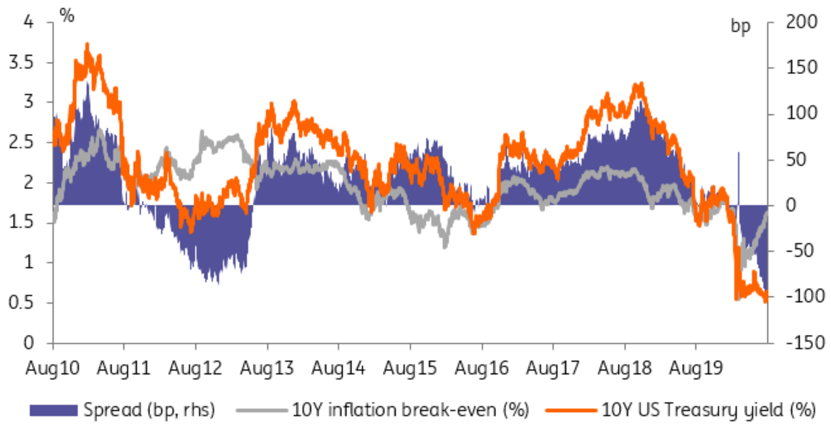
Rates Spark: time to get real with yields

The collapse in real yields has more to do with diverging economic views across asset classes than to a change in central banks' inflation boosting credential in our view. The long-term fundamental case for higher UST yields is light but technical factors could push them higher in the near term.



Source: Bloomberg, ING

Negative real yields, looking for a culprit

We've had doubts about the global narrative according to which the collapse in real yields, most visible in USD but by no mean a development specific to the US, heralded a change in inflation dynamics. Starting with a rates-centric view, the divergence between nominal yields and inflation break-evens is an extremely rare event. Most previous adjustments in real yields were brought by a sharp move in one of its components, whilst the other remained stable (eg in 2012 when inflation break-evens rose whilst yields stayed pinned down).

A more dovish Fed, and likely moves towards average inflation targeting, is a convenient culprit. After all, the Fed directly depresses nominal yields through QE, and its tolerance for higher inflation does provide an explanation for the move in break-evens. Given the Fed's track record in boosting inflation in the past decade, and various constraints ranging from the zero lower bound to a flat Phillips curve, we find it surprising that rates markets would attribute the Fed so much credibility all off a sudden.

Granted, record fiscal and monetary stimulus, the latest example of which being the interest rate cut to the Municipal Lending Facility overnight, and a threat to global supply chains could herald a change in global inflation dynamics. These are plausible long-term explanations and their discussion is beyond the scope of this publication. Suffice to say here that, like the Fed explanation above, we think this could be a factor behind the collapse in real yields but hardly the only one.

Long-term gloom but room for a jump in yields

In our view, nominal rates are far from numb to inflation risk, and yesterday's rout on the higher than expected US PPI print should serve to illustrate this point. What current nominal bond valuations betray is a much more gloomy economic outlook than one can infer from looking either at the stock market or at break-evens. Looking at our US economist's assessment, we would go by the nominal rates' view. This also seems to be the view taken at the Fed, judging from Thomas Barkin's overnight comments that the recovery is flattening.

This gloom helps explain why despite signs of an easing in the global safe asset shortage through the issuance of more government bonds, rates have remained pinned down. This does not mean that low yields are sustainable should the economy surprise to the upside. However, that's not our base case. For now, there is little in fundamentals that justifies a further move higher in rates.

We flagged earlier this week the risk of an adjustment higher in long-dated yields due to tomorrow's 30Y US T-bond auction. This provides a convenient horizon for those looking for a short-term move. Given our economic view, we would refrain from calling for a sustained adjustment higher in interest rates. It should be noted however that sharp sell-offs bring waves of long liquidations which can exacerbate the move. If the period immediately following tomorrow's auction doesn't see a recovery in 30Y USD rates, we'll likely see another leg higher.

Today's Events: US CPI

Today's European CPI readings are second readings but their US equivalent will be a first release. Given the jump in yields on yesterday's CPI, we exect the release to be closely watched.

Germany auction €4bn of 10Y debt today, followed in the US session by a 10Y T-note auction.

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