

Rates: Tox-tail soup

It does not take much to coax market rates lower. Re-heat a US-China trade war, add a pinch of US impeachment concern, toss in another UK vote on Brexit and then simmer in a mix of corporate angst and 2020 uncertainties. Market rates are then ready to test lower as soon as risk assets judge that the brewing cocktail is toxic enough to call it a day for 2019



Source: Shutterstock

The call on rates in the coming months (that morph from 2019 into 2020) is complicated by a remarkable mix of digital extremes. Either there will be a China-US trade truce or not, either there will be a resolution of the UK Brexit dilemma or not, either there will be a viable impeachment process or not, either the sub-50 PMIs are signaling a recession or not, either corporates lift the seeming embargo on investment plans or not, and we could go on.

There are diverging signals too. The US consumer is hot, and confidence still off the charts, while at the same time corporate America is far less certain, curtailed by narrower margins and expectations that remain muted at best. But impacted too by policy uncertainty, in the US, in Europe and in supply chains that spaghetti junction their way through both developed and emerging markets. Holding off on big investment decisions is then is not a bad strategy, but not good for growth.

Meanwhile, the US labour market is tight, but there is no (material) wage inflation. There is also no manufacture of inflation generally. The European central bank continues to struggle to generate inflation, and may even consider adding housing costs to their CPI measure in an effort to create some. US Treasury inflation-protected securities trade with an inflation discount, rather than the premium they have typically commanded, as market participants just don't see value in paying for inflation protection.

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Market flows also show that participants continue to buy duration. To do so they buy in longer tenors, and implicitly then take on a bet that inflation will not rise. They also by definition then bet that key central banks will not be raising rates any time soon. And market flows on the demand side these days include central bank buying, with the ECB continuing their quantitative easing program, and the Federal Reserve too as they too rebuild their balance sheet by buying bills.

These days you can pitch market rates virtually wherever you want and you'd find a decent rationale for that level. The most undisputed level is where rates currently trade - that's always the starting point. A 10-year Bund yield of -35bp is hardly sustainable. But then again a 10-year US Treasury yield of 1.7% looks incongruous against inflation expectations at the same rate i.e. a zero 10-year real yield (rounded). So they should be higher, eventually. But they are where they are right now.

But an equally valid question is where are they heading to in the next couple of months. Based off a supply/demand trade-off that has delivered the current price, or market rates, as a starting point, then the odds are that market rates test lower again before any real ability shows to muster a material move to the upside. There is a complex sauce being concocted; it does not smell that pretty and is more likely to brew net trouble than a run of positive solutions to our numerous digital outcomes.

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