

Rates: Path of least resistance

Market rates are likely to remain relatively low; at about current levels or lower in the coming weeks (and likely months). Structural reversion to higher rates would need evidence that there has been a positive turn of the tide. In the meantime, an information vacuum perception sustains vulnerability. These are strange times, so expect volatility



Source: Shutterstock

There are numerous nuances to consider as we examine the current circumstances.

First and foremost, rates were already in a stressed mode before the coronavirus narrative hit, and the subsequent move has confirmed the path of least resistance – lower rates.

Second, risk assets have been worried about a catalyst that could take back the outsized gains made in 2019, and this virus event is as good a catalyst as any. That vulnerability can become circular and push core rates even lower. However, let's not get carried away here. It does not mean we need to push our 1.5% target for the 10-year lower. For that to happen, we'd need to see a more definitive turn for the worse. We've not had that yet.

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As we progressed towards the end of 2019, there were numerous good reasons for the 10-year US yield to attempt a break back above 2%. But despite elevated US consumer confidence, a tight labour market and an improved trade war narrative, that break higher never really materialised. We saw this from the structure of the curve too, as the 5yr remained very rich to 2s and 10s, which is a classic sign that a preference was there to test the downside rather than the upside. This is why, backed by weak PMIs, our projections pitched a lower rates bias. Fast forward to January 2020 and it has just taken the flu from China to cause a significant move down to the 1.6% area.

That is not to underplay the event, because if there is one thing we do know is we are at the beginning of an event that could easily stretch months. The SARS virus is a go-to template, as there are more similarities than differences. SARS stretched from November 2002 to June 2003 before we got the all-clear, then the thing was in remission. Remarkably back then, the Federal funds rate was very similar to where it is today (1.75%). It had been cut from 6.5% after the dot.com crash, and ultimately fell to 1% after the SARS virus.

It is not easy to break out precise market reactions, but before the SARS flu had receded, the 10yr yield had fallen from around 4% down to a little under 3.25%. Part of this was the virus, but a large part was also the other background noise. The curve was already steep (c.200 basis points), and only steepened further on the final Fed cut to 1%.

Away from the virus itself, it is interesting to note the difference in the shape of the 2/10yr curve (200bp) and the level of the 10yr yield back then (4%) compared to now where we have a 20bp & sub-2% combo – a good illustration of the excess of demand oversupply that is driving yields today.

From a eurozone perspective, this is the last thing the European Central Bank needs. Europe is already down, with Germany and Italy at the bottom of the spectrum of contemporaneous growth observations while the ECB is practically out of bullets. That said, the Treasury/Bund spread has tightened, which means that the move in US Treasuries has been more significant than for Bund yields. There is already a deep negative discount in the price of eurozone bonds, but with the ECB likely standing pat at -50bp, there is a limit to how bad things can get.

For that to change, again, we'd need to see a clear turn for the worse on the virus impact.

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