Fundamentals Matter, Just Not Yesterday

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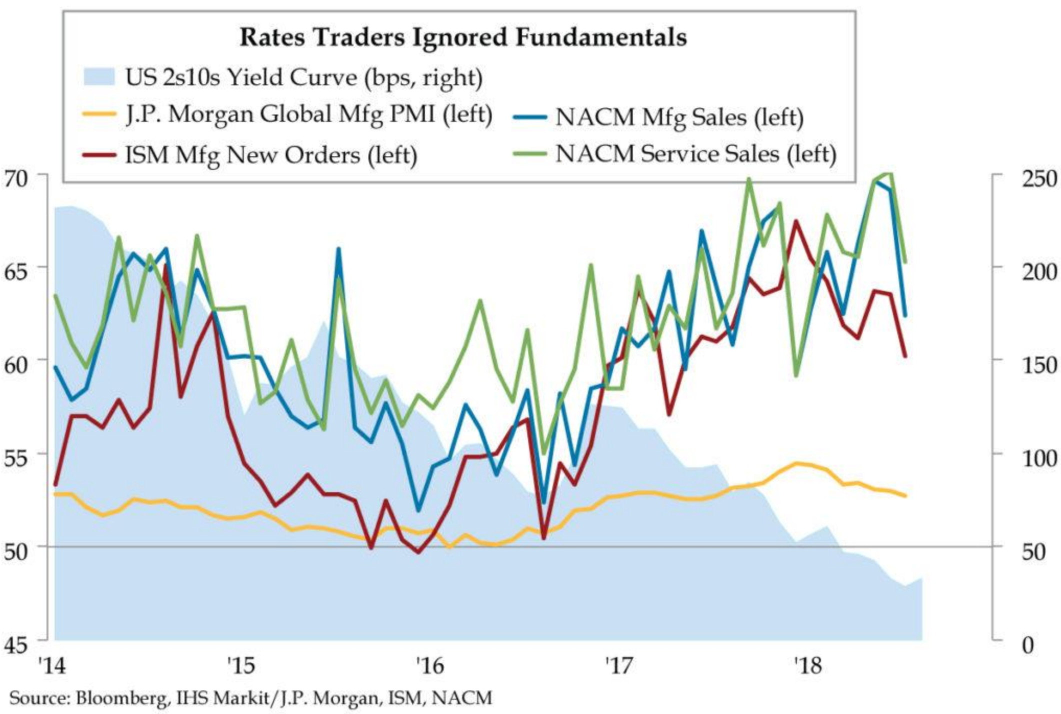

VIPs

- Bond yields spiked as BoJ doubles its ceiling on the 10-year Japanese benchmark to 20 bps

- **A momentum trade, not the fundamental evidence, drove the rate back-up**
- **None of the 36 July PMIs printed at/above 60; that has not happened in two years**
- **Credit managers are signaling a GDP downshift from 4% to 3%**
- **Forward looking managers are questioning whether the strong growth momentum continues**
- **US bond spreads will flatten and potentially invert as global growth decelerates**

The Bourdon-tube gauge graced ourselves with its presence in 1850. To this day, the modern-day tire gauge is one of the most commonly used instruments for measuring liquid and gas pressure. In the event you hadn't noticed, it's a bit of a hot summer. The impetus is even more pronounced, in these blazing hot summer days, to **not** hit the road without the certainty that your tires aren't at risk of leaving you waylaid roadside.

Investors are increasingly sensing they'll be stuck on the roadside in need of assistance as the air seeps out of the global reflation trade. And yet, yesterday's action in world bond markets defied what the data have begun to presage. Rather than sink, bond yields spiked on news that the Bank of Japan would double its 10-basis-point (bps) ceiling on the 10-year Japanese benchmark bond to 20 bps. Damned be the data. Traders did as traders do — they tested the technical waters to establish the outer boundaries of the new range.

That's a lot of boom-boom in the night as Wall Street traders slumbered. When traders arrived at their terminals yesterday morning, they were greeted by something they haven't seen in some time: Japanese Government Bonds (JGBs) had staged their largest move up in yield on Bloomberg's GMM (Global Macro Movers) screen. They rubbed their eyes. They blinked twice. And the JGB momentum trade took over the rates pit, at least for the trading day.

(If you know momentum trades, they are like juggernauts. Get out of the way; they are hard to stop.)

Technicals, the battle royale played out amongst fast-money traders, won the day. <u>But fundamentals cannot be dismissed validating a growing perception that global growth is slowing.</u> We say 'perception' because the evidence emanates from "soft" business surveys. The truth is, only hard fundamental economic data will sway economists.

The start of every calendar month is like a doctor's check-up on the global economy. Get out the stethoscope and listen to the panoply of purchasing managers' indices (PMI). They are the heartbeat, the proxies for the rate of global growth. In recent months, the pulse has been elevated, so much so that there have been a handful of PMIs running in the 60s. That's red-hot territory versus a breakeven of 50 that separates expansion from contraction.

But here's the catch: the 60-plus right tail of the distribution curve got chopped off. <u>Not one of the 36 individual country PMIs printed at or above 60 in July. Pay attention: it's been two years since that last happened.</u> The threat of tariffs and the consequential supply chain tightening that's bumped up input prices have converged to generate headwinds on demand **and** on capacity. Of those 36 global PMIs referenced, 60% were lower than last month; 80% were below the December peak as per the J.P. Morgan Global Manufacturing PMI.

Stepping back, purchasing managers get all the glory, but credit managers are the more valuable players. They have to be. They worry if their firms are going to get paid three, six or 12 months down the rocky road. The National Association of Credit Management's (NACM) July Credit Managers' Index revealed a decided downshift in sales across the manufacturing and service sectors. <u>According to our calculations, credit managers are signaling U.S. GDP will downshift from 4% to 3%. Yes, that's a material move.</u>

As the NACM survey posited, "What could be wrong with an economy that is sporting the fastest quarterly growth seen in four years (4.1% in Q2), the lowest rates of unemployment in years (between 3.8% and 4%) and a dramatic expansion of exports?"

The head of the survey's reply: "It seems that credit managers are seeing some…warning signs and are not as impressed with these good news reports. In fact, some of the issues can be read in those same reports. Much of what drove the fast growth in Q2 came from higher export levels, which took place as buyers of soybeans and other agriculture products rushed to get their orders filled before tariffs took effect. Sales will now start to fall like a rock." Them's fighting words.

Yield curves also are growth proxies – the stronger, the steeper, the better. But purchasing managers refused to pony up that growth was accelerating. Credit managers were equally un-accommodative. Yes, that was the Fed you heard stuttering.

Cooling global PMIs will flatten the global yield curve, validating the on-again, off-again flattening yield curve trade. As much as the cheerleaders would prefer it not be the case, the spread between U.S. 2-year and 10-year Treasury yields is precariously at risk of inverting; the forward curve already has. In-tune drivers would be well advised to pull over for a pit stop lest they veer off the highway victim of a blowout.