Deutsche Bank
Markets Research

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Rates
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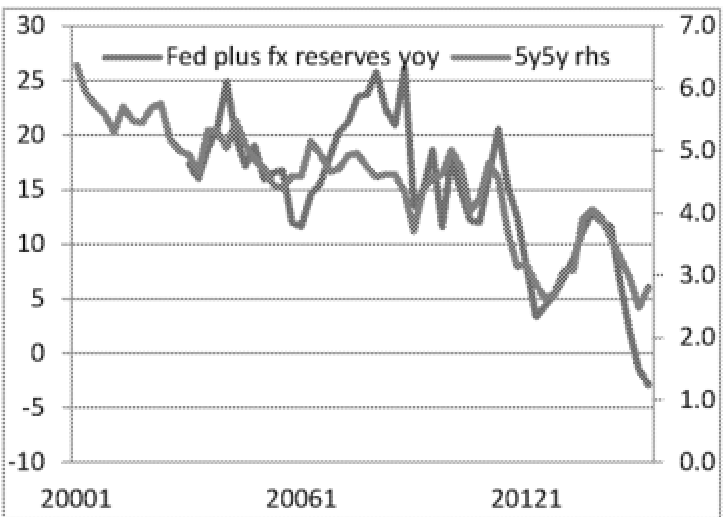
- Markets are fixated on the potential for Fed normalization to start earlier than currently priced and whether China's recent FX adjustment is the beginning or the end.
- At a superficial level there appears to be conflicting influences on rates. The Fed and China may undermine risk asset performance but the consensus is that if risk assets find support, fewer FX reserves are likely to pressure rates higher.
- On the contrary, we think the most important thing is that both the Fed and China's FX (ongoing?) unwind represent a tightening of global liquidity that clearly is negative for risk assets and clearly, at least for the last decade, has been positive for real rates and the curve. 5y5y is well correlated with changes in global liquidity and based on recent trends should be closer to 2 percent.
- This reinforces our view that the Fed is in danger of committing policy error. Not because one and done is a non issue but because the market will initially struggle to price "done" after "one". And the Fed's communication skills hardly lend themselves to over achievement. More likely in our view, is that one in September will lead to a December pricing and additional hikes in 2016, suggesting 2s could easily trade to 1 ¼ percent. This may well be an overshoot but it could imply another leg lower for risk assets and a sharp reflattening of the yield curve.

Decline in liquidity implies a lower 5y5y



Source: Fed and Deutsche Bank

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