reliable indicator than the commonly used difference between 10-year and 1 or 2-year US Treasury yields ■ In a similar vein, we can look at the difference between the forward 3-month LIBOR rate and the spot rate. This difference has increased as of late ■ However, the level and shape of the entire forward curve show that the market is of the view that the Fed tightening cycle is well advanced

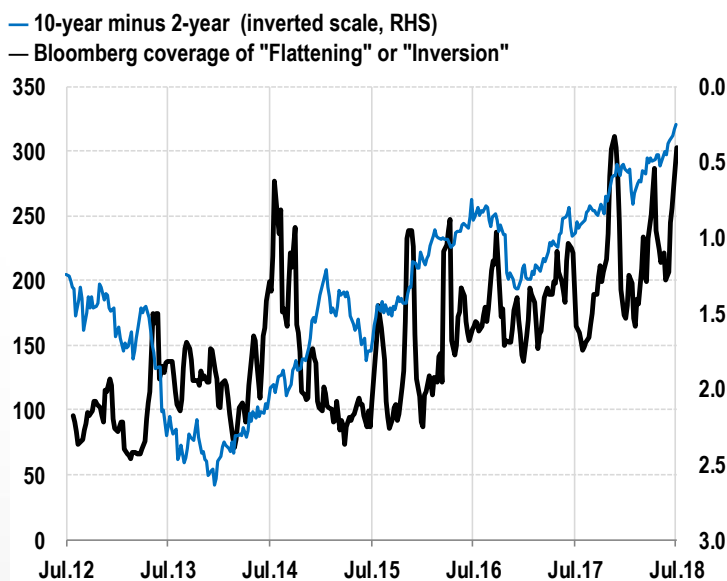
Is the growing media coverage of the US yield curve flattening (see chart) the equivalent of a summer hit on the radio? It is played many times per day, initially you like it but you end up getting bored by it. By now everybody knows that US recessions are generally preceded by a curve inversion so what else is there to be said? Perhaps we should shift our focus a little bit.

One recent interesting contribution came from the Federal Reserve<sup>1</sup> showing that the near-term forward spread does a better job in anticipating downturns than the long-term spread (e.g. 10-year minus 2-year). The former is calculated as the difference between the current implied forward rate (on Treasury bills) six quarters from now and the current yield on a three-month Treasury bills. It reflects market expectations about the near-term monetary policy stance: when it flattens it indicates that the market thinks the pace of tightening will slow. An inversion would imply an expectation of policy easing over the next 6 quarters. Such an easing, after a tightening cycle, would reflect concern of the central bank about an upcoming slowdown and this makes it also intuitively clear why this indicator provides a better signal than the long-term spread.

Along the same line we can look at the USD LIBOR rates and compare the difference between the 3-month rate in 6-months (so a shorter horizon than in the Fed study) and the 3-month spot rate. Chart 2 (next page) compares the evolution of this difference -the slope of short end segment of the LIBOR curve- to the federal funds rate. The swings in the slope are sometimes considerable. In 2000, the market moved from expecting further tightening to anticipating easing in a matter of months. In 2006 the curve inverted although the economy entered a recession only at the end of 2007.

.../...

