Chart of the week

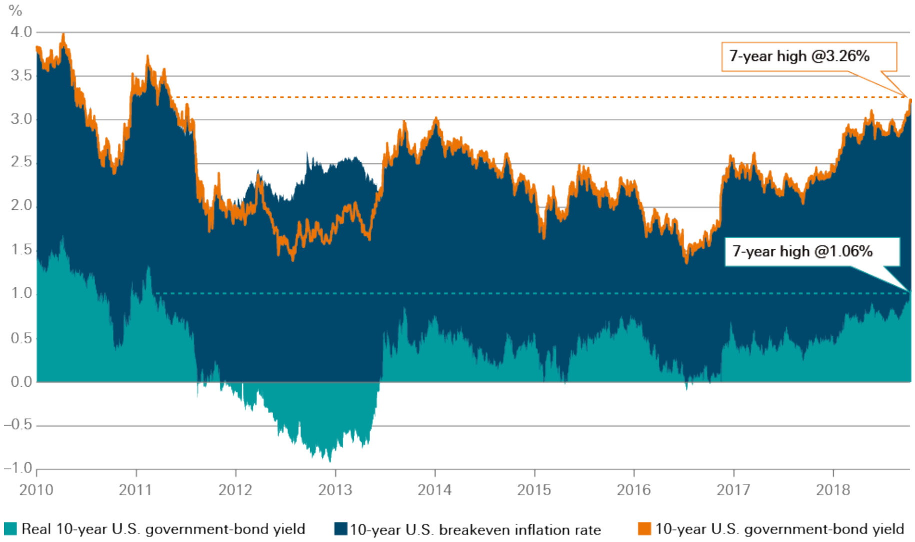
Rising real rates look like an odd trigger for equity markets to sell off.

On Wednesday, President Donald Trump blamed the tightening by the US Federal Reserve (Fed) for the selloff in equity markets. "The Fed is making a mistake. They're so tight. I think the Fed has gone crazy," he said, according to the Financial Times.[1] Our "Chart of the Week" suggests that matters may be a little more nuanced.

In recent weeks, yields on 10-year U.S. Treasuries have reached their highest level in seven years. To make sense of this, it helps to decompose yield into real interest rates and inflation expectations, as measured by the breakeven inflation rate derived from inflation-protected securities (TIPS). As our "Chart of the Week" shows, the bulk of recent yield rises was due to rising real interest rates, now also at a 7-year high. This suggests solid economic momentum ahead, which might eventually calm some nerves in equity markets as the earnings season gets underway. It also implies that for now anyway, the Fed is tightening roughly at the right pace, meaning quickly enough not to let inflation expectations out of hand.

Should equity investors count on this? There are three reasons for caution. First, U.S. Treasuries may be oversold at current levels. Several technical factors, from a temporary rise in currency hedging costs to the expiry of a tax break in mid-September probably contributed to weak Treasury demand and the resulting steady rise in yields. These factors may already be fading; according to recent survey evidence, short positioning has returned to extreme levels last seen in the middle of September. Second, rising real rates look like an odd trigger for equity markets to sell off. Perhaps U.S. Treasuries are less of a trigger than a scapegoat for equity investors fretting over other risks, starting with the simmering global trade tensions. And third, of course, there is no guarantee that the bond markets have gotten things right. Neither bond investors nor central bankers are as omniscient as one would sometimes wish.

[1] https://www.ft.com/content/c1fbab54-ccf9-11e8-b276-b9069bde0956



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 10/11/18

Glossary

Hedging Costs

Hedging costs are similar to an insurance premium paid for not being exposed to price movements of certain financial assets. The premium paid for an option is a typical cost of hedging.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Inflation-indexed securities

Inflation-indexed securities are securities whose coupon payments are tied to a inflation rate.

Real

In economics, a **real** value is adjusted for inflation.

Short

Short, in a financial-markets context, refers to approaches that seek to gain from a fall in the price of the underlying asset.

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

Risk warning

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