

## Rates: The twilight zone

We get accustomed to extreme levels as we hit them, but a 1.5% US 10-year inflation break-even and a practically zero 10yr real rate is worth paying attention to. German real yields at -1.5% is another one. These are not just levels, they are also market discounts painting a gloomy picture for the future. And these implied expectations are only getting worse



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The outlook for inflation is a key factor underpinning interest rate policy decisions. That outlook can be derived from forecasts, but it can also come from the market discount.

Billions if not trillions of dollars underpin that discount, typically with long-term investments. Right now that market discount is quite remarkable - the US 10yr breakeven inflation rate is at a mere 1.5%. This is remarkable as it is so low. It is telling us that US inflation will average just 1.5% per annum over the coming decade. While the ECB could only dream of such a discount, for the US, this is an exceptionally low inflation expectation at the tail end of a cycle upswing.

This tame discount for inflation is all the comfort that the Federal Reserve needs when it comes to pulling the rate-cut trigger. Market rates are impacted in a similar manner. Swap rates or conventional yields are nominal in nature. In other words, they consist of a real rate plus an inflation expectation.

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In simplistic terms, if the US 10yr rate is at 1.6% and the breakeven inflation rate is 1.5% then the implied real yield is about 10bp (as can be gleaned from inflation-protected Treasury yields). A few weeks back the 10yr real yield had, in fact, turned negative. While moderately positive now, further compression of nominal yields lower would likely force 10yr real yields back into negative territory.

Think about this for a moment. A US 10yr real yield at zero or lower paints a very poor picture for the future; it implies, at best, a very subdued growth prognosis. And that's for the US, where things have been relatively rosy in recent years. In Europe, the 10yr inflation breakeven is 0.75%, and nominal core yields are negative right out to 30yrs. Moreover, if nominal yields are negative, then by definition real yields are even lower. And they are; trading at a staggering -1.2% for 30yr Germany. The only silver lining here is there is an implied 30yr breakeven inflation rate of 1.3% underpinning that. But that's of little comfort.

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No wonder the ECB is worried. They are all in, and practically begging governments to loosen fiscal policy - anything to steer the eurozone away from the abyss. Whisper it quietly, but within that abyss lies a eurozone existential risk scenario that needs to be steered well clear of. While the discount from the US is one of mediocre growth, the discount from Europe, on the face of it, is for depression. Let's be clear, we are not calling for that. But the market discount is consistent with it (notwithstanding bond market supply/demand/QE dynamics).

For market rates, the prognosis is circular. Lower nominal rates generate a lower inflation breakeven, which in turn justifies rate cuts and lower real rates as core economies slow.

The pull of the eurozone (and Japan) is almost irresistible as they push against the extremes to the downside. This, in turn, exposes US market rates as being relatively high in the risk free space. And we go on. In consequence, the next target for the US 10yr is a break below 1.5%. After that, we are into the 1% to 1.5% zone. That may not appear extreme as low rates have in effect snuck up on us.

But we are now heading for new lows, taking out all of the lows seen since the financial crisis. As market discounts go, that's quite a bleak one.

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