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INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

What's in Store for Real Rates in the U.S.?

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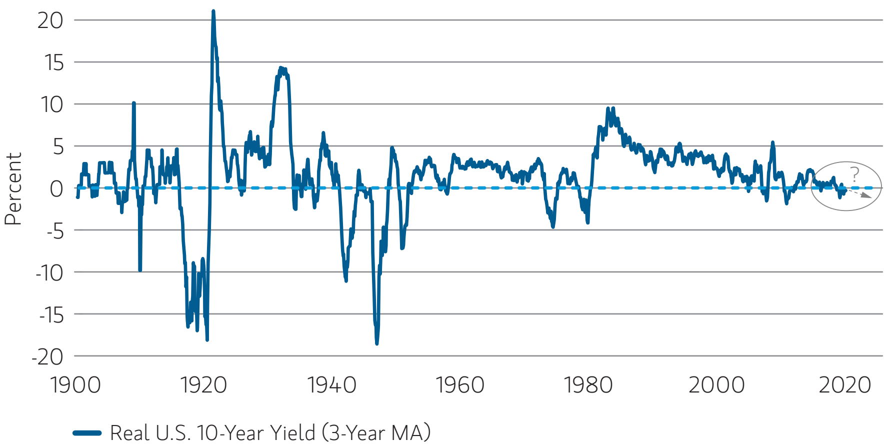
It is well understood that the recent 'everything bubble'—in which valuations for most major financial assets have reached historical extremes—is predicated on low real rates and the perception of their sustainability. Low real rates have also been viewed as an important driver of newly emergent trends, including U.S. dollar weakness and a bullish outlook for commodities. Any interruption to this low real rates regime could threaten valuations, and thus represents a major risk to the current market environment. We believe a further moderate back up in real rates is possible later in 2021 in the context of the strong U.S. economic growth that we expect this year. However, over the medium-term, that is over the next 2-3 years, this increase in real rates may prove fleeting as longer-term budgetary and debt dynamics will likely require real rates to be even lower than they are today (see *Display 1*).

DISPLAY 1

Real U.S. 10-Year Yields Trend to Remain Depressed Going Forward

Real U.S. 10-Year Yields (3-Year Moving Average)



Source: MSIM Global Multi-Asset Team Analysis and Estimates, Haver. Data as of March 12, 2021.

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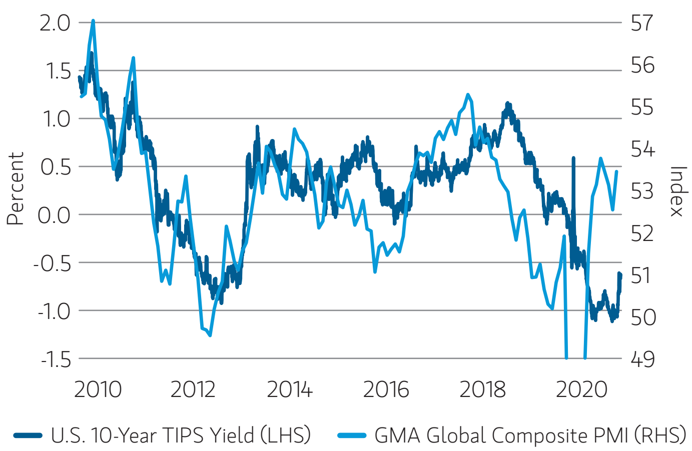
The U.S. 10-year TIPS (Treasury inflation-protected securities) yield, at -65 basis points today, is only moderately above its level in the third quarter of 2020, despite a substantial improvement in global growth which has historically been an important driver. Today's global composite PMI reading of 52.9, for example, would suggest that the U.S. 10-year real yield should be about +34 basis points, or about +100 basis points above current levels (see *Display 2*). The current break with the historical relationship between global growth and real yields to a significant degree reflects an altered perception of economic policy, future constraints of budget and debt dynamics, as well as a downward reassessment of trend growth.

The change in policymaker attitudes has been pronounced and is at this point well-known. Policymakers are focused on fighting the low growth and low inflation that marked the post-Global Financial Crisis recovery and expansion (with falling neutral real rates as a consequence). The Federal Reserve (Fed) is seeking to overshoot its inflation target and has committed to begin a liftoff of the policy rate only when inflation has reached and exceeded its target, with a lag, as opposed to reacting to anticipated inflation based on the Phillips curve framework. With fiscal tightening having been blamed for anemic growth following the Global Financial Crisis, premature fiscal consolidation—which would measurably impact growth—appears unlikely.

DISPLAY 2

Real Yields Too Low Relative to Current Growth

U.S. 10-Year TIPS Yields vs. PMI



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See Disclosure section for index definitions.

