Rates: Put these on and inflation disappears!

With bond market goggles on there is no inflation, it seems. Leave them on and look hard enough and a tint of distant deflation dawns. That's one version of where we are. The other rationalises the slip lower in market rates by an intense overflow of liquidity. We like that explanation most. But we are also tempted to at least give those goggles a go, just in case

A woman in New York wears protective goggles which must make seeing clearly what's in front of her pretty difficult

Inflation is a concern if we actually get it. And if we do, market rates should rise in anticipation of eventual rate hikes

Higher inflation is supposed to coincide with higher market rates. Why? Two main reasons. First, market rates contain inflation, so if inflation rises then so too should market rates. Second, higher inflation will typically cause central banks to raise rates; maybe not immediately, but eventually. Market rates would then typically rise as a consequence of the former and in anticipation of the latter.

But let's break this out. Inflation only matters if it persists. In other words, if inflation rises well above trend but then falls back to well below trend, then it matters far less, or at least it is less scary. Moreover, if the bond market believes that to be the future with a degree of conviction, then it need not worry about a short-term burst in inflation.

Central banks are intent on staring down inflation only when it is actually there

In addition, central banks during this particular recovery are very unlikely to anticipate inflation through a forecasting model. Rather, they seem intent on staring down inflation when it is actually there. The Federal Reserve has an explicit average inflation targeting policy now, which allows them to take some risks to the upside for inflation, and they have also mandated upon themselves a requirement to secure a recovery for the most vulnerable segments of society (and not just the median household). So an imminent rate hike risk is significantly downsized.

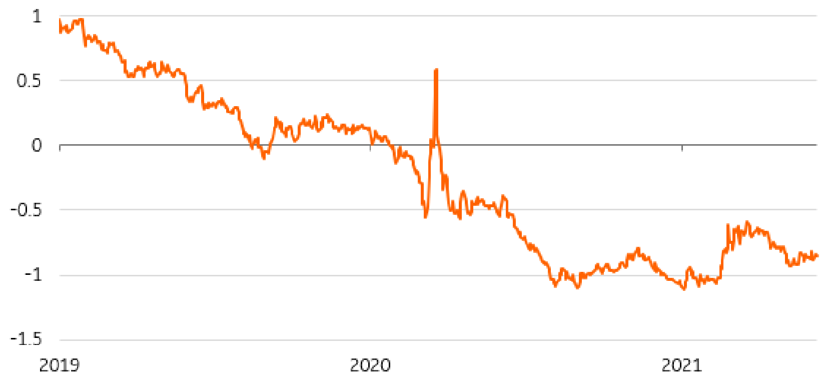
So far we've (just) had a rise in prices. Inflation has yet to be proven. Is this why market rates have fallen?

And as of yet, inflation has not been proven. Yes prices have risen, but that is not inflation - a lot of it is a base effect (not all, but a decent chunk). All the signs point to inflation. The very simple spurt in demand against an inability to supply is enough, and we are seeing that right left and centre.

Some in bond markets fear real wage erosion rather than a wage-price spiral

But that can be rectified - get the supply chains sorted and coax employees away from stimulus cheques and the supply side can come roaring back. Then, what we could have is a one-off rise in prices, with no follow-through. More worryingly, if price rises are followed by a lack of wage inflation, we would see real wage erosion, and more a deflationary feeling than a reflationary one.

US 10yr real rate (nominal market rate less inflation expectations), %



Source: Macrobond, ING estimates

We relate this, not because it is our view, but to help look into the mindset of certain segments of the bond market that are simply not believers that we have an inflation problem. And in fairness their opinion does matter, as bond holders receiving fixed coupons have the most to lose if inflation is in fact the real deal.

Negative real yields don't paint a pretty picture either.

The bond market has, in fact, built an elevated inflation expectation, but to do so it has had to dig deep into negative real yield territory. That in itself is a worrying sign. A negative real yield is not telling us anything positive about the future.

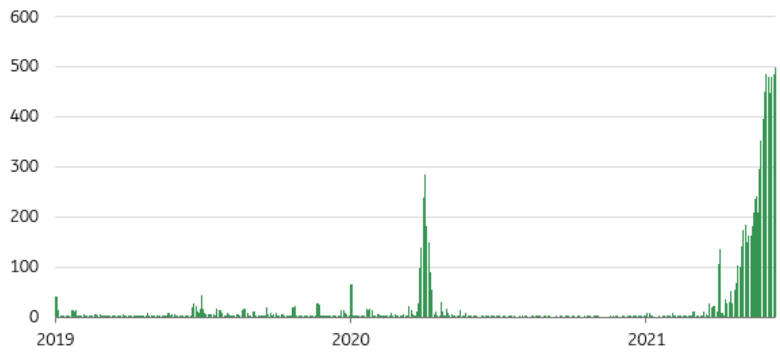
Or is it because market rates have been bullied lower by an excess of liquidity and strong international buying of Treasuries?

The counterargument is that bond markets are in fact concerned about inflation, but market rates are being bullied lower by an excess of liquidity. There is some merit in this argument. The near $500bn of overnight cash being posted back to the Fed on a daily basis from market players with nowhere better to put it is indicative of an excess of liquidity in the system.

> *Big liquidity is swashing around. This is really pushing market rates down*

The fact that front end bills rates and general collateral repo rates are posting negative rates tells us the same story and, in fact, is a partial cause for the posting at the Fed in the first place - zero percent at the Fed's window is better than sub-zero elsewhere. And what we see going into the Fed's reverse repo window is only a part of the excess. A lot of other forms of roaming liquidity will make their way into other asset classes, including the fixed income market, thus placing downward pressure on market rates.

Surplus cash going back to the Fed at 0% through its reverse repo facility, USD bn



Source: Federal Reserve, ING estimates

On top of that, we have the Fed buying bonds through its bond-buying programme (generating the liquidity in the first place), and non-public demand for US bonds remains high, too. Not just from domestic players, but also from international players that get a decent pick-up (even when FX adjusted). And remember, players sitting in Tokyo or Frankfurt don't care where US inflation is. The inflation rate that they need to outperform is their own domestic one.

Steady market rates have also tempted in (boring) carry buyers

The other important technical factor is volatility. Long end rates have done effectively nothing since the end of February. In March, the higher rates' narrative was still a very persuasive one, especially given the rapid rise in the rear-view mirror. But as we progressed through April, into May and now June, the environment has been one very conducive to simply holding bonds that may not yield a lot, but are churning out a steady running yield that is well in excess of funding costs (Fed at zero and ECB deeply negative); being long carry.

Probably more liquidity-driven, with long carry flows. But a nagging risk case scenario persists till its disproved

So which is it? Why are market rates facing down rather than up? Either there is no inflation concern, and central banks in consequence will not have to hike by much (if at all). Or, there is in fact an inflation concern, but it is being dominated by an excess of liquidity and desire to buy into boring carry positions that do just fine for as long as rates are steady.

If pushed, we are in the latter camp. This is a liquidity-driven spurge that is resulting in mis-valuation (market rates too low). But that's no more than an educated judgement. Nothing is for sure. In fact, using bonds as a pure predictor of the future, precisely the reverse is being discounted.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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