Cheap Money

The inversion of the US yield curve was inarguably August's big news story. Traditionally a sleepy month for the markets, the US ten-year Treasury bond yield fell below the yield of its two-year counterpart, resulting in the inverted yield curve becoming everyone's topic of conversation. Investors typically demand more yield for lending for longer terms; any time in the past this relationship has upended, the United States has fallen into a recession. While the yield curve's moves are predictive rather than prescriptive, at this point it feels almost like a self-fulfilling prophecy.

Spending has already begun to slow, and now, in the face of economic nationalism – and trade wars – the global economy faces some uncertainty. The United States has engaged in a program of tariffs against China, seemingly forgetting that importers and end-consumers pay increased costs to offset increased inputs. Those costs have just begun to manifest in US prices, with a recent Bloomberg survey suggesting that GDP could shrink 0.3% as a direct result of tariffing imports.

England continues to labour towards an exit from Europe, with roughly two months to solve a problem that has lacked resolution for over three years, creating a drag on British industry and frictions throughout the Eurozone. While economic nationalism can rally voters, beggaring a nation – under the auspice of gaining control – feels like poor policy in the execution.

Almost unnoticed in the backdrop were moves by the Central Banks of India, Thailand, and New Zealand – all cutting their lending rates in an attempt to spur local economic growth. Very quietly, the race to devalue currencies has started. A weaker currency on its face runs counter-intuitive to economic nationalism, but the goal this time around is to be a net-exporter, and a cheap domestic currency helps that along. Not every nation can be a net-exporter, for every seller there must be a buyer, for every exporter there must be a willing importer as counterparty.

It is natural to hear that a recession is coming and see it as cause for concern. Another way of viewing the arrival of a recession is to understand they are also a natural part of the cycle, and typically are found only by looking back at the data – frequently as the recession is called economies have already begun to rally. That is, at the end of any economic expansion comes a contraction – it is a law of economics. Likewise, at the end of a contraction comes an expansion.

Trade wars eventually end, and lower interest rates help to create the conditions for rapid growth, and rates have already begun to come down around the globe. Taking action to avoid short-term downward movements in equities is only beneficial if the timing of the buy is also well-timed. To profit from short-term moves in equities requires being correct twice, and to be correct twice will require timing the end of economic nationalism's destructive impacts.