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Liquid Insight

What the IMF didn't say about real yields

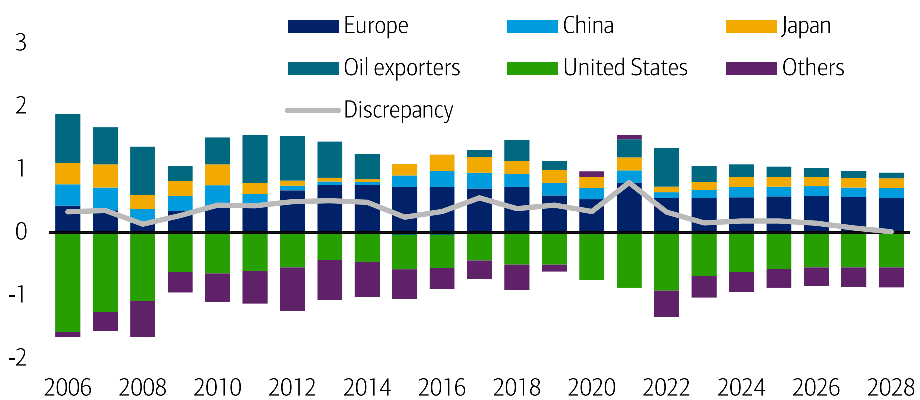
Key takeaways

- The IMF's new World Economic Outlook has a fascinating chapter on the natural (real) rate and its drivers.
- The contention that the global savings glut mattered less than the consensus might believe is something we would accept.
- However, savings imbalances still matter a lot for real yield differences, we would argue - an old relationship has returned.

By Mark Capleton

Chart of the day: Current account balances as a share of global GDP, %

Re-enlargement of global imbalances might partly explain recent relative real yield behavior.



Source: IMF World Economic Outlook April 2023

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Unpicking one of the IMF's unexpected conclusions

The IMF's fascinating analysis of natural real rate drivers is worth reading, despite the perhaps mundane conclusions for developed linker markets. One contrarian contention – that the so-called "global savings glut" was not a big driver of the ultra-low rate environment – needs elaborating. We would agree in principle, but nevertheless believe that global imbalances have re-established themselves as a prime driver of real yield differences between markets.

The idea that countries with large current account deficits and accumulated net foreign liabilities need to offer higher prospective returns is back in play. The inverse relationship between real yields and IIP/GDP ratios is important again. But this does not justify the expensiveness of Euro linkers.

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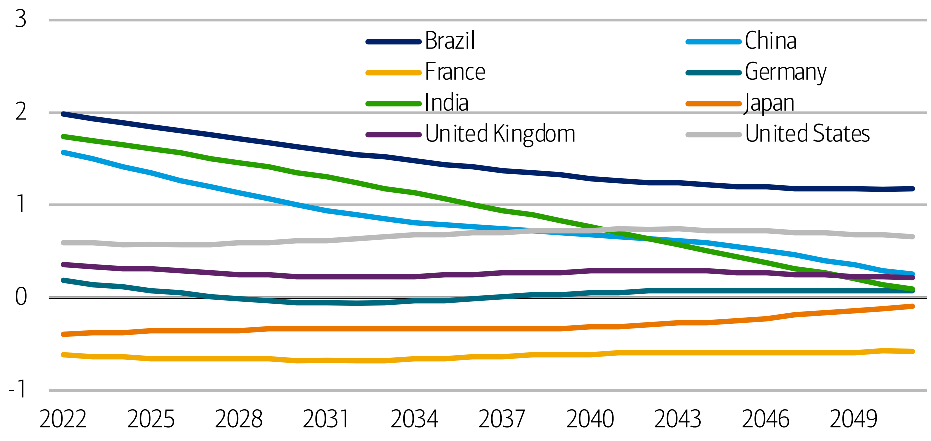
IMF on real yields – great story, dull ending

The lead story on any IMF World Economic Outlook will be the forecast summary. In the UK, the bottom-of-the-G20-table ranking for growth prospects inevitably got a lot of attention. However, the most interesting section, we would say, was the Chapter 2 discussion on "The Natural Rate of Interest: Drivers and Implications for Policy".

The road picture painted in words was of a slide back into a low real rates/low inflation regime, where the lower rate bound might easily bite once again. However, this message didn't quite fit with the baseline scenarios presented for developed economies, where the natural (real) rates are forecast to flatline (Exhibit 1). Meaningful natural rate reductions over time were restricted to China, Brazil and India in the IMF's analysis. And why France's natural rate is projected to run at a more negative level than Germany's is hard to fathom (perhaps because they will share a common nominal rate, but France is expected to experience higher inflation by the IMF, generating a lower real rate?).

Exhibit 1: IMF baseline scenario for natural rate prospects, %

An interesting message for EM linkers; developed markets not so much.



