

## Rates: Collateral damage

Despite ongoing Covid angst, steeper yield curves led by higher long rates gel with a positive vibe for the future. The vaccine helps enormously but big issues remain. Large negative real rates remain indicative of macro stress, and they have moved even deeper negative of late. We still look for higher market rates in 2021, helped by a reflation theme



The Fearless Girl statue in New York's financial district

### The short term outlook: (Un)Lucky dip

We kick off 2021 with market rates still exceptionally low. The German 10yr at -50bp is only marginally above the -70bp hit when Covid first struck. Even the US 10yr is struggled to really break to the upside, although has since finally broken above 1%. While an unconstrained Biden administration will push up the deficit meaning more supply, the near term macro angst will contain the extent to which US market rates can rise.

The macro data in the coming few months will be bad, clearly marking out a double-dip. That's always been a risk case scenario and it is now the central case. The risk case now centres on a longer dip, or something more sinister than a dip.

## The vaccine effect: Good, but big issues remain

The vaccine certainly helps to frame a better medium-term outlook, but other collateral damage left in the wake of the coronavirus impact needs addressing too. Market rates are still below current low inflation rates, which is far from natural as it means we live with negative real rates. Those negative rates paint a very dour picture of the future. In Germany, the 10yr real rate is at -1.5%. In the US it is closer to -1%; higher, but still depressingly low.

But at the same time, implied inflation expectations coming from the difference between conventional and real yields have risen. In the US the implied inflation expectation is now running at over 2% in the 10yr, while in Germany it is just below 1%. The problem is, elevated inflation expectations are partly down to depressed real yields, and that's far from ideal. We are still far from normal market rates.

## The strength of the recovery: The negative real rates conundrum

These are far from certain times, and negative real rates are the clearest measure of the extent of Covid-inspired collateral damage. At the same time (and to cling to positives), negative real rates are highly stimulative and should aid recovery.

The steepening seen in the US yield curve in the past couple of quarters is illustrative of a growing reflationary discount. We are not there yet, but once we get clarity that the dip being experienced is indeed just that, a short dip, there is the underpinning for the US 10yr to stay above 1%. In fact, the profile through 2021 pictures a 25bp ratchet higher in the 10yr in each quarter; not quite getting to 2%, but getting above 1.5% is on the cards.

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