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US: the signal and the noise

■ Asset prices can play a useful role when assessing the economic outlook ■ The big drop in treasury yields during August has raised concern although a nowcast points to satisfactory third quarter growth in the US. This would mean that increased uncertainty about the trade dispute has caused a flight to safe havens and a decline in long term interest rates ■ Swings in the communication about the trade dispute cause swings in investor uncertainty and hence in risk premiums. This reduces the signal quality of asset prices, which may end up weighing on the real economy

In theory, asset prices are an important input when analysing the economic outlook: 1) they can influence spending (e.g. when bond yields decline) 2) they reflect investor expectations 3) they are available on a timely basis. The temptation to give more weight to asset prices grows when the visibility about the true state of the economy is limited (i.e. when traditional data provide conflicting messages) or when things are moving quickly. Against this background, the considerable decline in bond yields in August has been a source concern. Firstly, because it caused an inversion of the US treasury curve, which in the past has been followed - with varying delays- by a recession. Secondly, it could also be interpreted as reflecting a significant downward adjustment of growth expectations by bond market investors. This interpretation is however not borne out by the data published in August. As shown in the chart, the nowcast[1] for real US GDP growth for the third quarter has fluctuated in a narrow range and, more recently, has been moving higher, reaching a respectable 2.3%.

What could explain the huge drop in treasury yields? A possible reason is that, irrespective of the data released so far this quarter, investors have become more pessimistic about the outlook for the subsequent quarters. Such an adjustment of expectations could happen because of a bad news shock, such as an increase in uncertainty or a hawkish comment by a central bank official.

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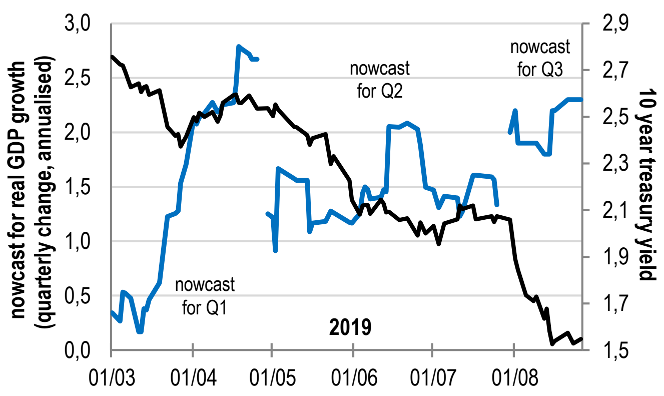
NOWCAST FOR US REAL GDP GROWTH AND 10 YEAR TREASURY YIELD



Source: Federal Reserve Bank of Atlanta, Datastream, BNP Paribas

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[1] A general description of nowcast is "*the prediction of the present, the very near future and the very recent past. The term is a contraction for now and forecasting and has been used for a long-time in meteorology and recently also in economics.*" (source: Now-casting and the real-time data flow, Marta Bańbura, Domenico Giannone, Michele Modugno and Lucrezia Reichlin, ECB working paper 1564, July 2013). The nowcast of the Federal Reserve Bank of Atlanta is a model-based estimate of current quarter real GDP growth based on data released for this quarter. No subjective adjustments are made.

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The latter factor is not applicable, quite on the contrary: the Federal Reserve has eased policy and has hinted that more rate cuts could come, so this leaves us with uncertainty as a possible explanation. Given the announcements made by President Trump about further tariff increases targeting China, and the Chinese retaliation more recently, assessing the economic outlook has, quite understandably, become more difficult. This has fuelled the demand for safe assets and caused a decline in bond yields, driving the term premium[2] of US treasuries further and further into negative territory. The phenomenon was global and has seen 10 year Bund yields reaching -70 basis points. This dynamic has probably been reinforced by the decline and increased volatility of equity markets, pushing asset allocators to buy government bonds or increase duration, hoping that declining bond yields and hence bond price appreciation would compensate for a decline in equity markets. Another factor is that investors with long-dated liabilities such as insurance companies or pension funds are forced to increase their bond exposure when yields decline, considering that this decline increases the net present value of their liabilities.[3]

Past tariff increases and the uncertainty about the outcome of the trade dispute between the US and China, make the interpretation of economic data more complex: to which extent do they e.g. explain the slowdown in exports or company investments? In addition, interpreting the development of asset prices becomes more difficult as price changes are dominated by important, uncertainty-driven swings in risk premiums, depending on the statements which are made. When the signal becomes less clear and the statistical noise increases, greater caution may very well prevail and hence weigh on the economy.

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[2] The term premium is the risk premium which the investor receives for taking duration risk by investing in longer maturities. When it is negative, the investor pays for taking this risk.
[3] According to Aon Hewitt, a consulting company, falling bond yields over the summer have caused an increase of Dutch pension fund liabilities of 4% (source: IPE, Dutch schemes headed for right cuts after dramatic funding drop, 12 August 2019).