

## Here's why US market rates are falling

A US economy littered with super-buoyant readings would typically place upward pressure on market rates. That is clearly not what is happening right now. The question is why? The Fed at zero and bond buying matters, as does signalling from negative real rates. Fixed rate receiving, big negative bond returns and inflation doubters are factors. And more ...



### It's supposedly a booming economy, but rates have been falling of late - why?

Some have argued that the prior rise in market rates was aggressive enough to fully discount the realized data. Maybe. Others have pointed to more recent instances of volatility, stretching from the Archegos collapse to Turkish central bank complications to the Covid crisis still gripping Brazil/India to the more recent upping the ante on US sanctions on Russia. Perhaps. These are certainly arguments that explain why market rates could fall. But surely we need more.

The absolute level of the US 10yr yield at around 1.5% is significantly deviant from a likely 10% nominal expansion in the US economy this year. And if that was not enough, within that 10% there is a 3-4% inflation experience to come. Bond markets hate inflation, as bonds pay fixed payments that get quickly eaten up it. The typical reaction to a spurt of inflation is a spurt of

higher yields as bond participants demand more protection for their real returns.

## The demand for bonds and realized negative total returns are factors

Which bring us to one explanation for why yields are remaining so low. Simply put, there is remarkable demand for bonds, all the way from US Treasury auctions that were snapped up last week, to primary deals right out the credit curve that get gobbled up on a routine basis. This is partly a consequence of the Fed pitching front end rates at zero and the generation of excess liquidity. Cash has to go somewhere, and it can't all go into equities.

---

*We see strong fixed rate receiver interest, where corporates look to lock in high positive carry and super low funding.*

---

The lure of 1.5% in the 10yr is not nothing. We see this in fixed rate receiver interest, where corporates look to lock in high positive carry and super low funding, while getting paid a much higher rate (equivalent to being long bonds).

What makes this a tad unusual is that 2021 is likely shaping up to be an official bear market for bonds. These are quite rare; there have been just four in the past four decades (2013, 2009, 1999 and 1994). The worst saw negative returns of 3.6% in 2009, closely followed by -3.4% in 1994. Currently US Treasuries are running on negative returns of -3.7%. And it was much worse, before the recent fall in yields.

---

*We are already at the worst to total returns for bonds seen in the last 40 years, so is enough enough?*

---

There is an argument that the bond market feels compelled not to deviate too far from the prior annual negative returns experience.

Even the bond market rally of 8% in 2020 is not dramatic enough to warrant the biggest bear market in modern times (in 2021); 8% is high, but there have been 9 occasions on the past 40 years when total returns were higher, and typically double digit. And then they were not always followed by a bond bear market.

## Another route is to question whether there really is inflation, or is it just a base effect

Another theory is the spurt we are seeing in inflation and growth just takes us back to where we were and makes no guarantee on the future. So, when Covid struck there was for example a collapse in hotel room prices. As we move forward prices rise back to where they were, officially registering inflation though a negative base effect.

There is a perfect storm here where price falls happened practically bang on a year versus price rises, making the inflation spurt look exaggerated. And if the aforementioned hotel room prices simply return to their previous state, and then stay there, well then there is in fact no inflation.

---

*Is there in fact no inflation at all, just base effects. And we're left with something rotten in the macro system?*

---

Then the argument goes that something remains rotten in the macro system; a similar feeling to the one had in 2019 (pre-Covid) when the market anticipated recession. The difference here is we are not anticipating a recession, as we have just had one. But that does not mean there can't be question marks about where we will be in say 2023? Making bold macro calls for 2021 is easy, but after that?

## **Real rates have turned deeper negative again - not great bond market signaling**

This is where the messaging from real yield space comes into its own. For a long time we've been uncomfortable with the notion of a full blow deflation ahead of us while at the same time the 10yr real yield trades deeply negative. So when it rose from -1% to -0.6% in February, that made sense. And indeed, it would have made sense for it to continue to de-negativize. But that is not what has happened. In fact, in recent weeks it has drifted back down to -75bp.

---

*When you see a negative 10yr real yield it does not tell us anything positive about the future.*

---

The correlation between the real rate and real growth is quite poor, because the a high real rate is often used to dampen real growth, and vice versa. But theoretically, a long-term positive real rate co-exists with long-term real growth in productivity, and by extension in economic growth. So, when you see a negative 10yr real yield it does not tell us anything positive about the future. It is a stimulative rate for sure (as it's practically 1% below implied inflation). But the signal it emits is not good.

There are structural issues that can be put forward to negate some of this negative thinking. One is the Federal Reserve has a massive markets rates reduction effect through it's bond buying program, and even when the Fed eventually tapers its purchases, it has still taken a huge chunk of the available securities away from investors, maintaining downward pressure on rates.

---

*The Federal Reserve is a factor. Zero front end rates and a bond buying program; both act to bully market rates lower*

---

This filters all the way down to real space through both crowding out and the need to price in a sensible implied inflation breakeven. This is a key area to keep an eye on, like lifting the hood to take a closer look at the workings.

## But we are still looking through this as no more than a tactical test lower

So where does this leave us?

Our considered judgement sees this downdraft in market rates is a tactical a test of the downside; one that will by definition reverse. We still hold to a reversion towards a 2-handle for the 10yr as a 2021 view.

However, we are not blind to what is happening, and we are watching real yields carefully, and indeed the curve structure (e.g. the still rich 5yr is a bond bullish signal), as bond markets are a shrewd predictor of the future.

We view fixed rate receiver interest for exceptional carry as a viable tactical explanation, we'd throw in the big negative returns already suffered, alongside strong demand for fixed income. And we also have to acknowledge that zero front end rates force cash out the curve, helping to richen that belly area. Add in the impact of the Federal Reserve as a vanilla but persistent big buyer of bonds.

These are not all new, accepted. But at times they can gel to produce what we have seen in the past few weeks, and it can persist as the test continues.

## Author

**Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom

this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.