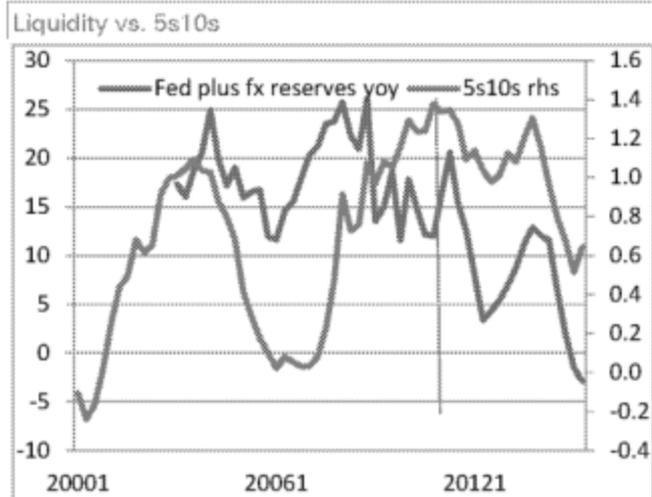
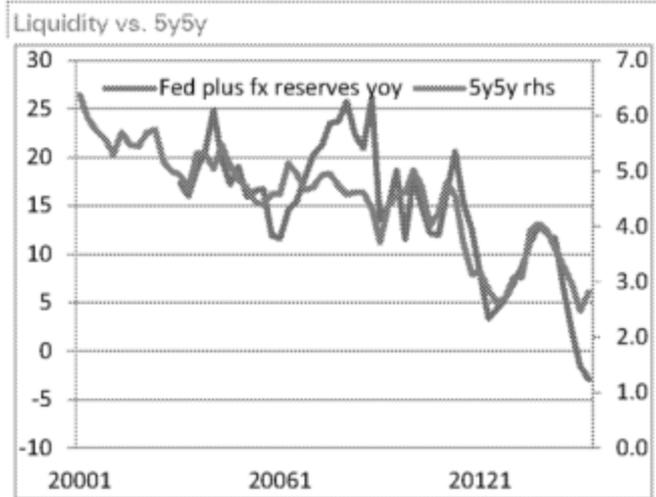




Right now the decline in central bank liquidity suggests 5y5y should be closer to 2 percent or below, not 3 percent or above. And this is before the Fed has tightened and China has potentially "finished" its adjustment.

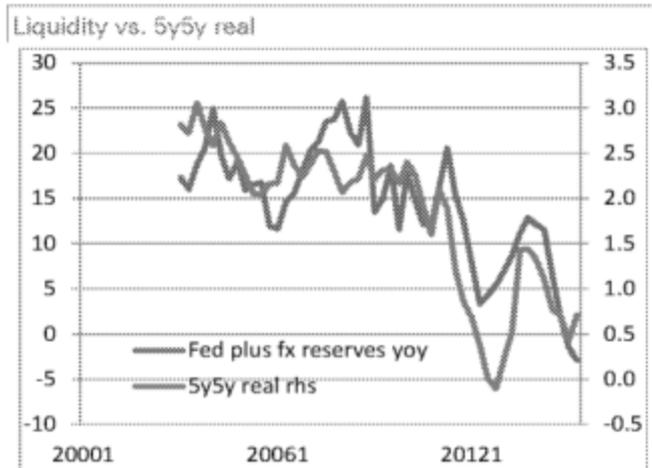


Source: Bloomberg Finance LP and Deutsche Bank

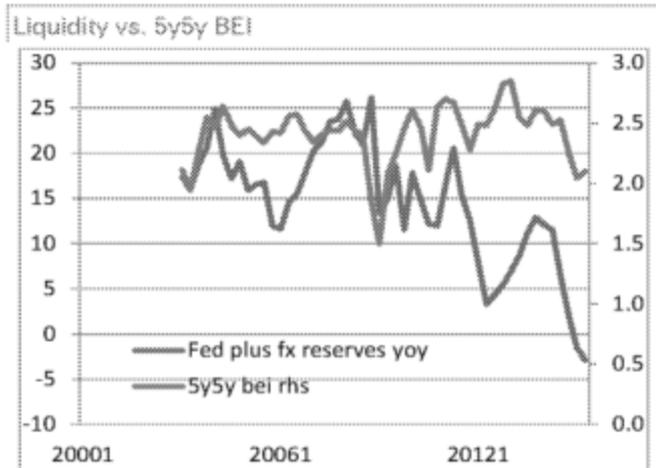


Source: Fed and Deutsche Bank

And of course the breakdown in 5y5y between real and inflation reinforces the story that it is the real rate not inflation expectations that drive this result. And this is again consistent with the risk asset concern that it is the lack of liquidity that undermines risk assets that in turn drives real yields lower, despite keeping breakevens relatively inflated. One conclusion is that if investors believe that liquidity is likely to continue to fall, one should not sell real yields but buy them and be more worried about risk assets than anything else. This flies in the face of recent concerns that China's potential liquidation of Treasuries for FX intervention is a Treasury negative and should drive real yields higher. It is possible that if risk assets do very well, then maybe the correlation with interest rates is broken. But like all these relationships for us, it is easier to work with the correlations that currently persist rather than to predict random breaks. And the potential breaks should be more cheaply hedged rather than making for a core portfolio allocation. I.e. cheap SPX calls based on rates lower. More generally, the simple point is that falling reserves should be the least of worries for rates – as they have so far proven to be since late 2014 and instead, rates need to focus more on risk assets.



Source: Bloomberg Finance LP and Deutsche Bank



Source: Fed and Deutsche Bank