US TREASURY CURVE: EVOLUTION AND MEDIA COVERAGE



p. 3

Markets Overview

p. 4

Pulse & Calendar

p. 6

Economic scenario

ECONOMIC RESEARCH DEPARTMENT



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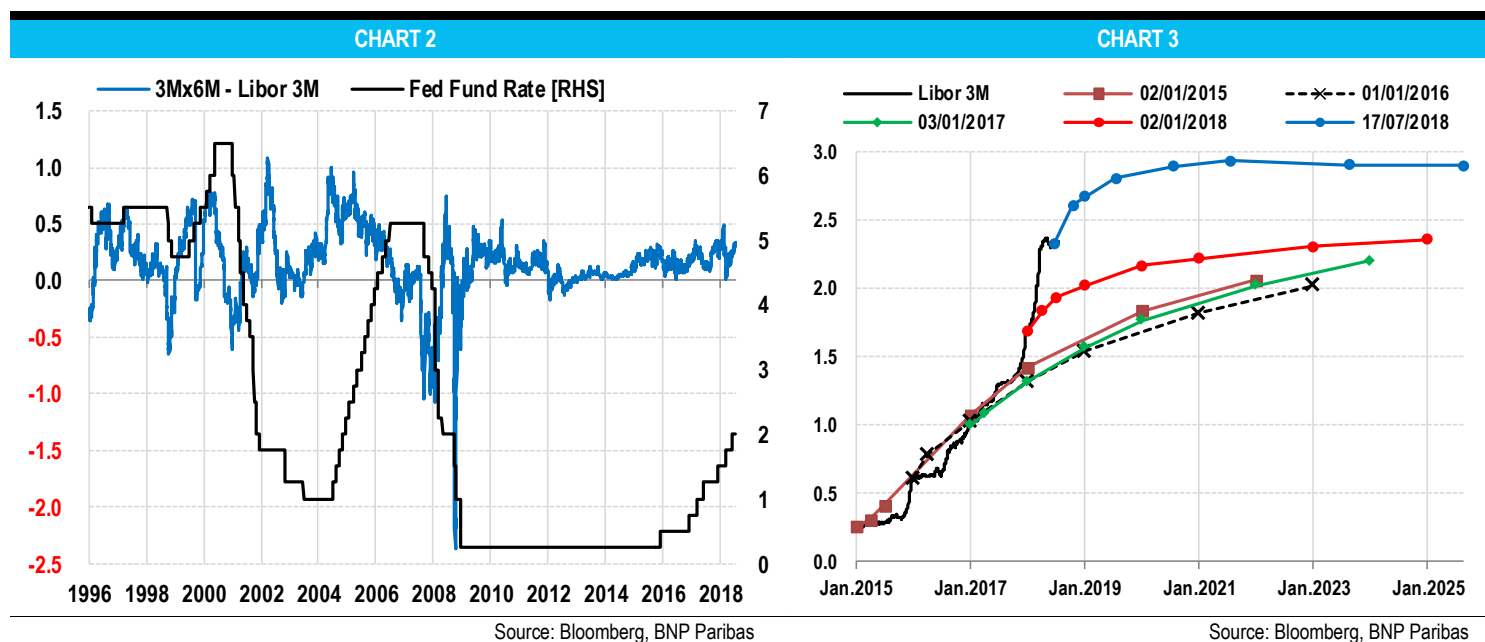
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Clearly the slope of the LIBOR curve not only depends on where we are in the business and monetary cycle but also on the level of the policy rate and the forward guidance of the central bank. This helps to understand why the difference between the forward and the spot LIBOR rate was very small in 2012 and 2013. More generally, a low policy rate and a cautious central bank mean that the curve may flatten quite easily based on incoming data, as was the case towards the end of March this year. This could also imply that the spread between the forward and the spot rate is quite volatile, which would reduce its quality as a recession indicator. Nevertheless, against the background of the flattening trend of the long-term spread, the recent steepening of the curve in chart 2 should be welcomed.

Chart 3 shows the evolution since 2015 of the dollar LIBOR forward curve and the observed 3-month LIBOR rate. Until 2017 the curve didn't move much but since then the upward shift has been quite significant, in line with the evolving messages from the Fed. To be noted is that for the most recent observation, the curve is very slightly downward sloping beyond the middle of 2021 which means that the market considers that the peak in Fed funds is not too far away. Going forward we should monitor whether it inverts in a more pronounced way or even earlier than is currently the case because that would spell badly for the economic outlook as seen by the market.

<sup>1</sup> (Don't) fear the yield curve, Eric Engstrom and Steven Sharpe, FEDS notes, 28 June 2018

William De Vijlder



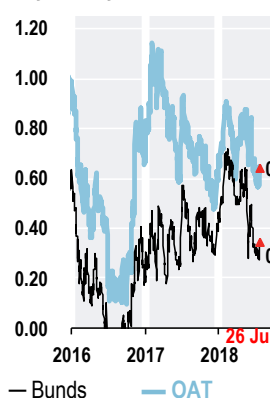
## Markets overview

### The essentials

Week 20-7-18 > 26-7-18

➔ CAC 40	5 398	➔ 5 481	+1.5 %
➔ S&P 500	2 802	➔ 2 837	+1.3 %
➔ Volatility (VIX)	12.9	➔ 12.1	-0.7 pb
➔ Euribor 3M (%)	-0.32	➔ -0.32	+0.1 bp
➔ Libor \$ 3M (%)	2.34	➔ 2.34	-0.5 bp
➔ OAT 10y (%)	0.61	➔ 0.64	+3.1 bp
➔ Bund 10y (%)	0.31	➔ 0.34	+3.5 bp
➔ US Tr. 10y (%)	2.89	➔ 2.98	+8.9 bp
➔ Euro vs dollar	1.17	➔ 1.17	-0.4 %
➔ Gold (ounce, \$)	1 229	➔ 1 227	-0.2 %
➔ Oil (Brent, \$)	73.0	➔ 74.6	+2.2 %

