Unexpectedly Low Rates Can Return

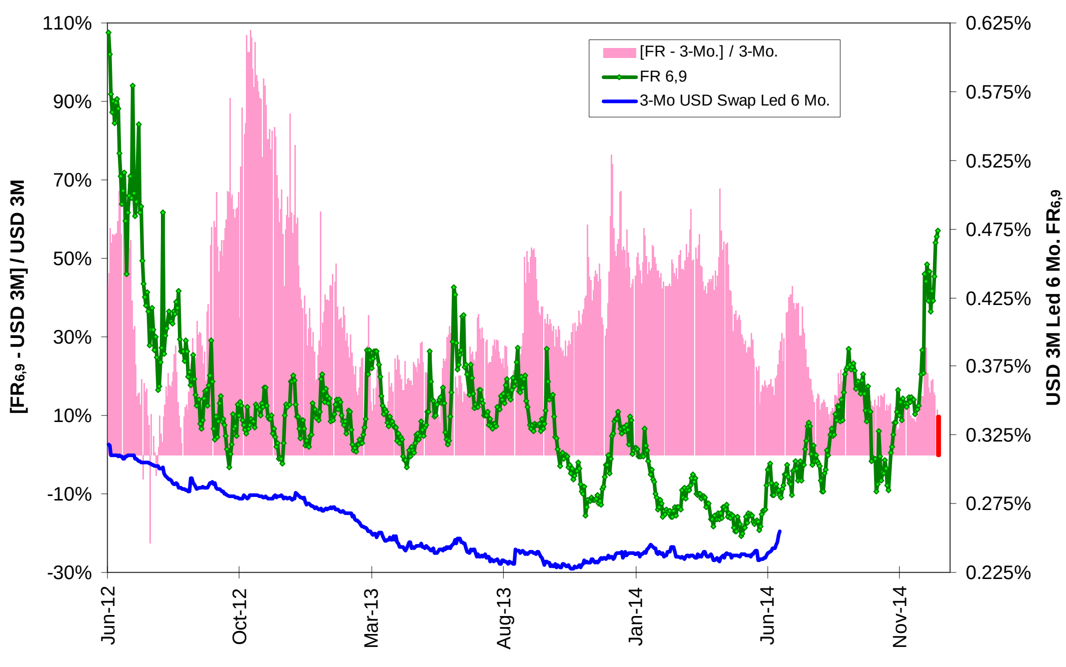
Markets and policymakers engage in a giant game of signaling back and forth to each other. When central banks start to dominate markets, as has been the case in the post-crisis world, that signal gets distorted. For example, if the Federal Reserve was the largest buyer of both conventional and inflation-protected Treasuries, they were distorting the very breakeven spreads they supposedly were reading. The whole thing really is a variation on the famous Uncertainty Principle where the simple act of observing something changes either its speed or position.

This creates some real problems as one of the implications of the rational expectations hypothesis is only unexpected changes in monetary policy can affect output and employment; those that were expected were acted upon and have changed behavior already. This is one reason why QE was predictably ineffective at macroeconomic stimulus; potential investors in real plant and equipment had to base their decisions not on the current low rates but rather on the expected higher rates.

Perma-Expectations

I first noticed the situation where very low current short-term interest rates anchor a very steep yield curve in the context of Japan in the early 2000s and dubbed it "perma-expectations." It has been a feature of the U.S. landscape as well. We can measure the extent to which short-term rates have been unexpectedly low by calculating a normalized yield gap between the forward rate between six and nine months ($FR_{6,9}$) and the three-month rate led six months. The higher the normalized yield gap is, the more short-term interest rates have been unexpectedly low. Let's take a look at this for the U.S. since expectations of QE3 began in June 2012, two and one-half years ago.

Market Expectations Since QE3 Anticipation Began In June 2012



Right now, the $FR_{6,9}$ is shooting higher on the charming belief short-term interest rates will be headed higher in 2015. While three-month rates led six months are rising, they are not rising as quickly because monetary conditions have not been tightened yet. The result is the normalized rate gap is near the low end of the range displayed and three-month rates have room to be fall sometime in 2015.

This is genius. Just as Mario Draghi has been able to convince markets there will be QE sometime, the Federal Reserve has been able to create some wiggle room for itself by promising interest rates will rise sometime, just not now.

Oh, if you are waiting for the actionable punchline, this perma-expectations situation is bullish for U.S. equities but has a much lower effect on the prospective return for 7-10 year Treasuries at present.