On The Jump In Real Interest Rates

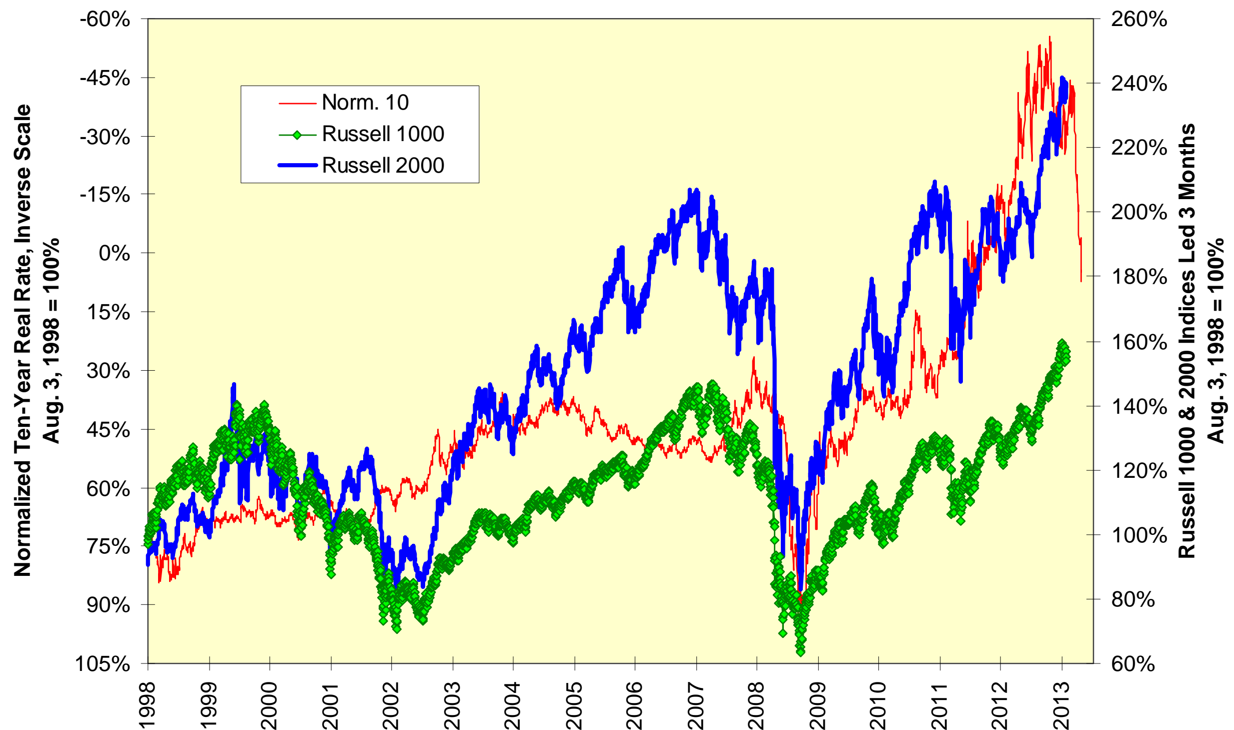
One of these days I am going entitle an article, "You Are Going To Lose All Of Your Money and Be Very Unhappy About It," but today is not that day despite all of the reasons we have to be cautious and defensive. Those reasons include Japan's tragicomic inability to destroy its own currency, the strong signal our own highs in money-printing have been reached, at least for this iteration, the unwinding of longstanding bond market complacency as evidenced by rising swap spreads and swaption volatilities, unwinding of yen and dollar trades into a host of markets ranging from Canada to a who's who of emerging markets and today's topic, the unprecedented surge in normalized real interest rates. Normalized real rates are the yield of TIPS divided by the nominal rate for that maturity.