However, a substantial increase in real rates may temporarily occur if inflation breaks out sustainably above its target, probably above 3.0% to 3.5%. With nearly $2 trillion of savings amassed by U.S. consumers, and additional stimulus measures in the works, we expect U.S. GDP growth could be +7.5 to 9.5% in 2021, such that the output gap could be positive—between +3% and +5%—by the end of 2021. Conventional analysis suggests a muted inflation outlook. But an output gap of this magnitude and current money supply growth (M2 growth at +26%) would both be near the highest levels ever (or since data began in 1949 and 1910, respectively). Supply side disruptions in the services sector may lead to prices accelerating this year as the economy reopens, in the same way inflation went up in segments of the goods sector that experienced bottlenecks in 2020. Given the ongoing highly stimulative policy setting (again, we expect fiscal consolidation to be difficult to achieve and the Fed to be reactive rather than anticipatory), an inflation outbreak is likely to occur eventually. The Fed will be required to step in to tighten policy, and this may cause real rates to rise significantly.

To assess how big such a cyclical back-up in rates might be, besides assessing various cyclical drivers behind it, it is useful to consider what the neutral level of real rates might be. We consider the following factors in determining this: potential GDP growth, aggregate debt growth—which we have found influences the relationship between neutral interest rates and GDP growth and, most importantly, debt sustainability. Taking each of these factors into consideration, we expect debt sustainability to dominate and over time severely depress real rates.

The Congressional Budget Office (CBO) and Organization for Economic Co-operation and Development (OECD) estimate potential U.S. GDP growth to be around 1.6%, which could be optimistic. In the past their potential growth estimates tended to be closely linked to growth experienced in the previous 6 to 8 years, and their current estimates are not an exception. Their current projections imply productivity growth of 1.3%, close to the average of 2010-2020. This may prove overly optimistic given the outlook for tighter regulation, compared with the deregulation experienced during 2017-2020, and it may overlook the drag on growth from substantially higher debt; but for the sake of argument we will use 1.6% as potential U.S. growth.

We have found historically that the pace of debt growth (best measured as the growth in the ratio of debt to GDP), along with past inflation, has been predictive of the gap between potential GDP growth and interest rates.[1] Based on the CBO's projections of federal debt growth and assuming private sector debt growing in line with GDP, real 10-year rates should be 0.10% today (-150 basis points below trend real GDP growth of 1.6%), implying somewhat higher real rates than today.

Arguably, U.S. fiscal outlook and debt sustainability considerations are more important in determining the medium-term outlook for real interest rates and are likely to dominate other factors. Hypothetically, if 2020's 13% cyclically adjusted primary deficit were to remain unchanged, the real 5-year interest rate required to maintain a stable debt-to-GDP ratio would need to be -11%, versus -1% today. Alternatively, to make debt sustainable at today's level of real rates, the cyclically adjusted primary deficit would need to be cut by 10 percentage points. Such a drastic fiscal austerity program is unlikely to withstand political constraints, as its impact on growth and inequality would be unacceptably large. In the past, countries that experienced fiscal consolidations of a similar magnitude went through crushing recessions (Sweden in 1993; Ireland in 2009; Spain in 2009; to name a few). These episodes were accompanied by increasing monetary accommodation as interest rates were cut. Although fiscal consolidation of the early 2010s did manage to reduce the budget deficit from the -9% to -10% range in 2009-2010 to -2.8% in 2014-2016, this was at the cost of slow growth and low inflation, which, as discussed, policymakers view to have been a mistake that they have vowed not to repeat. In contrast to previous fiscal tightening episodes which usually were accompanied by monetary easing, room for additional monetary accommodation is at best limited today. According to research by the International Monetary Fund, fiscal consolidations in the past have tended to lead to rising inequality, which would be especially problematic today when concerns about this issue are being incorporated into economic policy goals. Due to increased policymakers' concern with inequality, it seems likely that tax-based austerity measures would be more politically viable than spending based measures. We note that in the past tax-based fiscal consolidations have been more negative for growth than spending cut-based ones.[2]

It seems likely that some combination of moderate deficit reduction and a significant degree of financial repression would be required to prevent debt from ballooning out of control. For example, if we assume 4% nominal GDP growth (a bit above potential) and half the fiscal consolidation of the 2010s (i.e. about 3-4% cumulative versus 6% in the 2010s), over the next 10 years, real 5-year rates would need to fall to -3% to stabilize debt in this fiscal scenario. Given this debt overhang, it seems that any back up in real rates on hawkish Fed repricing due to stronger GDP growth and higher inflation would be fleeting over the medium term.

The main risks to this prospect of lower real rates would be outright deflation, as policy rates would be unlikely to be cut into negative territory. But given policymakers' commitment to supporting growth and the public's lack of concern with debt and deficits, this outcome appears unlikely. A substantial improvement in trend productivity growth would have the potential to lead to higher rates too, but we do not currently anticipate it.

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[1] Global Multi-Asset Viewpoint, "Secular Outlook for Bond Yields: Structurally Higher" January 2019.

[2] International Monetary Fund. Research Department. "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation" Chapter 3 in World Economic Outlook. October 6, 2010.

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