

Rates: Why rates are collapsing

Bond markets are enjoying the art of the steal. On one side of the balance sheet, core issuers are obligated to return less money than they have been lent right out to 10 years. On the other side, investors have eyed the 10-year US at 2% and concluded that that is a steal when compared with other (negative yielding) risk-free rates



One of the notable aspects of likely easing from the Federal Reserve from the end of July is it effectively marks a turn in the cycle. While we argue that the cut will be precautionary and likely followed by just one additional cut, others argue that a July cut will be the beginning of a series of cuts. The 100+ basis points of cuts discounted by the markets is consistent with the type of policy response required into a marked macro downturn.

What troubles us more is the prognosis for the eurozone – the land that got left behind. While the US Federal Reserve has the luxury of cutting from a point of strength, the ECB is still cutting from a point of weakness. History shows that Fed policy has been a forward indicator of ECB policy but not this time, as it seems the ECB has missed out completely on the rates uplift part of the cycle.

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From a market rates perspective, the important nuance here is the Fed managed to pull away from the zero-to-negative-rates-anchor that dominated post the financial crisis. So there was escape velocity. But two factors have limited the extent of the move. First, the likes of European and Japanese rates have acted as a magnet, and second, the underlying disinflationary tendency never really went away.

The magnet of other core rates has been important. When the US 10yr hit 3.25%, the German 10yr was in the 30-50bp area, and had previously (briefly) hit 1%. The move in the US 10yr from 3.25% back down to 2% coincided with the German 10yr reverting to negative yields. That move down to -30bp was a massive one, as it was essentially a capitulation to crisis-style levels.

In consequence, we are staring down the barrel of an ECB gearing up to join the monetary loosening, and so skipping the tightening bit completely. It's a loosening beyond prior extremities, a deeper dive into the realms of what should be considered an abnormally inverted state. And a change at the top of the ECB (from a definite dove to a likely dove) implies maintenance of extreme policy and thus extreme rates.

The whole spectrum of global risk-free rates has shifted deeper into negative territory

When viewed in this light, a handle of 2 on the 10yr US yield is in fact a generous level. Sure it was even more generous at 3.25%, but the whole spectrum of global risk-free rates has shifted not just lower, but also deeper into negative rates territory – any return is better than paying a borrower for the privilege of lending cash to them. Hence, no great surprise that the US 10yr has slipped below 2%.

And as always it is circular. The US 10yr below 2% is a level that bears more relation to the German 10yr yield at -30bp than it does to contemporaneous US fundamentals, which is a remarkable thing to assert. Relative value vis-à-vis other risk free rates together with an excess of demand (including QE) oversupply are dominant drivers of the absolute level of market rates, and by implication central bank rates.

And then there is the phenomenon that is the German 10yr yield. At -30bp, the implied discount is for 10 years of pain; in fact, depression is imputed. The Japanification of Europe is the common jibe. It could be. But it also reflects a safety play for investment funds that seek to warehouse cash in a market-place that can take big volume, and has the assurance of proxy-Deutschemark status should it all fall apart.

And this is why what happens in e.g. Italy is important. Not just for Europe, and German yields. But also for US yields, and risk free rates generally. The stress of any description can bring ECB quantitative easing, an excess demand for “safe” bonds, and thereby ever lower rates.

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