# Weekly roundup (week 45) 15.11.2023

Markets posted mixed results last week. Government bond curves flattened (with the front-end underperforming), corporate credit markets performed well, and credit spreads tightened in both investment-grade and high-yield markets.

Most equity markets ended the week within 1% of their starting points; commodities underperformed, moving lower across all markets as the outlook for weak global growth was given more weight than the outlook for tight supply geopolitics.

The Reserve Bank of Australia raised its key rates (as expected) by 25 basis points (bp) to 4.35%. The hike was accompanied by dovish language. China slipped back into deflation, with consumer prices down -0.2% year-on-year in October, due to falling food prices and weak domestic consumption. In our view, this gives the central bank more leeway to implement stimulus measures before the end of the year. This week, investors will be keeping a close eye on the expected meeting between Xi Jinping and Joe Biden to assess relations between China and the United States.

In Europe, the International Monetary Fund (IMF) warned against prematurely celebrating the defeat of inflation. The IMF said that historically, it takes an average of three years (our take: times change) to bring inflation down to lower levels, and that a failure to finish the job could lead to a new round of monetary tightening, which could reduce growth by 1%. This warning is in line with the European Central Bank's September consumer survey, published last week, which shows that inflation expectations for the next 12 months have risen from 3.5% to 4%. On a slightly more optimistic note, the IMF also predicts that Europe is heading for a soft landing; it does not expect a prolonged recession in the region. For the Eurozone, the IMF forecasts growth of 0.7% for this year and 1.5% for 2024.

In the US, the main data release was the third-quarter Senior Loan Officer Opinion Survey, which reviews bank lending standards as a good indicator of economic growth. The survey surprised economic supporters, showing an improvement in banks' willingness to lend compared with the second quarter. The net balance (the tightening of bank lending standards minus the easing of bank lending standards) fell from 50.8% to 33.9%. Lending conditions remain restrictive by historical standards, but we believe further easing would be encouraging and help support growth in the future.

The US 10-year government yield was virtually unchanged over the week, which makes sense considering the light economic data calendar and the Federal Open Market Committee (FOMC) on hold due to Friday's Veterans Day holiday. However, this doesn't show the daily battle investors have been waging to fix the 10-year Treasury's break-even yield; daily yield swings have been huge, averaging 12 basis points. What's to blame? The most frequently cited culprit is the term premium.

The term premium is an elusive concept - it's defined as the difference between long-term yields and the expected evolution of short-term interest rates over the same duration.

In other words, it's the difference in yield that investors demand to hold a long-term bond instead of continually renewing very short-term securities at the same maturity. The glaring problem with this definition is that no one can predict the expected evolution of interest rates over a long period (say, the next ten years). Minneapolis Fed President Neel Kashkari summed up the term premium best when he said it's "the economist's version of 'dark matter' - it's the residue of all the things we can't explain". It's the premium investors look for to protect themselves against unforeseen risks. With the FOMC on hold, even hinting that increasing the term premium does the job of monetary tightening for them, what do U.S. bond investors fear?

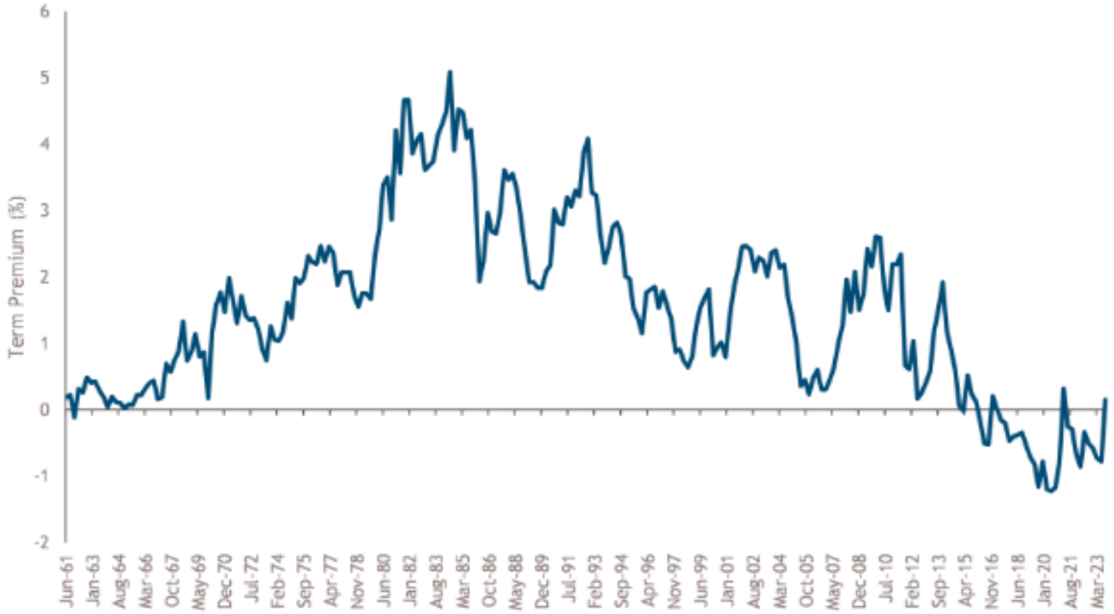
Static inflation. Tight labor markets, multiple supply chains or deglobalization, alongside the transition to cleaner energy. There is great uncertainty about the FOMC's ability to bring inflation back to its 2% target. Or, indeed, whether the 2% target is appropriate.

Government fiscal responsibility. For fiscal year 2022, the U.S. federal deficit stood at $1.375 trillion. This deficit worsened considerably in fiscal 2023, with the U.S. Treasury estimating it at $1.7 trillion. With next year an election year, and the incumbent administration not certain to win, only a brave forecaster could expect the administration to tighten its fiscal belt, foreshadowing further deterioration.

Excessive bond supply. The gross supply of government bonds is estimated at US$4.1 trillion for 2024, up from US$3.3 trillion in 2023. With the FOMC's quantitative tightening program in effect (reducing bond supply) and other natural buyers of US government bonds now selling to defend their currencies (e.g. China and Japan), the risk of a supply/demand imbalance is possible. This week's US$24 billion 30-year auction may have served as a warning; with a yield 5.3 basis points higher than the yield indicated before the sale, only one other auction in the last decade has returned so far from the advertised yield.

What we can conclude is that, for government bond investors, unforeseen risks are geared towards increasing the term premium - and by historical standards, the term premium is still at extremely low levels (see this week's chart). It may also be the underestimation of this premium that forces the FOMC to cut rates, as the term premium rises further, constraining the economy and sending it into recession. The central bank's track record for soft landings is not great

# Chart of the week: 10-year Treasury term premium




2023.11.15.T-bond premium

Source: Bloomberg, November 10, 2023



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