What *the* Global Bond Market Is Telling Us

By Desmond Lachman

A tale of two markets.

It is not often that the global sovereign bond market and the global risk markets have held as divergent a view as to the world economic outlook as they have done in recent months. This could portend real trouble ahead for world financial markets and the global economy.

While global sovereign bond markets, along with the world's central banks, are now signaling that real trouble might lie ahead for the U.S. and global economies, global equity and credit risk markets have continued to party like there was no tomorrow.

Considering that the sovereign bond market is generally a very much more accurate forecaster of economic recessions than are the equity and credit risk markets, financial market regulators should be asking themselves whether the global financial system is sufficiently robust to withstand a sharp repricing of global risk in the year immediately ahead.

A clear sign that global equity markets entertain a rosy view as to the world economic outlook is the historically high valuations at which these markets have been trading. In the case of the United States, today's high equity valuations have only been experienced on three occasions in the past one hundred years.

A clear sign that global credit risk markets think the world economy's skies will remain forever blue is their very tight spreads with respect to the

Desmond Lachman is a Resident Fellow at the American Enterprise Institute. He was formerly a Deputy Director in the International Monetary Fund's Policy Development and Review Department, and the Chief Emerging Market Economic Strategist at Salomon Smith Barney.

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Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Masters at Risk Making

New UK Prime Minister **Boris Johnson** *could soon crash the world's fifth-largest economy out of the European Union without a deal.*

The introduction of a parallel currency, which could very well occur if Italian politician **Matteo Salvini** *were to become prime minister, is bound to undermine investor confidence in Italy's continued commitment to euro membership.*

OFFICIAL WHITE HOUSE PHOTO BY JOYCE N. BOGHOSIAN

U.S. President **Donald Trump's** *America First trade policy views China as a strategic risk rather than as a reliable economic partner, and threatens to impose a 25 percent import tariff on European and Japanese automobiles.*

risk-free alternatives. An indication of this optimism is the fact that credit spreads on U.S. high-yield debt and on emerging market debt with respect to U.S. Treasury bond yields have remained at close to their pre-2008 economic crisis lows.

The global sovereign bond markets are telling a very much gloomier story as to where the world economy might be headed. One indication of this has been the recent marked inversion of the U.S. yield curve. This inversion would imply that the U.S. bond market expects that generalized U.S. economic weakening will force the Federal Reserve to aggressively cut interest rates.

A more dramatic indication of sovereign bond market pessimism is the fact that a record US$13 trillion of global sovereign bonds, and around one half of all European sovereign bonds, offer negative interest rates. This would imply that these bond markets are expecting that gloomy global economic conditions will keep inflation down at an unusually low level for the indefinite future.

To be sure, bond markets and the world's central banks are generally sensitive to economic and political risks. However, what seems to have them now on high alert is that this time around there are an unusually large number of such risks in a group of systemically important countries. They worry that these risks have an uncomfortably high chance of materializing and that if those risks were indeed to materialize, they would have the potential to destabilize the global economy.

Global sovereign bond markets are now signaling that real trouble might lie ahead for the U.S. and global economies.

Among the more immediate of these risks is that the United Kingdom, the world's fifth-largest economy, could soon crash out of the European Union without a deal. Both the Bank of England and the International Monetary Fund are warning that such an occurrence would most probably result in at least a 5 percent decline in the UK economy in the year immediately following its disorderly European exit. This would be bound to have significant spillover effects to a European economy that is already on the cusp of a recession.

Heightening the chances of a hard Brexit is the commitment by Boris Johnson, the United Kingdom's new prime minister, to have the United Kingdom leave the European Union with or without a deal on October 31. That is when the United Kingdom's extended deadline to negotiate a Brexit deal with the European Union ends. Johnson is making this commitment to fend off a mortal challenge to the Conservative Party from Nigel Farage's surging Brexit Party.

A still more serious, albeit less imminent, threat to the global economy is the risk that we could have a recurrence of the Italian sovereign debt crisis. With the Italian

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economy being approximately ten times the size of that of Greece and with it having the world's third-largest sovereign debt market, an Italian debt crisis would pose an existential threat to the euro's survival and to the European banking system. The European economic crisis that would ensue would almost certainly reach our shores.

Heightening the risk of an Italian debt crisis is the reckless budget policy path on which the country's populist government is now embarked. At a time when the country is already saddled with Europe's second-largest public debt-to-GDP ratio after Greece and a weak banking system, the Italian government is insisting on the introduction of a large unfunded tax cut that would raise its budget deficit to around 5 percent of GDP.

It is also not helping matters that the Italian government is seriously floating the idea of issuing small denominated bonds (so called mini-BOTs) with no maturity date that would have the same denominations as euro notes and that could be used to pay future tax liabilities. The introduction of such a parallel currency, which very well could occur if Matteo Salvini were to become prime minister, is bound to undermine investor confidence in Italy's continued commitment to euro membership.

President Trump's America First trade policy has already resulted in a marked slowing in the Chinese economy that has had important spillover effects to China's regional trade partners as well as to the highly export-dependent German economy. Although a truce was declared in the U.S.-China trade war at the recent Osaka G20 meeting, there remains the real risk that such a truce might be short-lived. This would appear to be particularly the case considering that the Trump administration is increasingly viewing China as a strategic risk rather than as a reliable economic partner.

Financial market regulators should be asking themselves whether the global financial system is sufficiently robust to withstand a sharp repricing of global risk.

After the U.S. Commerce Department's determination in March that U.S. and Japanese automobile exports constitute a national security risk, there is the real risk that Trump will follow through on his threat to impose a 25 percent import tariff on European and Japanese automobiles. This threat is casting a dark cloud over an already enfeebled German economy that would only get darker if President Trump were to follow through.

In the case of the United States, today's high equity valuations have only been experienced on three occasions in the past one hundred years.

At a time when the world debt-to-GDP ratio is at a record level, a triggering of any of the economic risks identified above, not to mention a geopolitical event such as the closing of the Straits of Hormuz, could have major repercussions for the global financial system. As Warren Buffett never tires of reminding us, it will be then when the tide runs out that we will find out who has been swimming naked.

In a world drowning in debt and characterized by so many systemic economic risks, one has to hope that global policymakers are not suffering from a false sense of security on the grounds that the U.S. banking system is in a very much better position to weather a global economic shock than it was in 2008. While this might be true of the United States, the same might not be said of the European banking system in general and of that of Italy in particular. It also must be a matter of deep concern that a disturbingly large proportion of global credit risk resides in the lightly regulated non-banking sector in general and in the hedge funds and equity funds in particular.

In 2008, Queen Elizabeth famously asked why no one had forewarned her about the Great Economic Recession. Should the world experience a global economic and financial crisis next year, global policymakers will not be able to ask the same question. The global bond market is now warning all who might be bothered to listen that there is a very good chance that it will not be too long before the world economy again experiences an unusually severe recession. ◆