

Rates: The bonkers relationship between inflation and yields

"Hey neighbour, here's \$100. Give me back \$91 in 10 years and you're good! Just pay me the inflation rate..." That's the negative real rates market of today, not in the inverted eurozone rates space, but in the US, where a macro boom brewing. So why are real rates so negative? Partly it is well-founded future fears. But the here and now should dominate far more.



No love for a bull run in bonds

There is zero value in bond markets in a static state. Rates need to fall to generate returns

So US inflation is set to hit 4%, and then eventually calm toward 2%. There are various nuances around this, but that's the central narrative out there. Hitting 4% is not the point of controversy; we are practically there now. The real question is what happens then? Does US inflation remain elevated or does it ease back?

The 4yr implied breakeven inflation estimate (from conventional versus market real yields) is 2.8%;

that's an expectation of 2.8% inflation per annum for the next four years. We have not had a run like that in the past couple of decades. Interestingly, both headline and core US inflation have averaged bang-on 2% in the past 20 years. It's been lower in the past 10 years though, with core running at 1.9%, and headline at 1.7%. Those dips below 2% in the past decade provide the Federal Reserve with room for an upside overshoot.

The market anticipates inflation running at 2.8% for the coming three years. Over 30 years there is a zero real return

A 2.8% inflation experience over four years would bring the headline average back up to 2% (actually a tad higher) and push the underlying core inflation rate up to 2.25%. These are not extreme outcomes. In fact, they are quite tolerable. But, if that is the outcome, then the big question is what are market rates doing at levels that provide minimal to no inflation protection? The US 30yr swap rate is at exactly 2% right now. That's effectively an extrapolated real yield of zero for 30 years, at best.

A zero real yield means that actual returns simply equal inflation so that in real terms there is no change in value. It's the equivalent of putting a pile of cash into the ground to be dug up in 30 years. In an extreme hypothetical zero-inflation environment, that cash today would be worth exactly the same in 30 years. This is a perfect equivalence to where the US 30yr is currently priced (where the yield is exactly offset by inflation to give a zero real return).

So why is this? Why are market rates not comfortably above breakeven inflation rates so that an implied positive real return is discounted?

Negative real yields are pointing to negative implied returns and there's no protection there

And by the way, it gets even more perverse when we look at the benchmark 10yr yield. Here, there is a negative real yield of -90bp. That is the equivalent of lending your neighbour \$100 on a promise to get \$91 back in 10 years' time. A deeply negative real return (that needs to be compensated by realised inflation). But that is where the market is priced.

It gets worse : in the 10yr there is a real rate of -80bp (negative). No protection for returns here.

This is not an unusual state of affairs for the typical eurozone investor in high-grade government bonds, as these have been trading in negative real territory for years now. But, the European Central Bank has purposely pitched rates in the negative space. The idea is to generate a super-stimulus through ultra-cheap funding conditions. And it has not been awful for bond market investments as falls in rates have pushed up bond prices, securing reasonable returns; at least up until 2021.

There are two issues here though. First, 2021 is already shaping up to be a big bear market for bonds, as market rates have been revived from Covid-inspired lows (pushing bond prices down). So negative running yields are a double insult. Second, the prognosis for the US is not for negative rates. The Federal Reserve has not gone negative and has no intention of going there. Moreover, there is absolutely no need to go there as the economy is undergoing a post-pandemic boom.

Given that, again, why are we here? Why are market rates not discounting better times? The US 10yr rate is 1.6%. Inflation market expectations in the coming 10 years are running at 2.5%. Hence a -90bp real yield as the economy heads towards a boom.

Memories of 2019 are a factor, as is strong demand for fixed income - very supportive

One simple answer is the market is mispriced. If the US 10yr yield was at, say 2.5%, the negative real yield would be gone. But even there, that just about matches market inflation expectations to leave something close to a zero real yield, i.e. no return. To get some semblance of a return, the 10yr should in fact have a handle of three, and above. But it clearly doesn't.

There are some concerns that the economy can't take higher rates.

But what if the US 10yr went to 2% or 3%? a key question then is, can the market take it? It may seem like a perverse one, but remember that the approach of 2.5% for the Fed Funds rate at the end of 2018 was enough to see the market start to discount a recession by mid-2019. US real rates in fact dipped negative at that point. And that was before we even had a sniff of Covid. Some of that unease lingers, even as we enter boom-like circumstances. In addition, the drag coming from negative rates in Europe and Japan is also still there. That sense of underlying macro unease has not fully gone away. It remains a viable explanation for the maintenance of resistance to (radically) higher market rates.

And any uplift in market rates is also muted by strong demand for bonds

Then there are technical factors. One key one is the remarkable demand for fixed income (bonds). Our analysis above shows there is little sense to this from a real returns perspective, especially in a low spread product. But that does not affect one particular big buyer - the Federal Reserve. The ongoing bond-buying programme is a persistent factor keeping market rates under wraps (a part rationale for the policy in the first place).

But it is not just the Fed. US pension funds continue to build their fixed income portfolios, which helps to buffer their underfunded pension positions. In addition, a rump of payers looks at the 10yr above 1.5% as presenting medium-term value. Now throw in corporates that have been using these levels as an opportunity to receive here and swap into ultra-low Fed-impulses funding levels.

This all adds up. It's part structural, but there is a transitory effect too, and therein lies its vulnerability.

A macro boom should eventually tip the bond market over

While we respect these circumstances and are monitoring the various drivers closely, we are left with the conclusion that this love affair with ultra-low yields is temporary. It is hard to imagine that we can continue through boom-like conditions with associated inflation risks and not see an eventual ratchet elevation in market rates.

And it need not be a permanent rise. We could well end up getting back to where we are now (or lower) should macro circumstances subsequently disappoint (say in 2022).

But given the risk that this could be the real deal for inflation uplift, it would seem prudent for the bond market to better reflect that risk in the current pricing of yields. We continue to view a 2-handle on the US 10yr as probable. It may take a few months, or it could happen in a flash, but we think we'll get there. After that? We'll cross that bridge when we come to it.

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