BNY MELLON

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**

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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.

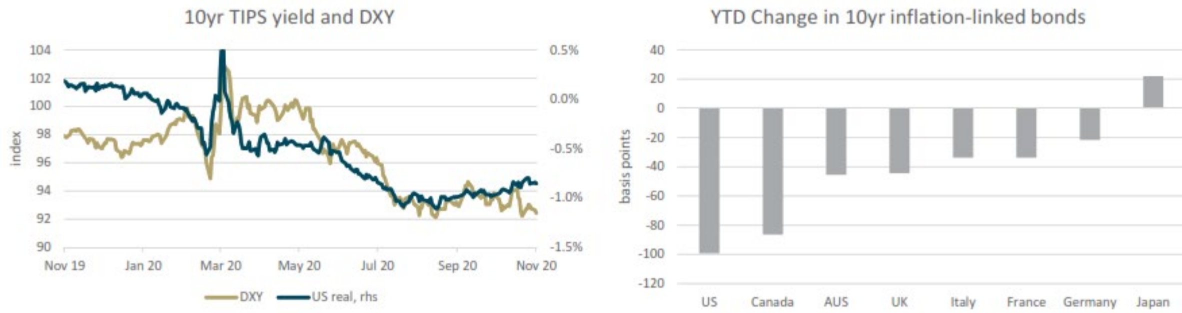
Low real yields in the US have corresponded to a weakening USD since the pandemic. This is why we think the dollar’s weakening bias will stay intact into 2021.

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.

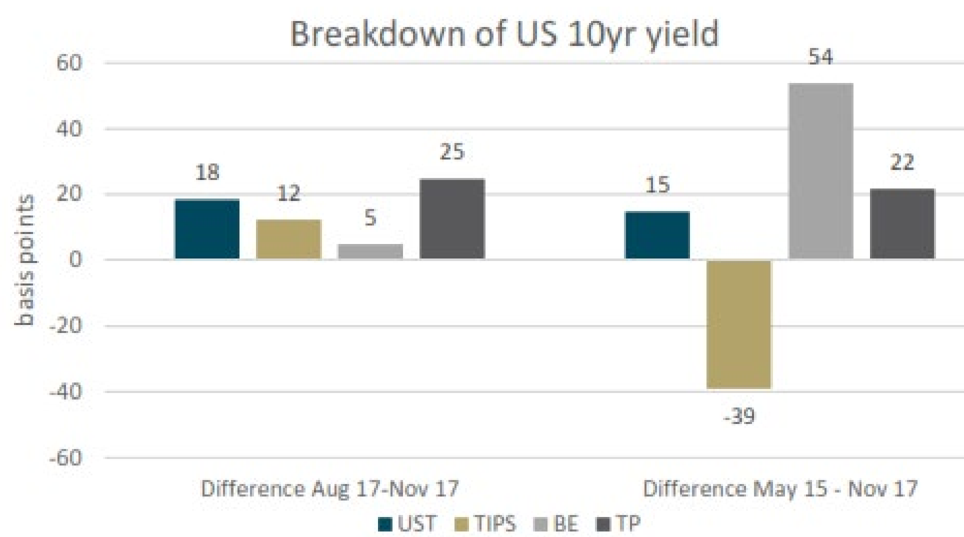
Over that same six-month period, the 10-year TIPS yield has fallen by nearly 40 basis points, corresponding to a decline of 7.2% in the DXY.

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

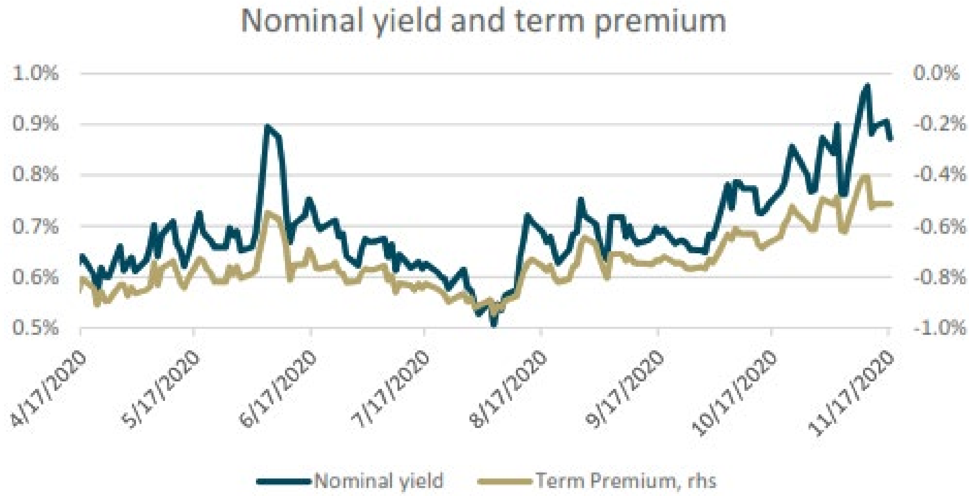


Source: BNY Mellon Markets, Bloomberg; data as of November 17, 2020

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



Source: BNY Mellon Markets, Bloomberg, NY Federal Reserve; data as of November 12, 2000

Please direct questions or comments to:

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