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 26/07	-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	2.34 at 04/05	1.69 at 01/01
Libor 12M	2.81 at 24/07	2.11 at 01/01
£ BoE	0.50 at 01/01	0.50 at 01/01
Libor 3M	0.79 at 25/07	0.52 at 04/01
Libor 12M	1.04 at 17/04	0.76 at 03/01

At 26-7-18

Yield (%)	highest' 18	lowest' 18
€ AVG 5-7y	0.67 at 08/06	0.41 at 18/04
Bund 2y	-0.61 at 07/03	-0.79 at 29/05
Bund 10y	0.34 at 15/02	0.27 at 19/07
OAT 10y	0.64 at 08/02	0.57 at 13/07
Corp. BBB	1.57 at 11/06	1.17 at 08/01
\$ Treas. 2y	2.68 at 26/07	1.89 at 01/01
Treas. 10y	2.98 at 17/05	2.41 at 01/01
Corp. BBB	4.34 at 17/05	3.59 at 01/01
£ Treas. 2y	0.69 at 21/03	0.40 at 01/01
Treas. 10y	1.33 at 15/02	1.23 at 01/01

At 26-7-18

10y bond yield & spreads

4.40%	Greece	405 pb
2.71%	Italy	236 pb
1.73%	Portugal	138 pb
1.31%	Spain	96 pb
0.70%	Belgium	35 pb
0.64%	France	29 pb
0.61%	Austria	26 pb
0.58%	Ireland	23 pb
0.51%	Finland	16 pb
0.50%	Netherlands	15 pb
0.34%	Germany	

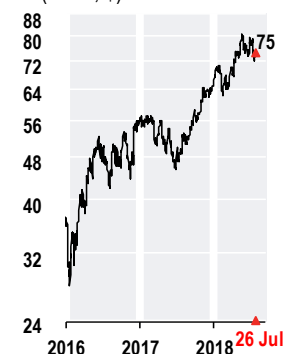
### Commodities

Spot price in dollars	lowest' 18	2018(€)
Oil, Brent	74.6 at 13/02	+15.4%
Gold (ounce)	1 227 at 19/07	-3.0%
Metals, LMEX	3 027 at 19/07	-8.8%
Copper (ton)	6 267 at 19/07	-10.5%
CRB Foods	342 at 04/04	+4.9%
wheat (ton)	199 at 16/01	+29.2%
Corn (ton)	131 at 11/07	+5.9%

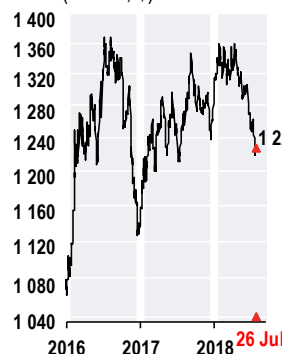
At 26-7-18

Variations

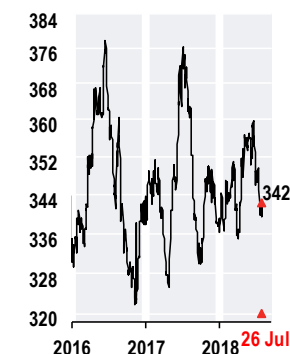
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



### Exchange Rates

€ =	highest' 18	lowest' 18	2018
USD	1.17 at 25/01	1.16 at 29/05	-2.9%
GBP	0.89 at 02/03	0.86 at 17/04	-0.1%
CHF	1.16 at 19/04	1.15 at 31/05	-1.0%
JPY	129.49 at 02/02	125.87 at 29/05	-4.3%
AUD	1.58 at 26/03	1.53 at 09/01	+2.8%
CNY	7.91 at 24/07	7.42 at 29/05	+1.2%
BRL	4.35 at 06/07	3.87 at 08/01	+9.1%
RUB	73.40 at 11/04	68.06 at 09/01	+6.2%
INR	80.08 at 25/04	75.92 at 08/01	+4.5%

