



United States

Rates  
Gov. Bonds & Swaps  
Rates Volatility

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## US Overview

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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.
- We think risk/reward has shifted toward paying spreads in the front end. Financing is challenging with term GC trading high relative to LIBOR, but we think rolling the position overnight should allow investors to average in financing better than LIBOR, providing some backstop against tightening if significant additional intervention-related selling does not materialize.
- We like being long front end breakevens in forwards, e.g., one-year breakevens implied by short maturity TIPS, such as the 7/2016s and the 7/2017s. One can also hedge out energy prices in that trade to create a synthetic exposure to core CPI. A simpler version of the implied front end forward breakevens is to be long front end breakevens outright. They have lagged oil prices.
- 5-year inflation basis has recovered, while 30-year inflation basis has done less well, and remains in the low end of the long term trading range. Investors should consider inflation basis steepeners by being long 30-year inflation basis against 5-year inflation basis.

### The case for more liquidity

Investors are rightly concerned about the impact of both a possible early start to Fed normalization and the probably yet-to-be-resolved Chinese FX adjustment. There is a reasonable consensus that both encourage further downside to risk assets. There is more uncertainty around bond yields. Potential FX intervention might imply selling of Treasuries, especially the front end where most reserves are held. But if higher short rates from either those sales or Fed tightening, undermine equities, bond yields might actually fall.