

Aerial View

Morning Briefing

Nov 18, 2020

Real Rates and the Dollar

- **US real rates have fallen by 60 basis points since the Fed fired its bazookas in March**
- **Real rates have led the USD lower, and low real rates tend to weaken a currency over the long term**
- **Most of the increase in inflation expectations has been felt in real rates, not nominal; term premium has also risen**



John Velis PhD
FX and Macro Strategist,
Americas, BNY Mellon

[Email >](#)

Real Yields and the Dollar

US real interest rates, as measured by index-linked bond yields, are at record lows, down nearly one full percent since the beginning of the year, and 1.8% since the end of 2018.

This is sending a clear signal about US policy, growth, and inflation prospects in the years ahead: not enough productivity-enhancing capital investment and subdued labor force growth in the future.

Low real yields in the US have corresponded to a weakening USD since the pandemic. This is why we think the dollar's weakening bias will stay intact into 2021.

The two charts below show the path of 10-year US yields over time, as well as the past 12 months, with the right-hand graph also showing the DXY Dollar Index.

To the degree the 10-year TIPS yield reflects the real risk-free return on funds, the dollar becomes less attractive. While not the lowest in among developed markets, it has undergone the largest decline since the pandemic began.

With the dollar 3.6% overvalued, and being the second-most overvalued currency (trailing Switzerland, but not by much) in the G10, we continue to believe that long-term flows will slowly but steadily exit the dollar.

Real Rates and the Dollar



Source: BNY Mellon Markets, Bloomberg; data as of November 17, 2020

The USD has followed real yields lower since the pandemic

Over long periods of time, there is a clear relationship between real interest rates and a currency's real value, as the historical experience of Japan shows or even that of the USD against gold (shown below).

With regard to gold and the real interest rate, it's easiest to think about the latter as the return on the closest competing asset, after inflation; the lower the return on the real risk-free asset, the higher the bid on gold.

Real Rates, the Yen, and Gold



Source: BNY Mellon Markets, Bloomberg, BIS, World Bank; data as of November 17, 2020

Most of the increase in the term premium has been reflected in lower real rates

Breaking Down the 10-Year Rate

The US real interest rate (again, as measured by the yield on 10-year inflation-linked bonds) has been in decline since November 2018, falling from 1.16% to -0.85% yesterday, a nearly 200 basis point drop over the period.

It's fallen 60 basis points just since the end of March this year, after the Federal Reserve launched its many bazookas of policy easing. Rapidly falling real yields have steadied (coincidentally or not) since the Jackson Hole announcement of average inflation targeting by the Fed, around the end of August, and the DXY has traded between 92 and 94 during that period.

Over the past six months – since mid-May – the yield on nominal 10-year US Treasuries has gone up by around 15 basis points and, even though it recently flirted with the high 90s last week on the Pfizer vaccine news, yields have stabilized in the 80s.

Over that same six-month period, the 10-year TIPS yield has fallen by nearly 40 basis points, corresponding to a decline of 7.2% in the DXY.

This divergence in real and nominal 10-year yields results in a 54 basis point increase in 10-year breakeven inflation expectations. The interesting thing is that the increase in inflation expectations has been reflected more in the real yield (lower) than the nominal yield (slightly higher).

With stalling growth, the Fed's interest rate policy is well understood to stay at zero for several years, and a smaller labor force and a labor market slow to heal have been our candidates to list as the culprits in the real rate's decline.

While one might be quick to suggest that large-scale asset purchases by the Fed since the pandemic are the real reason, it should be noted that the Fed's holdings of TIPS is less than 11% of total TIPS outstanding, while its holdings of notes and nominal bonds is nearly 30% of total outstanding.

Components of 10-Year Yields



Source: BNY Mellon Markets, Bloomberg; data as of November 17, 2020

Moreover, the entire increase in nominal yields has been more than reflected in a rising

term premium (as estimated by the New York Fed) as well, reflecting higher long-term uncertainty, even as bond volatility has remained low, as we discussed yesterday.

Curve uncertainty is a potential risk in 2021. The return of the term premium, combined with real rates anchored so low, is likely to translate into continued dollar risk.

The Nominal Yield has been Driven by the Term Premium

Nominal yield and term premium



Source: BNY Mellon Markets, Bloomberg, NY Federal Reserve; data as of November 12, 2020

Please direct questions or comments to:

