Rates: Sinister market discount

Things are discounted to remain bad, or even get considerably worse, for an extended number of years. A snapshot of current curves rings many alarm bells. The hold-out hope has been the US, but with the 30-year now below 2%, that hope is waning fast. We don't like it, but the path of least resistance is still for lower market rates.

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While there has been a keen and sensible focus on global central banks in recent months, there have also been some remarkable moves seen at the other extremity of core curves. Not only is the German 30-year yield below zero, but the US 30-year yield has broken below 2% in the past few weeks. That takes the US 30-year yield to a new cycle low, taking out the financial crisis and subsequent angst-period lows. If we are to believe the market discount, then these are the worst of times. Plus, things are discounted to remain bad or even get considerably worse, for an extended number of years.

These remarkable valuations have been heavily influenced by two key questions that are very difficult to answer.

1. The first question centres on core central bank policy, and to what extent central banks have the capability to influence activity, and by extension inflation. Central banks may (and

indeed were) key in averting depression following the financial crisis, but their ability to influence has been severely impaired since. Japan has struggled, Europe is now struggling and while the US is in better shape, it is far from clear that the Fed has the control it once had.

2. The second issue revolves around politics and global policy disagreement. Here the immediate focus is on the future of Europe (and the eurozone) and by extension Brexit and trade relations. Overlaying that is the widening gap between the narratives coming out of the US and China with respect to the resolution of trade disagreement. Things on this front are getting worse, and likely to get even worse before a tone change is probable.

The preliminary answer to the first question, coming from the central market discount, is that central banks have lost considerable capacity to influence economies. And the second political issue is one that augments the answer to the first question, as political wrangling such as Brexit and trade wars makes it even more unlikely that central banks can have the impact that they could have. And in a way, central bank efforts to cushion economies in fact make more room for trades wars and allow the like to deepen.

Long end rates have long noses. Often the 30-year rate can behave differently from shorter tenors, as the 30-year will pick up on ultra-long trends. This can manifest in very steep 10/30-year spreads for example as the 10-year gets pulled lower by front end vagaries, but the 30-year maintains some degree of longer-term aloofness. This can be a comfort that all of the bad stuff being discounted today will go away eventually. There is an element of this in play on current core curves, where the 10/30yr is far steeper than the 2/10yr e.g. in the US the 2/10yr is flat while the 10/30yr is 50bp.

That said, there has also been a clear flattening tendency in play in recent months. And flatter curves imply a lower forward discount for higher rates in the future e.g. a completely flat curve implies no rise in rates, and an inverted one discounts cuts on fears for recession. A snapshot of current curves rings many alarm bells. The German 2/10yr curve is a mere 20bp, implying a minimal forward discount for higher rates, ever. The absolute 10yr yield at -65bp is even more sinister in terms of implied discount (imputes depression). The hold-out hope has been the US, but with the 30yr now below 2%, that hope is waning fast. We don't like it, but the path of least resistance is still for lower market rates, with most such room in long-tenor rates.

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