

## Rates: Why they are so low

Core rates are low for many reasons, ultimately a reflection of excess demand over supply - which has been affected by quantitative easing. But there is also a fear factor in play, not just flight from struggling emerging markets, but also from the Italian story which could, although not our base view, disrupt the eurozone significantly



Source: Shutterstock

### Flight to safety from emerging markets

Core rates are being constrained by fear. And it has little to do with future recession worries, at least not directly. The biggest fears are centred on various brewing idiosyncratic risks lurking outside core markets. There is an emerging markets aspect to this centred on the likes of Argentina and Turkey. The catalysts vary, but 40-50% collapses in respective currencies is as good as a barometer as any. This has generated a flight to safety, infecting the likes of Brazil, South Africa and Russia. The drivers vary, ranging from election uncertainty to macro mismanagement to sanctions fears. But one outcome is clear; this all generates flows into safer shores, like Treasuries and proxies.

### Ultra low bund yields act as an anchor for Treasuries

At the same time, while the US economy is jogging along nicely (prompting a steady rhythm of

hikes from the Fed) there is also a brake in play in the guise of bund yields that remain far closer to crisis level than they arguably should be. In our last edition, we marvelled at the 30 basis point bund yield. Since then it has managed to crawl up to 35 basis points; still remarkably low. This, however, has far less to do with Turkey or other emerging markets stories. We are not even convinced it has to do with the fragility of the recovery. We, in fact, think there is a euro existential question being slowly brought back to the fore. It may amount to nothing more than a test, but it is still one that needs passing.

## **We have been here before: Near a point where Greece could have left the project**

The sovereign debt crisis very nearly saw Greece exit the eurozone. If it had, it would have been a big deal. But at the same time, as the crisis unfolded, market participants and indeed politicians began to harden to the notion that what had been unthinkable had become a live possibility. In the end Greece had a large debt problem, but when contextualised against a relatively small economy it was manageable. As we roll forward to today a lot of positive things have happened, like a QE programme that probably prevented a dip into depression, a significant reduction in excesses, macroeconomic growth and rescue mechanisms put in place.

## **We don't subscribe to extremes, but the current Italian story does affect pricing**

That said, Italy is a whole other matter in terms of size and potential to unravel the single currency. Now we don't think that will happen we hasten to add. But worries about the extremes and what they could entail are part and parcel of the decision-making tree that financial market participants will use to price spreads against a backdrop where one of those branches does end up with the extinction of the euro. A less extreme scenario would be where Italy leaves and the rest stumbles on with a massive mess in its wake. At the other extreme is a baseline view that this all blows over, and in the end is a negotiation tactic on the part of an eclectic government that pushes populist ideals to the limit, but not over it.

Italy has positives in its favour. Nominal growth (including inflation) is running at 2.7% and the primary surplus (fiscal balance excluding interest rate payments) is 1.5% of GDP. Given that Italy has a debt/GDP ratio of 130%, a factor of 1.3 times the sum of the above two inputs solves for a breakeven coupon print of 3.2%. The Italian 7-year yield at 3% is a decent proxy for the average coupon, which is dangerously near the breakeven rate. Why is this important? Well if Italy is forced to print coupons above 3.2% it would mean that its debt/GDOP ratio will rise (unless offset by higher growth or a higher primary surplus, both of which are unlikely). No conclusion here, yet; but watch this space.

## **What keeps investors awake at night is why some sleep better: Being long 10-yr bund at 35 basis points**

And why tell this Italian story? To paint a picture. Bottom line, no pension fund board would criticise a policy decision to buy 10-yr Germany at 35 basis points, as this looks as good an insurance policy as you could get in the case of an extreme event that saw Italy exit the euro; a deutschemark proxy. And this anchors US Treasuries too.

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