Scary Movie

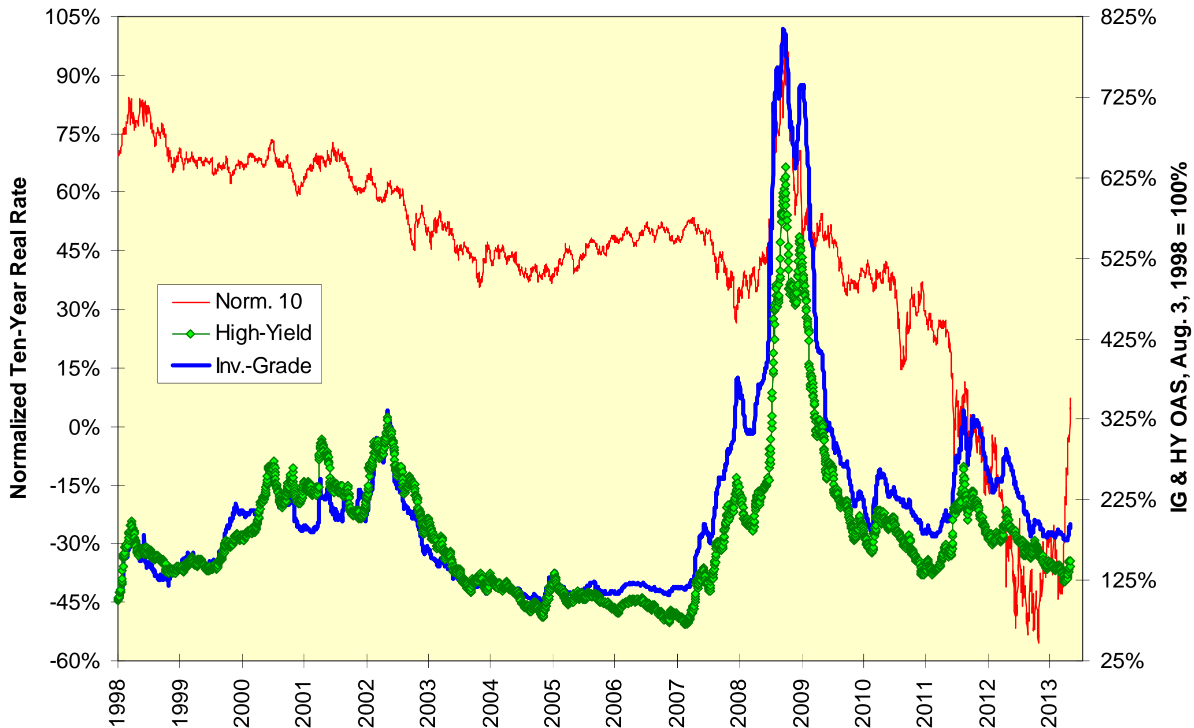
While the jump in normalized real rates did not kick into high gear until the start of May, they had reached their low at the start of QE4 in December 2012. I commented on the negative outlook for Treasuries in January; the haven bid resulting from the March Cyprus fiasco and Japan's April expansion of QE simply delayed the inevitable.

Japan has demonstrated during all of its Lost Decades how simply printing money does not lead to inflation; indeed, to the extent negative real rates simply enabled low-productivity government transfer payments globally, they short-circuited the creation of money and credit in the banking system. The prospect of central banks ending their monetization of public debt meant fiscal stimulus would contract at the same time monetary stimulus was slowing. This meant real interest rates had to rise to start to ration capital to higher and better uses; restated, we might see an actual market rate for money once again in our lifetimes.

And rise they did, as seen in the chart below on an inverse scale. As stock prices, especially for the small-capitalization Russell 2000 index (accessible via IWM), have lagged normalized real rates by three months on average, higher interest rates look very scary indeed.



The picture is not quite as frightening for corporate bonds. The option-adjusted spreads for both high-yield and investment-grade bonds (accessible by HYG and LQD, respectively), have not moved up alongside normalized real interest rates. The real operator here is the lack of excess liquidity will end credit-spread compression and expose both classes of corporate bonds to direct interest rate risk.



A Ray of Hope

The current situation is unprecedented, and that makes drawing direct and negative conclusions a little more difficult than it appears. The last jump in normalized real rates occurred during the 2008-2009 financial crisis as inflation expectations collapsed; this followed the downturn in equities already underway since either July or October 2007, depending on how you want to date things.

Similarly, bond risk led the rise in normalized real rates. The current environment has had normalized real rates rising while OAS levels have trended lower until just recently.

The key takeaway is market risk had become too lopsided and too dependent on the single variable of central bank expectations, a risk discussed here last week. This opened everything up to execution vacuums and the exigencies of algorithmic trading; a few bad-hair nights in Japan really rattled market windows everywhere else. While higher normalized real rates are anything but bullish, they remain extraordinarily low by historic standards. This is not the end of the world or the start of a market death-spiral so much as it is the first confirmation the end of the post-March 2009 printing-money-is-the-answer-to-whatever-your-question-is era is over.