About Those Negative Yields

Last week's five-year TIPS auction was priced to yield -0.55%, which means at least one of three things must be true:

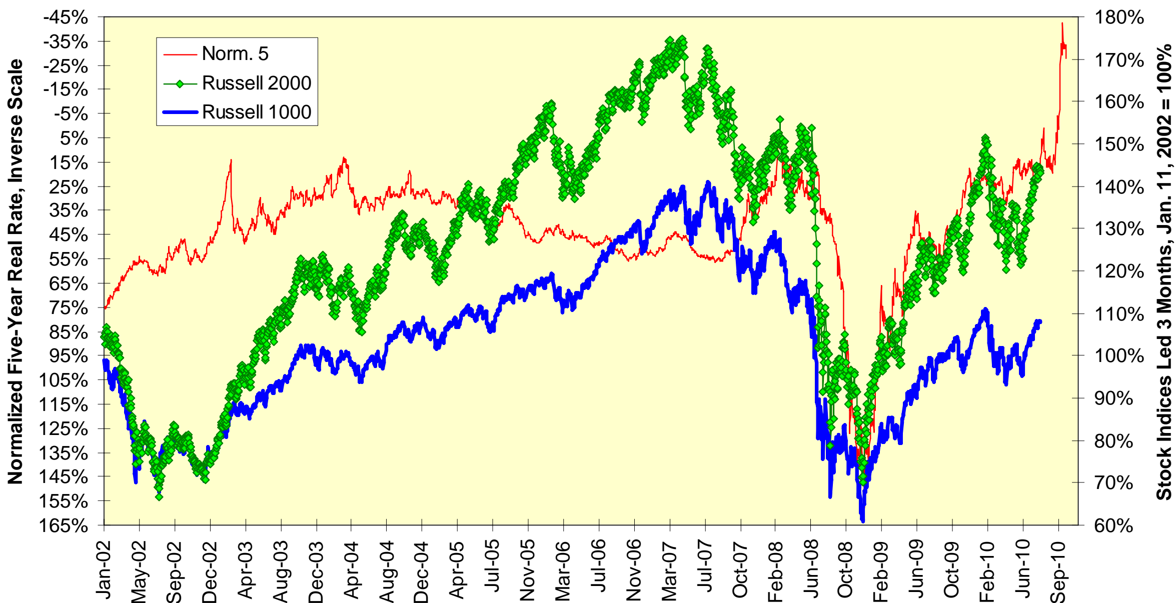
1. Nominal interest rates are too low;
2. Breakeven rates of inflation have to fall; or
3. The sellers of TIPS, contrary to their own history, are underpricing inflation insurance

The reason these must be true in some combination is if nominal rates are too low, the only way a breakeven rate equivalent to expected growth in the CPI can be achieved is to overpay for the TIPS and hope – always a dangerous word in investing – the after-tax accrual of the inflation index will produce a return equivalent to the five-year Treasury. This is a dangerous game, is it not, for the issuer of the TIPS has no incentive at all to sell the TIPS too cheaply?

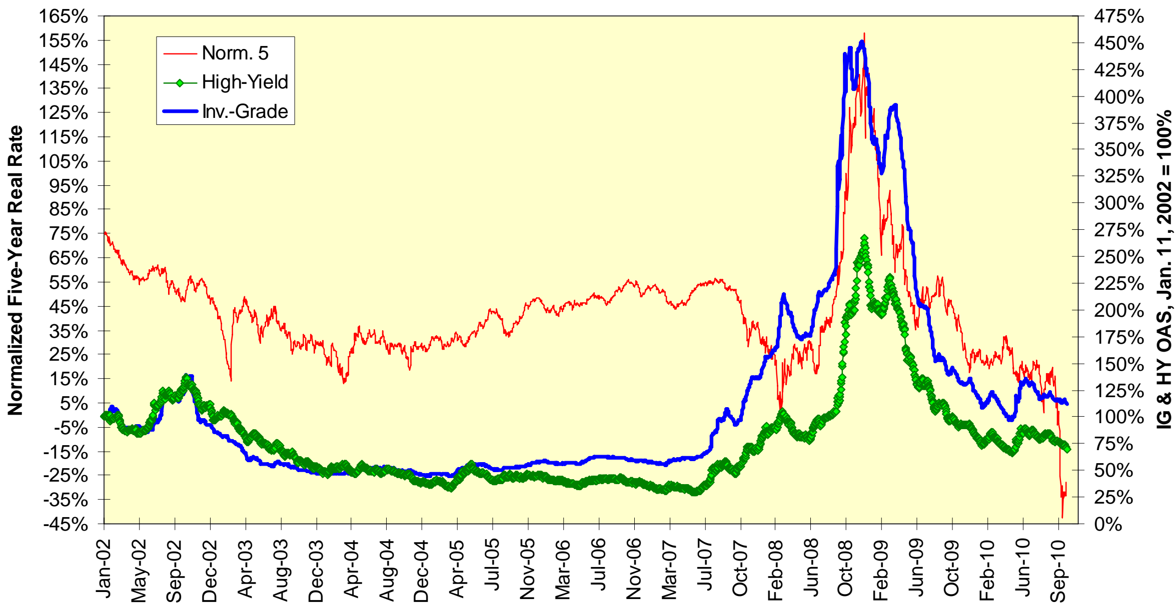
It also indicates the market has a very substantial fear all of the Federal Reserve's money-printing will lead to inflation; otherwise, why would TIPS buyers pay a premium and take a known loss upfront in an environment where the reinvestment return on coupons received is close to zero? If this is the Federal Reserve's definition of a fear of deflation, they are confused.

If we map this real rate normalized to the nominal five-year rate itself on an inverse scale, we find it has led stocks, especially the Russell 2000 index, by three months on average. On this basis alone, the drive to negative normalized real rates looks extremely bullish.

Real Rates And Stocks



However, this very same normalized real rate has ceased driving down the option-adjusted credit spread for both high-yield and investment-grade corporate bonds. As a matter of fact, these spreads would have to return to the halcyon credit-bubble days of 2007 if they did follow these normalized real rates lower, and investors do not make the same stupid mistake twice, do they?



The Endgame

While stocks can advance from here for any number of conditions, including stronger earnings growth or even the money illusion produced by the mistaken belief they can withstand higher inflation, the implications of negative real rates for corporate credit are stark and speak to the end of the Federal Reserve's tawdry money-printing campaign. A separate analysis of prospective equity returns as a function of credit spreads and lagged normalized real rates confirms the highest returns are achieved when investments are made at a high real-rate level and during times of declining credit spreads.

The present combination of stable credit spreads and negative real rates means gains in corporate bonds will occur only if credit spreads narrow by more than the expected capital loss on the TIPS purchased at a premium. More money will not do that. If corporate bonds cannot rally, this will constitute a headwind for stocks that will require higher-than-expected earnings growth. More money cannot do that, either. All more money can do at this point is finance the dollar carry trade and keep us on our Japanese path.