

Rates: Flight to safety

One possibility is that the Fed under-delivers on market rate cut expectations. This could force long rates lower as the disappointment on the extent of the delivery of cuts prompts investors to switch out of risk assets into Treasuries, which still offer a positive yielding risk-free rate



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How low can rates go?

These are exceptional times. The bond market is calling for a US rate cut - a sequence of them. The Federal Reserve took note and acknowledged the discount through various commentaries. And then we got a meagre 75k rise in US employment, signalling real evidence of some slowing in the labour market. Participants calling for rate cuts feel emboldened, and we've now pencilled a couple in, but the call for market rates is complex, and especially with so many cuts already discounted. We examine how low they can go.

Despite the fundamentals, a sub-2-year US yield could be rationalised by a flight to safety. Given a choice of global risk-free rates, US Treasuries remain in a class of their own; they offer a positive yield (compare that to negative yielding German and Japanese yields). In that sense, a 2-handle could be viewed as a "steal", especially with the USD seemingly intent on remaining at the extremities of its fair value range. This combination as a stand-alone could rationalise a break into

the 1.75% to 2.00% range, with all the trade war/Brexit/dis-inflation/uncertainty noises echoing in the background.

A break below 1.75% would need significant safety flows

For a break into the 1.5% to 1.75% range, these safety flows would need to be significant. Again, this is perfectly possible should the verbal back and forth on trade take another turn for the worse, as we suggest, with associated freezes on corporate decision making. Note that it would imply the 10-year trading through the current 10-year break-even inflation rate on Treasury Inflation Protected Securities (TIPS) at 1.73%. At the extremity, the real 10-year yield would likely approach zero (currently 44bp). This isn't impossible, but it would imply quite a negative macro scenario for the coming years.

It would also likely imply a semi-permanent inversion of the yield curve. The 2-year would be anchored by the federal funds rate, in the sense that it should be a breakeven versus the funds rate in the coming two years, more or less. Meanwhile the 10-year could trade well through as there is no similar anchor, and especially if we have dis-inflation in the background (as inflation is the biggest issue in the 10-year).

The Fed is still likely to under-deliver on the rate cuts

Leaving aside fundamentals for the moment, we know the Fed would prefer not to cut rates aggressively; as the more they cut, the closer they get to the ultimate floor of zero and a reversion back to quantitative easing (in the most extreme scenario). So it could make sense for the Fed to drag their heels on rate cuts, and instead let the market do the easing for them, dragging down mortgage rates etc. It would be oxygen for President Trump's criticism of the Fed, but could be a smart path for the Fed – let the aggressive market expectations and lower long tenors yields do the work of propping up the economy and risk asset markets.

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That narrative could support a scenario where the funds rate gets cut to 1.75%, but the 10-year temporarily trades through this to the 1.5% - 1.75% range as worries peak (only to subsequently and slowly revert higher, eventually back above 2%). Such an outcome is still a significant undershoot versus current fundamentals, although the same could be said of the 2-year Schatz yield of -70bp, which is quite a large discount for the coming few years at the very least.

One of the nuances that we identify here is the likelihood that the Fed under-delivers on the market rate cut expectations. This could force long rates lower than otherwise since disappointment on the extent of delivery of cuts flow into Treasuries – which still offers a positive yielding risk free rate.

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