Source: IMF World Economic Outlook April 2023

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To us, the discussion was far more interesting, giving a fairly comprehensive overview of multiple potential macro and financial, global and local real rate drivers, explaining that several of these (demographics, deglobalization, climate mitigation measures, etc.) are more nuanced and ambiguous than many might argue.

Indeed, perhaps we've been guilty of taking too strident an opinion on the implications of these issues when we've discussed them in the past. For instance, in 'The old normal shows signs of life' (Global Rates Viewpoint, 3 September 2018), which we revisited in 'The US can't lift all inflation boats' (Liquid Insight, 24 March 2021), we argued that demographic change (restoring pricing power to labor) and waning globalization would drive inflation and real yields higher. Higher nominal and real rates would be required to keep inflation in check, we argued, unless protracted fiscal repair to bear down upon both inflation and elevated debt/GDP ratios did the hard work instead, i.e. unless we entered a near-permanent state of tight fiscal/easy money policy.

Reframing one aspect of the IMF's analysis

In the accompanying IMF blog about the Chapter (which we quote from below because it's an easier read), the IMF mentioned:

"Our analysis concludes that global forces matter, but that their net effect on the natural rate has been relatively modest. Fast growing emerging market economies acted as a magnet for advanced economies' savings, lifting their natural rate up as investors took advantage of higher rates of return abroad. However, because savings in emerging markets accumulated faster than these countries' ability to provide safe and liquid assets, much of it

was reinvested in advanced economies' government securities—such as US Treasuries—pushing their natural rate back down, especially since the global financial crisis in 2008."

We would broadly agree about the net effect, but would frame the transmission mechanism differently. We're comfortable with the notion that there's a global component to expected real returns, so if prospective real returns are high in one region, they can attract inflows, firming real rates in slower-growing regions.

But the more likely dynamic here, especially for, say, China, without easy access to foreign savings at the time, was that fast growing emerging markets did accumulate excess savings but these manifested themselves in the form of current account surpluses, creating reciprocal current account deficits elsewhere. Current account deficits are savings shortages for the countries that experience them, and savings shortages lift required real returns and rates. But yes, either way, the end result was that these excess savings were "recycled" into advanced economies' government securities, bearing back down on those rates. So the net impact on developed economies' real rates was probably more complicated and ambiguous than the consensus "global savings glut depresses real yields" message would have one believe.

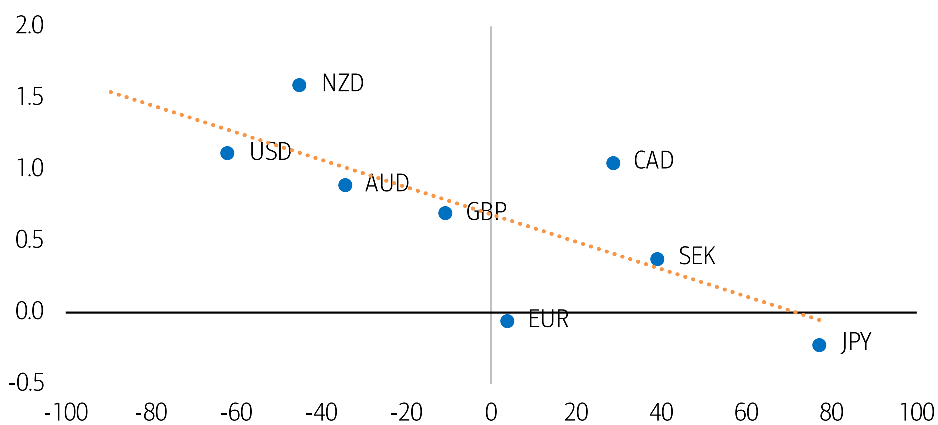
If our reframing is fair, it's worth elaborating

In this, the nature of the savings imbalances matter as much as their size, we would argue. If imbalances are small, and advanced economies can be thought of as "self-sufficient" in savings, then those savings will be allocated to a broad range of financial and non-financial assets. Similarly, if imbalances are more substantial but accrue in private hands (e.g. the businesses that are growing the trade surpluses), then assets acquired will also likely be diverse. However, when excess savings are accumulated (or at least channeled) by states via currency intervention, then those savings that are recycled are concentrated almost exclusively in government securities.

This, for a period, seemed to undermine a longstanding thesis; that countries that run persistent current account deficits and accumulate large net external liabilities (a negative net International Investment Position (IIP)) will need to offer higher real yields – indeed, higher real prospective returns on assets generally – with the opposite being true for countries with positive net IIPs.

And the real yield/Net IIP relationship was further distorted because of the zero lower bound problem. For instance, in the case of Japan, floored nominal policy rates in conjunction with very low/negative inflation expectations meant that Japan had relatively high real yields despite its large net asset position. However, the original ('old normal') thesis appears to hold once again.

Exhibit 2: 10y real yields (y-axis) versus net external assets/GDP ratio (x-axis), %
UK real yields adjusted for RPI-CPI "wedge" assumption for 2030.



