Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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The Real Reason Rates Are Surging

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

This week, Dimitri Delis, PhD, our team's senior econometric strategist, shares his thoughts on interest rates:

The surge in 10yr Treasury rates over the past three weeks is not related to inflation fears, but can be attributed primarily to a 40 bp jump in real rates, as inflation expectations have remained relatively muted. Short-term inflation pressures resulting from pandemic-related production constraints and labor market challenges should fade as economic activity normalizes. Fiscal and monetary policy have done little to unanchor inflation expectations. The surge in real rates reflects an elevated level of optimism that may be too aggressive. Higher real rates suggest economic growth is gaining traction, but the increase may adversely impact risk assets. Rising real rates may trigger a measured or panic-driven rotation out of stocks and into bonds, thus limiting any significant rise in nominal yields.

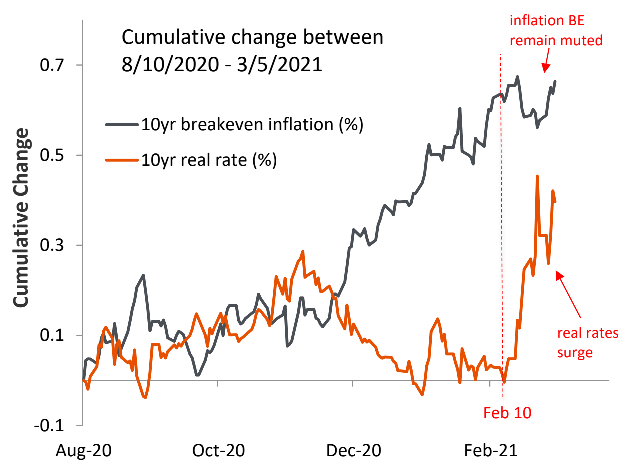
It's all about real interest rates

- This past August the 10yr Treasury rate closed at a record low of 0.51%, but since then it has steadily increased by 106 bp to 1.57% (as of 3/5/2021). During this time, the rise in nominal rates has been driven by both real rates (+40 bp) and inflation breakevens (+67 bp). However, the most recent increase in rates is not related to inflation. Indeed, between February 10th and March 5th the surge in nominal 10yr Treasury rates can be attributed solely to a 40 bp jump in real rates, as inflation expectations remained relatively muted (Figure 1). Although higher real rates suggest economic growth is gaining traction, the increase may adversely impact risk assets and render investors uneasy over the sustainability of the recovery as borrowing costs rise. Inflation breakevens and real rates can move higher in the near term, but such moves may be short-lived for the following reasons.

Inflation expectations still well-anchored

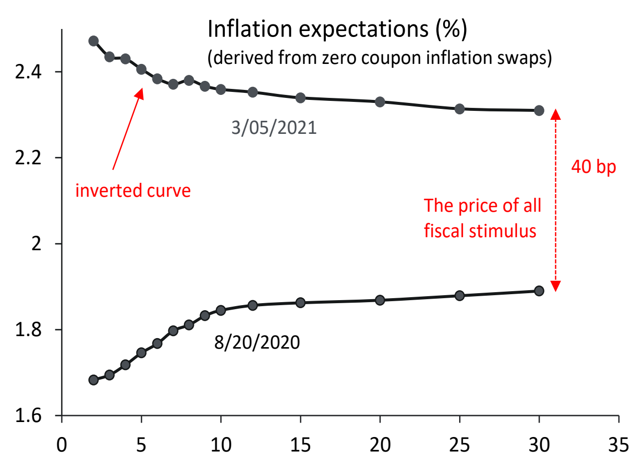
- The fiscal and monetary policy response to the COVID-19 crisis is unprecedented and should support reflation, but the fiscal and monetary responses to the 2008 Financial Crisis were also unprecedented at the time, and it became consensus view that they would result in higher levels of inflation. However, that did not happen. Currently, fiscal and monetary policy have done little to unanchor expectations, as long term inflation expectations have shifted higher by only 40 bp since August (Figure 2).

Figure 1: The recent rise in nominal rates is mainly due to a surge in real rates, as inflation expectations have remained muted



Source: Bloomberg, Piper Sandler

Figure 2: Long term inflation expectations have increased by only 40bp as the curve has inverted

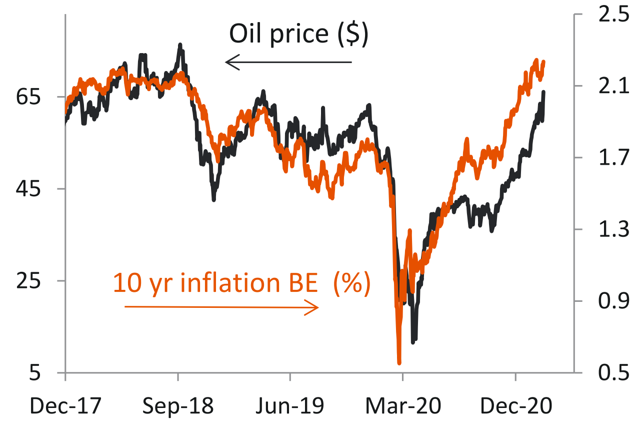


Source: Bloomberg, Piper Sandler

Recent ISM indicators in the manufacturing and service sector have shown prices jump to their highest levels since 2008. However, these are short-term inflation pressures resulting from pandemic-related production constraints and labor market challenges that continue to impact the supply chain. Such pressures should fade as economic activity normalizes. This view is consistent with the current term structure of inflation expectations, which is inverted, as near-term expectations are higher than long-term inflation expectations (Figure 2). Over the next few months, headline CPI may jump above 3%, but this will be related to base effects from rising energy prices, which last year dropped to extremely low levels.

