Economic Analysis

Turbulence in International Financial Markets

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Carlos Serrano
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The last few weeks have seen tensions increase in global financial markets. Most countries have seen high levels of volatility in their securities markets, and bond yields in highly developed countries have fallen; German 30-year-bond rates are negative, meaning that investors are paying the German government, over 30 years, for the privilege of having their money protected in safe assets. Moreover, most currencies have depreciated against the US dollar. Why is this? Generally speaking, there are various factors that led to greater aversion to risk in the markets but, in my view, the event that triggered these latest happenings was the inversion of the yield curve in the United States on August 14, which saw the yields of long-term government bonds fall below those of their short-term counterparts.

In particular, the markets are watching the correlation between 2- and 10-year bonds and, on several occasions since August 14, the yields of the former have been higher than those of the latter, which is uncommon. Usually there would be a liquidity premium, which is why markets always demand higher returns from longer-term investments. It so happens that, without exception, all of the recessions in the United States over the last six decades were preceded by a yield curve inversion. While there are no solid theories explaining this phenomenon, the thinking is that the curve inverts because markets foresee an economic slowdown that will lead the Federal Reserve to lower interest rates and, consequently, cause long-term rates to fall in anticipation of this. This could be a self-fulfilling prophecy.

In other words, even if conditions would not led to a recession, the fact that the markets think that there may be one results in the widespread pessimism that can cause one. But why are the markets expecting a slowdown or recession? I see the primary cause as the uncertainty generated by Trump's trade war with China. While the tariffs themselves may have an impact, it is the uncertainty surrounding them that causes more damage. Since investors don't know whether or not there will be tariffs, or how big these may be, they prefer to wait for greater clarity before investing in new plants or ordering more supplies. I believe that the uncertainty is worse than imposing set tariffs known to be the new standard. This dynamic has led to an irregular situation.

Trump imposes tariffs because he is seemingly averse to the United States having a trade balance deficit with China. However, the tariffs cause uncertainty that leads to investors preferring to seek refuge in safe assets such as bonds from advanced markets, particularly US treasury bonds. Increased demand for treasury bonds causes the dollar to appreciate. And the dollar being stronger, thereby making US exports more expensive than those from other countries, including China, means that the US's trade balance doesn't change, and that the deficit could even increase. The further Trump takes the trade war, the more the dollar appreciates and the less effective his measures will be. Given the difficulty of anticipating how far trade aggressions will escalate, I believe it to be a safe assumption that this period of volatility will continue at least until next year's US presidential election. What can Mexico do to best handle this situation? Endorse the commitment to keeping macroeconomic fundamentals strong; negotiate to get the new trade agreement with the United States and Canada swiftly ratified; and give investors better indicators of certainty. In the future, episodes like the one causing disputes over gas pipeline contracts should be avoided.

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