Source: BofA Global Research, Bloomberg, Refinitiv

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The re-establishment of an "expected" inverse relationship no doubt reflects the move off the lower rate bound for all except Japan, and the fact that global imbalances have increased once again (see our Chart of the Day). We could perhaps explain the cheapness of NZ and Canada on the trend line as a consequence of them being small illiquid markets. The expensiveness of the Euro market will partly be a result of choosing Germany – the most expensive 10y – rather than, say, a blended rate of issuers. But that cannot be all there is to it.

We accept that a material component of the cheapening in US real swap rates relative to Euro real rates results from the divergent IIP/GDP trends for the two economies (with weakening US IIP position aggravated by dollar strength in recent years):

Exhibit 3: US & Euro 30y real swap rates and spread between them, bp
Trend widening might well be partly related to the fact that…

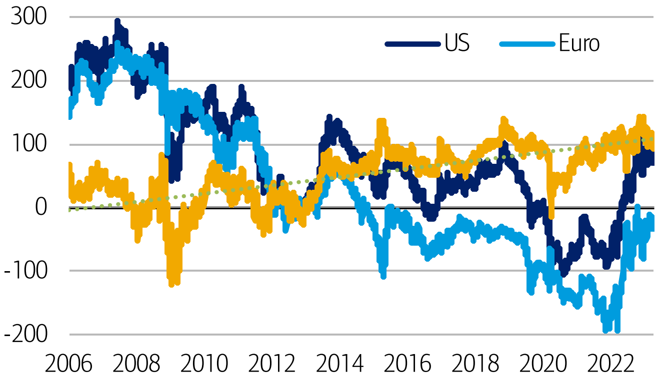

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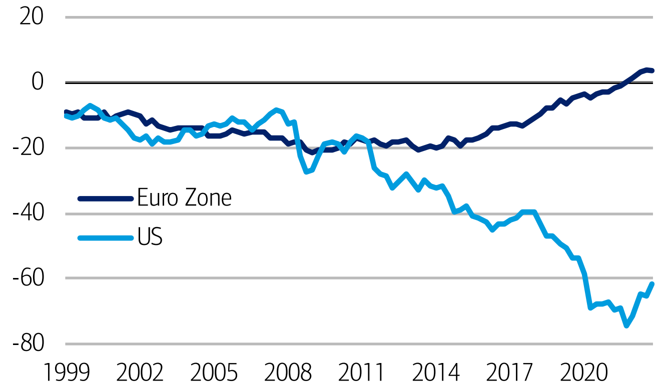
Exhibit 4: US & Eurozone net IIP/GDP ratios, %
…the US's call on foreign savings has grown while the Eurozone's shrank.



Source: BofA Global Research, Refinitiv

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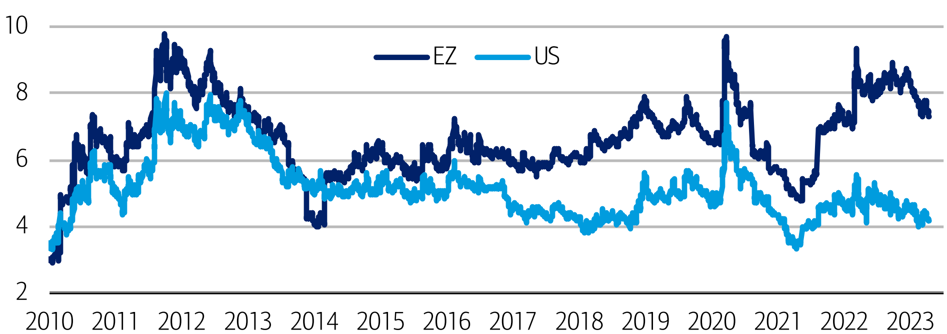
Nevertheless, we would go back to the apparent expensiveness of the Euro linker market by this metric in Exhibit 2, and take comfort from the IMF projections that these global imbalances should subside. We think a large part of the spread reflects a relative scarcity issue – the TIPS market is so much bigger than the Euro linker market, and this is aggravated by the higher proportion owned by the central bank in the latter.

The IMF article mentions the issue of opportunity cost – that the risk free real rate should be related to the prospective returns available from riskier assets. So it is interesting that while real yields are so much lower in the Eurozone, equity earnings yields there are much higher. The resulting gulf between the earnings yield gaps in the two markets is therefore huge. By this metric, the Euro inflation market is very expensive:

Exhibit 5: Equity earnings yield gaps for US & Europe (S&P 500 and Stoxx 600, respectively), %
Earnings yields (inverse of PE ratio) less 30y real swap rates.



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- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- After the storm, **Global FX Weekly**, 31 Mar 2023
- Budding stability **Global Rates Weekly**, 31 Mar 2023
- As the market dust settles, **Liquid Cross Border Flows**, 3 Apr 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: After the storm 31 March 2023

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