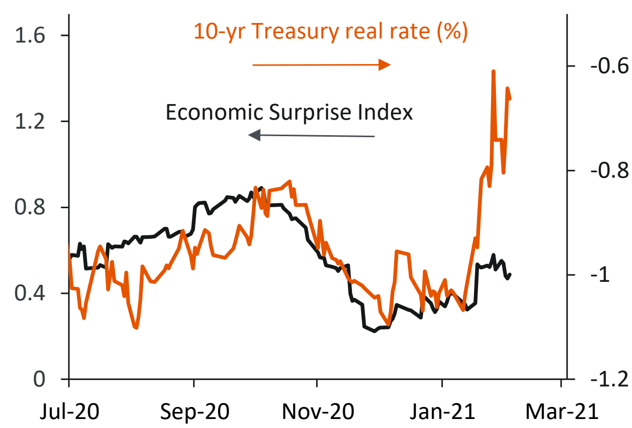
- The strong correlation between the 10yr inflation breakeven rate and oil suggests that if oil prices continue to climb, the 10yr Treasury rate may move higher (Figure 3). However, after a 36% rally so far this year, the price of oil may be too frothy and may move lower, as a stronger dollar begins to weigh on crude's best start to the year on record. Indeed, over the past three weeks the dollar has increased to its strongest level in more than three months. Also, higher prices could drive a resurgence in fracking as consolidation in the industry has resulted in stronger companies, that have the efficiency of scale to reduce production costs even further.

Figure 3: Breakeavens have moved higher along with the rise in oil prices



Source: Bloomberg, Piper Sandler

Figure 4: Real rates could be pressured lower in the months ahead



Source: Bloomberg, Piper Sandler

Real rates are too optimistic

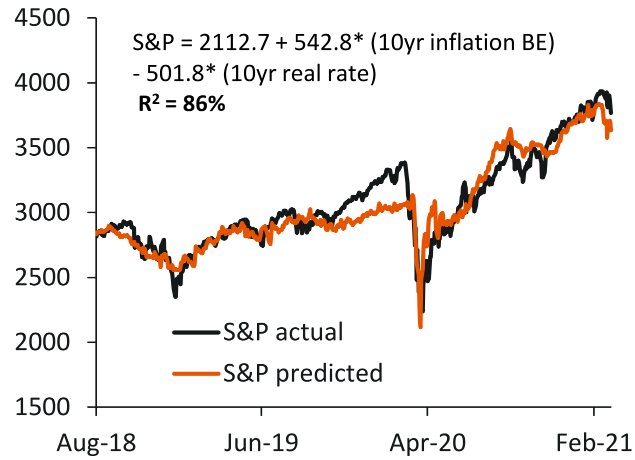
- The rise in real rates can be considered a positive development as it reflects improving economic growth expectations. Some of the economic data seem to support the "growing economy" narrative. However, a strong and vibrant economy does not depend on successive stimulus checks or repeated rounds of extended/expanded unemployment benefits. At some point the growth outlook will run up against the reality of a soft labor market, as all this stimulus is temporary and will eventually run out. The surge in real rates reflects an elevated level of optimism that under current economic conditions may be too aggressive. Since July, real rates have been tracking the Bloomberg Economic surprise index, but the divergence that has emerged over the past three weeks suggests that real rates could be pressured lower in the months ahead (Figure 4).

Real yields raise tipping point for stocks

- Looking at periods of rising real rates, the equity market usually has a difficult time coping with higher real rates, especially when real rates increase swiftly instead of gradually. At the same time it is common for equity prices and inflation expectations to advance in the same direction with both moving higher during periods of stronger future economic growth. To quantify the potential effect that rising interest rates may have on equities, the 10yr Treasury real rate and the 10yr inflation breakeven rate were used as independent parameters in our model calculations. Our analysis, illustrates that over the last three years 86% (R^2) of all changes in the S&P 500 can be explained by these two variables (Figure 5). The relationship between the S&P 500 and breakeven inflation is positive, while it is negative with real rates.

- With 10yr breakevens at 2.24% and the 10yr Treasury real rate at -0.67% our model is predicting a fair value for the S&P of 3661. Currently the S&P 500 is trading at 3842 suggesting that equity valuations may be somewhat rich given the latest changes in rates. According to our model, another 50 bp increase in real rates would push the S&P lower by about 251 points or 7%. **Therefore, if real yields continue to increase, the risk of a measured or panic-driven rotation out of stocks and into bonds will grow, thus limiting any significant rise in nominal yields.** Figure 6 illustrates the predicted level of the S&P 500 for various combinations of 10yr Treasury real and inflation breakeven rates. There is potentially a tipping point where higher rates have a real effect on stock price valuations, especially if real rates keep rising and inflation expectations start declining.

Figure 5: Real and inflation breakeven rates are highly correlated with the S&P



Source: Piper Sandler

Figure 6: S&P 500 values for various combinations of 10yr Treasury real and inflation breakeven rates

Predicted S&P

10yr Treasury real rate (%) \ 10yr inflation BE (%)	1.50	1.75	2.00	2.25	2.50	2.75	3.00
-1.25	3554	3690	3826	3961	4097	4233	4368
-1.00	3429	3564	3700	3836	3972	4107	4243
-0.75	3303	3439	3575	3710	3846	3982	4117
-0.50	3178	3314	3449	3585	3721	3856	3992
-0.25	3052	3188	3324	3459	3595	3731	3867
0.00	2927	3063	3198	3334	3470	3605	3741
0.25	2801	2937	3073	3209	3344	3480	3616

Source: Piper Sandler

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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