We Are Entering the 7th Inversion - Get Ready!

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Yesterday we looked at the [z-score of various asset classes](). Long statistical lesson short, everything is overpriced except housing. Because central bankers don't buy houses with quantitative easing (QE).

The biggest offenders of the statistical law "reversion to the mean" are government bonds. Because government bonds are on top of the list of central bank asset purchases.

Today's *Capital %26 Conflict* focuses on what exactly is going on in the US bond market. Why? Because every financial asset in the world is built on US Treasury bonds.

US government debt is, in theory, risk free. This means it is used in the pricing models of almost all financial assets. And these pricing models heavily influence actual market prices.

If you look up a financial pricing equation, there's bound to be a risk-free rate – a r_f – in there somewhere. That's because everything in financial markets draws its value in relative terms. The "relative to what" is the risk-free rate, US government bonds. Economists would call it the opportunity cost of investing.

The reliance on Treasury bonds as the risk-free rate means that, if US government bonds go haywire, everything else does too. Trillions of derivatives contracts suddenly become financial weapons of mass destruction with a software bug in the guidance system.

But why would the US Treasury market go haywire? Especially with central bankers in charge?

The political wildcard

The only thing central bankers don't seem to have control over is politicians. And they're capable of messing with the US Treasury bond market in all sorts of creative ways.

There are two you need to worry about right now. And the data is already worrying for you.

The US Treasury yield curve tells you how bonds of different maturities are priced. Usually, investors require higher returns for longer dated bonds because there's a higher risk of something going wrong over longer periods of time. This means the yield curve slopes upward.

But when it slopes downward, that suggests a recession is coming. Investors are looking for a safe haven in the medium term. They bid up the price and the yield goes down.

Bloomberg explains that the American yield curve is getting dangerously close to inverting. And points out "The Treasury yield curve has inverted a of the past six downturns going back to the 1960s, including prior to the last two recessions in 2000 and 2006."

So is a recession bound for the US? The problem with the centuries-old indicator is that central bankers have completely distorted it with their buying of bonds. Who knows what the yield curve would look like without their trillions?

However, the US certainly has gone an unusually long time without a recession. And economic mismanagement at the political level could be the trigger.

Which brings us to your second concern.

The deadlines loom

The American government is close to hitting its debt ceiling. And getting the budget approved by congress is set to be a struggle too.

Both of these could lead to trouble. Perhaps even default. The American Treasury secretary is already authorised to use “extraordinary measures” to scrape up cash.

I know what you’re thinking. This is an age-old problem that never actually plays out. There’s always a last-minute compromise. And you’re right.

But Donald Trump isn’t your average politician. He sees politicians and government as the problem. And that means he doesn’t fear what financial markets fear most – trouble in the Treasury market.

In May, Trump argued that a government shutdown would be just what the country needs. On Twitter, of course. But he’s been persuaded to compromise each time the deadlines loomed since. That’s unlikely to continue unless he gets a hurricane in December or starts a war with North Korea.

On 8 December, the US government hits its budget deadline. On 1 March, it hits the debt ceiling. Both negotiations look like they’re in deadlock.

If Treasury bond yields go haywire as those deadlines approach, everything else in financial markets will too.

Bombarding free trade with the rules

Who would’ve thought that a Canadian state government’s subsidy of an airline manufacturer would cause a trade rift between the US and UK?

The US government has announced a 219% tariff on a particular line of Canadian Bombardier jets at the request of Boeing. The wings and fuselage are made in Belfast, putting thousands of jobs at risk.

Liberal Democrat leader Vince Cable said: “Do we really believe the US will save us from Brexit with a comprehensive trade deal, when this is how they deal with fair and free international competition?”

But wait a minute. Are subsidies fair and free international competition?

The UK government also funds Bombardier’s manufacturing with more than £100 million. And this is hardly new, according to the Fraser Institute:

> *Bombardier’s corporate welfare began, at least federally, in 1966 when it received its first disbursement of $35 million from the federal department, Industry Canada. In the decades since, various Bombardier iterations received over $1.1 billion (all figures adjusted for inflation) in 48 separate disbursements from just Industry Canada. That includes two 2009 cheques worth $233 million*.

It’s no wonder the Americans are grumpy. Their allies are funding a rival company to Boeing and then whining about free trade…

The tariff is also in line with Boeing’s decade-long pursuit of Airbus’ illegal subsidies at the World Trade Organization. If international bodies won’t level the playing field, Trump will.

This must be the sort of thing Donald Trump rages against when he says “fair trade”. Perhaps he demands an end to subsidy practices if we’re going to make a pitch for trade with the US. “Even our closest allies must play by the rules,” said US commerce secretary Wilbur Ross.

British Remain politicians are circling like vultures. They see this as a failure of post-Brexit trade negotiations.

It’s not; it’s the opening of those negotiations, Trump .

Until next time,

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Capital %26 Conflict