At 26-7-18

Variations

### Equity indices

Index	highest' 18	lowest' 18	2018	2018(€)
CAC 40	5 640 at 22/05	5 066 at 26/03	+3.2%	+3.2%
S&P500	2 873 at 26/01	2 581 at 08/02	+6.1%	+9.3%
DAX	13 560 at 23/01	11 787 at 26/03	-0.8%	-0.8%
Nikkei	22 587 at 23/01	20 618 at 23/03	-0.8%	+3.6%
China*	85 at 26/01	83 at 19/07	-3.1%	-0.6%
India*	584 at 29/01	547 at 23/05	+2.9%	-1.6%
Brazil*	1 857 at 26/01	1 603 at 27/06	+3.2%	-5.5%
Russia*	608 at 26/02	571 at 16/04	+8.7%	+3.6%

At 26-7-18

Variations

\* MSCI index



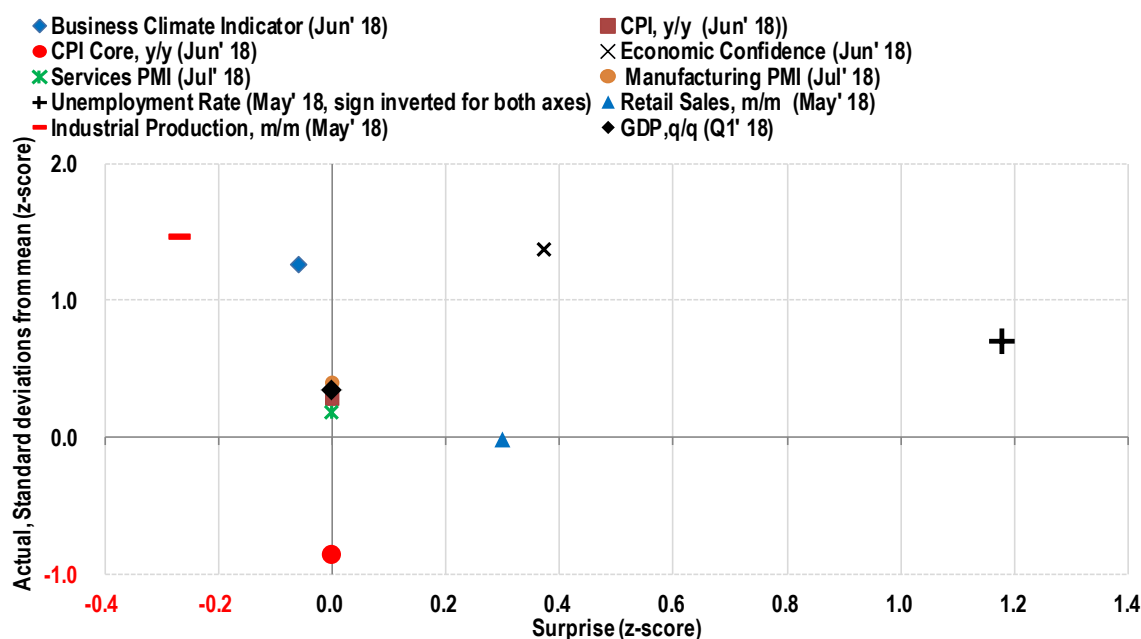
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## Pulse

## Eurozone: Good growth environment though no longer amazing

Several indicators were in line with market expectations but unemployment surprised positively (i.e. it was lower than expected) as well as economic confidence and retail sales. The business climate and even more so industrial production disappointed. Apart from core inflation, most indicators are well above their long-term average which reflects a good growth environment.



Source: Bloomberg, Markit, BNP Paribas

## Indicators preview

Date	Country	Event	Period	Survey	Prior
07/30/18	Eurozone	Economic Confidence	July	--	--
07/30/18	Germany	CPI EU Harmonized MoM	July	--	--
07/31/18	United Kingdom	GfK Consumer Confidence	July	--	--
07/31/18	France	CPI EU Harmonized MoM	July	--	--
07/31/18	Eurozone	Unemployment Rate	June	--	--
07/31/18	Eurozone	GDP SA QoQ	2Q	--	--
07/31/18	United States	Personal Income	June	--	--
07/31/18	United States	Personal Spending	June	--	--
07/31/18	United States	PCE Core MoM	June	--	--
07/31/18	United States	Conf. Board Consumer Confidence	July	--	--
08/01/18	France	Markit France Manufacturing PMI	July	--	--
08/01/18	Eurozone	Markit Eurozone Manufacturing PMI	July	--	--
08/01/18	United States	ISM Manufacturing	July	--	--
08/01/18	United States	FOMC Rate Decision (Upper Bound)	August	2.00%	--
08/02/18	United Kingdom	Bank of England Bank Rate	August	--	--
08/02/18	United States	Durable Goods Orders	June	--	--
08/03/18	France	Markit France Services PMI	July	--	--
08/03/18	Eurozone	Markit Eurozone Services PMI	July	--	--
08/03/18	Eurozone	Markit Eurozone Composite PMI	July	--	--
08/03/18	Eurozone	Retail Sales MoM	June	--	--
08/03/18	United States	Change in Nonfarm Payrolls	July	--	--
08/03/18	United States	ISM Non-Manufacturing Composite	July	--	--