AerialView@BNYMellon.com

Disclaimer

bnymellon.com

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may be used as a generic term to reference the corporation as a whole and/or its various subsidiaries generally. This material and any products and services may be issued or provided under various brand names in various countries by duly authorized and regulated subsidiaries, affiliates, and joint ventures of BNY Mellon, which may include any of the following. The Bank of New York Mellon, at 225 Liberty St, NY, NY USA, 10286, a banking corporation organized pursuant to the laws of the State of New York, and operating in England through its branch at One Canada Square, London E14 5AL, UK, registered in England and Wales with numbers FC005522 and BR000818. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the US Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon, London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV, a Belgian public limited liability company, with company number 0806.743.159, whose registered office is at 46 Rue Montoyerstraat, B-1000 Brussels, Belgium, authorized and regulated as a significant credit institution by the European Central Bank (ECB), under the prudential supervision of the National Bank of Belgium (NBB) and under the supervision of the Belgian Financial Services and Markets Authority (FSMA) for conduct of business rules, and a subsidiary of The Bank of New York Mellon. The Bank of New York Mellon SA/NV operates in England through its branch at 160 Queen Victoria Street, London EC4V 4LA, UK, registered in England and Wales with numbers FC029379 and BR014361. The Bank of New York Mellon SA/NV (London Branch) is authorized by the ECB and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV operating in Ireland through its branch at 4th Floor Hanover Building, Windmill Lane, Dublin 2, Ireland trading as The Bank of New York Mellon SA/NV, Dublin Branch, is authorised by the ECB and is registered with the Companies Registration Office in Ireland No. 907126 & with VAT No. IE 9578054E. The Bank of New York Mellon, Singapore Branch, subject to regulation by the Monetary Authority of Singapore. The Bank of New York Mellon, Hong Kong Branch, subject to regulation by the Hong Kong Monetary Authority and the Securities & Futures Commission of Hong Kong. If this material is distributed in Japan, it is distributed by The Bank of New York Mellon Securities Company Japan Ltd, as intermediary for The Bank of New York Mellon. If this material is distributed in, or from, the Dubai International Financial Centre ("DIFC"), it is communicated by The Bank of New York Mellon, DIFC Branch, regulated by the DFSA and located at DIFC, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE, on behalf of The Bank of New York Mellon, which is a wholly-owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. Not all products and services are offered in all countries.

The information contained in this material is intended for use by wholesale/professional clients or the equivalent only and is not intended for use by retail clients. If distributed in the UK, this material is a financial promotion.

This material, which may be considered advertising, is for general information purposes only and is not intended to provide legal, tax, accounting, investment, financial or other professional advice on any matter. This material does not constitute a recommendation by BNY Mellon of any kind. Use of our products and services is subject to various regulations and regulatory oversight. You should discuss this material with appropriate advisors in the context of your circumstances before acting in any manner on this material or agreeing to use any of the referenced products or services and make your own independent assessment (based on such advice) as to whether the referenced products or services are appropriate or suitable for you. This material may not be comprehensive or up to date and there is no undertaking as to the accuracy, timeliness, completeness or fitness for a particular purpose of information given. BNY Mellon will not be responsible for updating any information contained within this material and opinions and information contained herein are subject to change without notice. BNY Mellon assumes no direct or consequential liability for any errors in or reliance upon this material.

This material may not be distributed or used for the purpose of providing any referenced products or services or making any offers or solicitations in any jurisdiction or in any circumstances in which such products, services, offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements.

The terms of any products or services provided by BNY Mellon to a client, including without limitation any administrative, valuation, trade execution or other services shall be solely determined by the definitive agreement relating to such products or services. Any products or services provided by BNY Mellon shall not be deemed to have been provided as fiduciary or adviser except as expressly provided in such definitive agreement. BNY Mellon may enter into a foreign exchange transaction, derivative transaction or collateral arrangement as a counterparty to a client, and its rights as counterparty or secured party under the applicable transactional agreement or collateral arrangement shall take precedence over any obligation it may have as fiduciary or adviser or as service provider under any other agreement.

Pursuant to Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the applicable rules thereunder, The Bank of New York Mellon is provisionally registered as a swap dealer with the Commodity Futures Trading Commission ("CFTC") and is a swap dealer member of the National Futures Association (NFA ID 0420990).

BNY Mellon (including its broker-dealer affiliates) may have long or short positions in any currency, derivative or instrument discussed herein. BNY Mellon has included data in this material from information generally available to the public from sources believed to be reliable. Any price or other data used for illustrative purposes may not reflect actual current conditions. No representations or warranties are made, and BNY Mellon assumes no liability, as to the suitability of any products and services described herein for any particular purpose or the accuracy or completeness of any information or data contained in this material. Price and other data are subject to change at any time without notice.

Rates: neither BNY Mellon nor any other third party provider shall be liable for any errors in or delays in providing or making available the data (including rates, WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates) contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees' negligence. The WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates are provided by The World Markets Company plc ("WM") in conjunction with Reuters. WM shall not be liable for any errors in or delays in providing or making available the data contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees' negligence.

The products and services described herein may contain or include certain "forecast" statements that may reflect possible future events based on current expectations. Forecast statements are neither historical facts nor assurances of future performance. Forecast statements typically include, and are not limited to, words such as "anticipate", "believe", "estimate", "expect", "future", "intend", "likely", "may", "plan", "project", "should", "will", or other similar terminology and should NOT be relied upon as accurate indications of future performance or events. Because forecast statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. iFlow® is a registered trademark of The Bank of New York Mellon Corporation under the laws of the United States of America and other countries.

This document is intended for private circulation. Persons accessing, or reading, this material are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

Currency Administration is provided under and subject to the terms of a definitive agreement between BNY Mellon and the client. BNY Mellon exercises no investment discretion thereunder, but acts solely pursuant to the instructions in such agreement or otherwise provided by the client. Unless provided by definitive agreement, BNY Mellon is not an agent or fiduciary thereunder, and acts solely as principal in connection with related foreign exchange transactions.

All references to dollars are in US dollars unless specified otherwise.

This material may not be reproduced or disseminated in any form without the prior written permission of BNY Mellon. Trademarks, logos and other intellectual property marks belong to their respective owners.

The Bank of New York Mellon, member FDIC.

© 2020 The Bank of New York Mellon Corporation. All rights reserved.