

## Rates: Escape velocity

Ben Bernanke coined the phrase "escape velocity" in 2010, essentially saying that there needed to be plenty of oomph to growth, so the gravitational forces of deflation were left behind. Although an aspiration at the time, two years later, the Fed was discussing how best to taper bonds. The metaphor is quite apt again, for both the economy and the bond market



Source: Former Federal Reserve Chairman Ben Bernanke

### The big driver here goes beyond reflation to an inflation spurt

It was only a month ago that the US 10-year threatened to break below 1%. Crucially it didn't, and indeed at the time, we noted that, if it did, it would not be down for long.

But since then, not only has it held above 1%, but that platform facilitated a leap to 1.5% in the space of just a few weeks. The tail end of that saw a 15 basis points rise in yield in intra-day trading in just a day (that's pretty big, by the way, if you're not a bond guru).

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*This certainly had the feeling of escape velocity. It coincided with a classic underperformance of the 5yr to the curve - the kind of thing you would look for to really class this a bear market for*

*bonds.*

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And this move had nothing to do with supply pressure, by the way. It was and still is all about the build of a reflection theme. Moreover, it is a reflation theme with a very significant tint of an inflation spurt, one that may prove to be more persistent than many had thought possible.

## **Morphing the deflationary tail risk to one of inflation - we like that one**

The Federal Reserve has, in a very persistent way, managed to morph the deflation tail risk into an inflation one - a risk they prefer to deal with. Moreover, aiming in that direction ticks other important boxes, such as growth and implied employment objectives. For bonds, though, this is a dangerous game, as inflation is a bond investor's worst enemy.

In fact, inflation is a significant risk for any security that pays the holder a set fixed amount with regularity into the future; inflation just eats away the value of that in real terms. Hence the rise in yields as compensation for higher inflation expectations. As we face a growth and inflation combination of at least 6% and 3%, respectively, it should be no surprise for us to be looking for 2% as the next big level to aim for on the US 10yr Treasury yield.

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*We have successfully escaped the deflationary pit of despair - staying comfortably above 1% keeps that at bay. Next stop is 2% to price in a 2% inflation environment on a zero real yield.*

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Even at that level, an implied zero real yield still does not feel like an equilibrium. If there has really been escape velocity, then the 10yr is still looking up from there, rather than fearing a lurch back.

## **There are risks to this in the guise of Europe and risk assets**

So what are the risks? There are many, in fact.

The first is the juxtaposition between the US clamber to exit from the threat of negative rates to the eurozone's seeming reluctance to cast off those very same shackles. The ECB's soundings have been more along the lines of viewing the rise in yields (which has turned into a global thing, in fact) as detrimental to the recovery rather than as a sign of one.

In that sense, there are two risks. One is that eurozone yields remain a drag for US yields, so that, say, a 200bp Treasury - Bund spread presents a ceiling for the US 10yr. The other is that the rise in US rates is so abrupt that it does, in fact, result in self-harming, negating the benefits of escape velocity as the economy and yields flop back down again.

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*Should the Federal Reserve start to contemplate a taper of bond purchases, the experience in 2013 shows that risk assets can get*

*very unnerved by it.*

The third risk links this to the prognosis for equities and credit spreads. So far, so-called risk assets have held up fine. In fact, equities hit new highs in places. The trouble in fixed income is all about the rise in core rates, as credit spreads have been contained. But, this space is littered with risk, especially if inflation and market rates continue to rise. That combination leaves corporates with higher re-funding costs and discounts future earnings more deeply, pushing up price/earnings ratios.

A tapering discussion from the Fed could be as good a catalyst as any for a risk asset underperformance, perhaps a severe one. And it would act to curb the upside to bond yields as cash would then flow back to the relative "safety" of bonds. [This could happen as early as the summer.](#)

Until then, it looks and feels like market rates will continue to test higher. From the Fed's view, this is tolerable as it discounts a success for them, as they are seen to be successfully generating reflation. The eurozone views it through a different prism, almost as a threat to the recovery, perhaps for good reason as they have been burnt many times before.

We'd like to think this is the real deal. It certainly feels like escape velocity in the US, and might just be enough to put some tempered optimism into the eurozone too. The holy grail of a positive 10-year swap rate is here, far sooner than we'd expected. Better not to get sucked back down to the depths of the inverted upside-down world of negative rates.

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