08/08/18	Japan	Eco Watchers Survey Current SA	July	--	--
08/08/18	France	Bank of France Ind. Sentiment	July	--	--
08/09/18	United States	PPI Final Demand MoM	July	--	--
08/10/18	France	Industrial Production MoM	June	--	--
08/10/18	France	Private Sector Payrolls QoQ	2Q	--	--
08/10/18	United States	CPI MoM	July	--	--
08/13/18	Japan	GDP SA QoQ	2Q	--	--
08/14/18	France	ILO Unemployment Rate	2Q	--	9.2%
08/14/18	Germany	GDP SA QoQ	2Q	--	--
08/14/18	Germany	CPI EU Harmonized MoM	July	--	--
08/14/18	France	CPI EU Harmonized MoM	July	--	--
08/14/18	Eurozone	GDP SA QoQ	2Q	--	--
08/14/18	United States	NFIB Small Business Optimism	July	--	--
08/15/18	United Kingdom	CPI MoM	July	--	--
08/15/18	United States	Retail Sales Advance MoM	July	--	--
08/15/18	United States	Industrial Production MoM	July	--	--
08/15/18	United States	Capacity Utilization	July	--	--
08/15/18	United States	NAHB Housing Market Index	August	--	--
08/16/18	United Kingdom	Retail Sales Ex Auto Fuel MoM	July	--	--
08/16/18	United States	Housing Starts	July	--	--
08/16/18	United States	Building Permits	July	--	--
08/17/18	Eurozone	CPI MoM	July	--	--
08/17/18	United States	U. of Mich. Sentiment	August	--	--
08/22/18	United States	FOMC Meeting Minutes	August	--	--
08/23/18	France	Business Confidence	August	--	--
08/23/18	France	Markit France Manufacturing PMI	August	--	--
08/23/18	France	Markit France Composite PMI	August	--	--
08/23/18	Eurozone	Markit Eurozone Composite PMI	August	--	--
08/23/18	Eurozone	Consumer Confidence	August	--	--
08/24/18	Germany	GDP SA QoQ	2Q	--	--
08/24/18	United Kingdom	GDP QoQ	2Q	--	--
08/24/18	United States	Durable Goods Orders	July	--	--
08/27/18	Germany	IFO Business Climate	August	--	--
08/28/18	France	Consumer Confidence	August	--	--
08/28/18	United States	Conf. Board Consumer Confidence	August	--	--
08/29/18	Germany	GfK Consumer Confidence	Sep	--	--
08/29/18	France	GDP QoQ	2Q	--	--
08/29/18	United States	GDP Annualized QoQ	2Q	--	--
08/30/18	Germany	Unemployment Change (000's)	August	--	--
08/30/18	Eurozone	Economic Confidence	August	--	--
08/30/18	United States	Personal Income	July	--	--
08/30/18	United States	Personal Spending	July	--	--
08/31/18	United Kingdom	GfK Consumer Confidence	August	--	--
08/31/18	France	CPI EU Harmonized MoM	August	--	--
08/31/18	Eurozone	Unemployment Rate	July	--	--
08/31/18	United States	U. of Mich. Sentiment	August	--	--

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
<b>Advanced</b>	<b>2.3</b>	<b>2.3</b>	<b>1.5</b>	<b>1.8</b>	<b>2.1</b>	<b>1.9</b>
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
<b>Euro Area</b>	<b>2.6</b>	<b>2.2</b>	<b>1.5</b>	<b>1.5</b>	<b>1.8</b>	<b>1.8</b>
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
<b>Emerging</b>	<b>5.9</b>	<b>5.9</b>	<b>5.8</b>	<b>2.4</b>	<b>3.1</b>	<b>3.2</b>
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			
<b>US</b>	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
<b>Ezone</b>	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
<b>UK</b>	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
<b>Japan</b>	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			
<b>USD</b>	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
<b>EUR</b>	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)



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