US Rates: Dipping negative

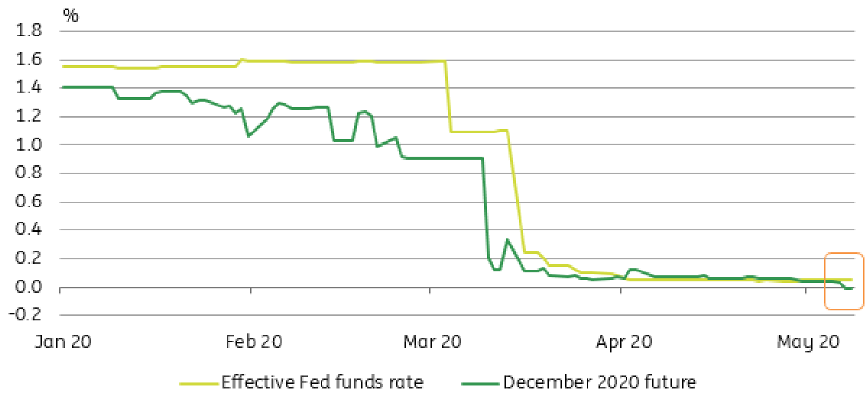
US interest rates futures have moved to discount negative rates. That does not mean the Fed will move to negative territory, but no doubt they are watching. There is a remarkable stand-off here between the rally in risk assets versus a more sinister interest rate discount. The rates market is trading with the notion that rates need to stay low. But negative?

US future rates move into negative territory for the first time

These are remarkable times for rates. Yesterday saw the US fed funds interest rate futures strip start to discount negative rates. They are not negative by much, just a few basis points. But it is symbolically important. They were also pushed there on quite high one-day volumes, and the levels hit yesterday are being backed up by maintenance in negative territory.

The profile shows negative rates taking hold from the end of 2020, then hitting the deepest negative by mid-2021, and subsequently returning to positive territory by early 2022. Again we are just talking about a few basis basis points here, but once we are in negative territory that psychological barrier has been broken, making a deeper negative discount a higher probability risk should the economy, eg, take a deeper dive.

Effective funds rates versus the December 2020 futures discount



Source: Bloomberg

Overnight rates have peppered around zero - the Fed is watching

There have been episodes of negative rates in overnight space on occasion since the Federal Reserve moved the funds rate to the zero to 25bp range. The effective fed funds rate is at 5bp and the SOFR index has been pitching the implied rate in the area of 5bp too. The futures strip is now discounting a move into the -2bp to -3bp area. Not big movements, but there is a clear directional view imputed.

Our central view is that the Federal Reserve does not move into negative territory for fed funds, mostly as it has not been a magic pill in other parts of the world. The Eurozone continues to struggle, as does Japan, and Sweden having been a first mover into negative rates has since moved out, and is showing no inclination to return. There is just no clear evidence that it is the clear way to go.

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Remarkable that negative futures correlates with risk-on elsewhere

That said, if the economy was to move from a version of V or U to and L, and if the Treasury, States, Cities and Counties found themselves with massive debt burdens to service, then there could be a place for negative rates. We are some way away from that.

The latest market discount is important though. It represents a clear market bias. The Federal Reserve will take note of it. It is also coinciding with a fall in Treasury yields. We still think the 2yr yield will hit zero, and for the front end to pepper zero in the coming months as the economy creaks, (dominating the build of supply pressure).

> What is even more of a head scratcher is the move into negative rates out the future strip has happened during a period where there is a risk-on mood in play. So either risk assets have a different opinion on the outlook for the economy, or they are comforted by the notion that the Fed will not be going anywhere near the rate hike trigger any time soon. Fine, but that is not a sustainable rationale.
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> It is tough to view this move to negative rates as being a good thing. It's stodgy down there. Ask the Europeans and the Japanese.

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