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Rates: why real rates are the key for direction

A long-run real return is what you get over and above long-run inflation. In Europe, it's still negative. In the US, it's barely positive. Lower market yields of late have come from an easing in inflation expectations. But with real rates still so low, there is a natural pressure for market rates to be driven higher again, as real pressure slowly re-builds

People walk past a store in Rome, Italy

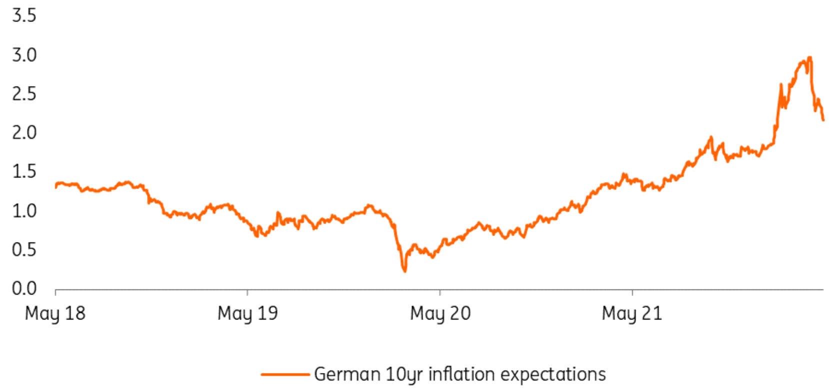
Source: Shutterstock

An easing in long-run inflation expectations especially in the eurozone

Market rates have shown a tendency to ease off the highs in the past few weeks. This has been more pronounced in the US, resulting in a tightening in differentials vis-à-vis eurozone market rates. The big driver has undoubtedly been an easing in inflation expectations. For example in the US, the market-implied average inflation rate in the coming 10 years has eased lower to 2.6%, down from 3%. This market discount is still not low enough for the Federal Reserve to be completely comfortable, but it is heading in the right direction.

The eurozone is experiencing the same with, for example, the implied average German inflation rate now at 2.2%, compared with almost 3% about a month ago. That's quite a move in a very short period of time, and in fact, it likely overstates the degree to which inflation expectations have actually fallen.

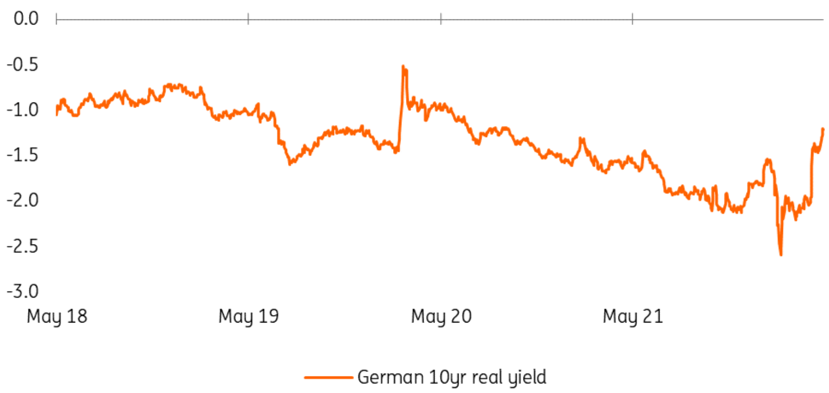
German inflation expectations have fallen significantly in recent weeks (%)



Source: Macrobond, ING estimates

The reason for this reflects the construction of 10yr inflation expectations; achieved by subtracting inflation-linked bond yields from regular market yields. In recent weeks, regular market yields have been constrained by weak risk assets and slowdown narratives. But real yields continued to rise from deep negative levels. In consequence, implied inflation expectations have optically collapsed.

The German real yield is on a journey higher (%)



Source: Macrobond, ING estimates

Real yields are still too low and are primed to resume their rise, pressuring market rates

So what are real yields exactly? Marketwise, they are yields on bonds that pay the holder delivered inflation, so they are “inflation-protected”. The par coupon paid on such a bond is then a real coupon, i.e. a return above inflation. And as the market moves, that translates into a moving real yield. It’s effectively the yield received after being compensated for inflation.

The thing is, the real yield is still deeply negative in Germany. Even though the German 10yr real yield has risen by some 2.3% since March, it’s still at only -1%. A long-run negative real yield is not a natural state. Even in the US, real yields were negative until recently, and now are barely positive, at just 10bp.

> *Theory links real yield to productivity and technological improvement*

Logically, real yields should be positive. Theory links them to growth, with particular links to productivity growth and/or technological change. Negative real yields paint a negative picture. While it can be argued that there are central bank bond-buying complications here, that is far from the complete explanation as to why real yields are still so low. There is room for real yields to rise in both the US and Germany. The US 10yr real yield should rise to 1% and the German 10yr real yields must move to zero at a minimum. If not, we really have not recovered fully.

Note that upward pressure on real yields is a threat to risk assets. Higher real yields place direct pressure on equity valuations, as price-earnings ratios contract when real earnings are discounted back to the present. One of the reasons (but far from the main one) that equities have sold off is higher real rates. And should equities stabilise here and push on higher, it would in fact provide more room for a further rise in eurozone real yields, and a resumed rise in US ones.

Should market rates rise from here, expect the driver to be higher real yields

Do higher real yields mean higher nominal yields? Likely yes. But such real pressure should be muted by an ongoing easing in inflation expectations, especially in the US.

For example, hypothesize a rise in the US 10yr real yield to 1%. If that coincides with a fall in inflation expectations to 2.25% to 2.5%, that gives us a nominal yield of 3.25% to 3.5%. Which is as good a target as any for yields to peak at. And that’s our call for 3Q.

For the eurozone 10yr, you can easily see how difficult it is to square a zero 10yr real yield with a 2% inflation expectation, and that suggests the 10y should be hitting 2%. As we factor in the energy crisis currently playing out, we're not quite in line with that view, but the rationale for a move in that direction is there.

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