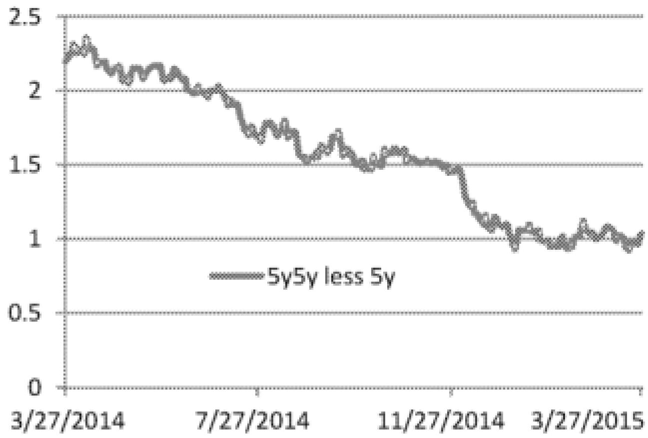
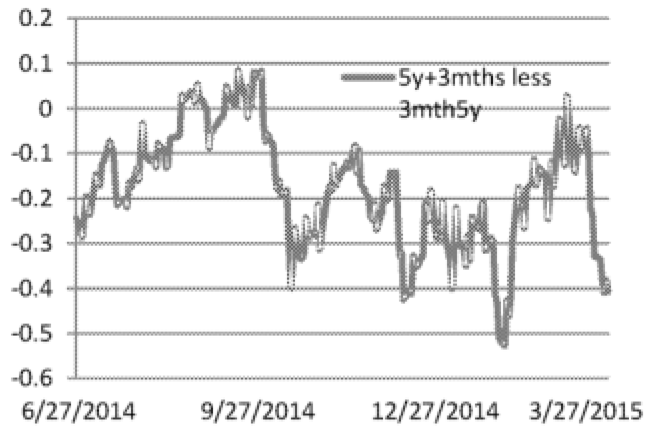
5y5y less 5y




Source: Bloomberg Finance LP and Deutsche Bank

5y realized vs. 3mth forward 5 yr rate




Source: Bloomberg Finance LP and Deutsche Bank

There are three themes that form this outlook and various risk factors that could force a reappraisal and need to be closely monitored. Two, the terminal Funds rate and term premium, relate directly to longer term rates, where we use the 5y5y as a proxy. One, the Fed, relates to the evolution of the front end in terms of the timing and speed of normalization.

Terminal funds can be viewed as the sustainable terminal rate for the Fed in the sense that it is an equilibrium i.e. the Fed does not have to keep raising rates or reverse course. 5y5y has been a good proxy for the terminal rate in that it pretty much sits on top of Funds at the end of each cycle -- therefore represents an upper ceiling i.e. the fed would not have had to reverse course if funds never reached 5y5y *ex ante*. In the Fed's ACM term premium model 5y5y has averaged in 2015 2.59 percent. This is a little higher than the Treasury 5y5y and about 30 bps higher than the market pricing for 5y5y OIS, currently around 2.3 percent. Whichever way we look at it the market is clearly pricing for a terminal Funds rate somewhere around 2 ½ percent if not a little below. For this rate to be higher we think there would need to be a sustained shock higher in sustainable growth expectations.

With 2014 GDP now in, what is once again so impressive is that GDP has not failed to disappoint. Nominal growth finished the year a paltry 3.66 percent and the year averaged 3.88 percent. This is bang in line with the average of the last 5 years since 2009, of 3.85 percent. You could be forgiven for thinking that we actually were witnessing an accelerated economic recovery in reading the economic consensus. The fact is that this is nonsense. The economic growth has been incredibly stable at a sub 4 percent nominal pace for five years. No acceleration. Just the same. Will 2015 be any different. Best guess, "no". Note that this is why there is no productivity growth to speak of as the labor market recovery that has been impressive has cannibalized productivity. This raises core issues as to the sustainability of labor market strength, profitability and the ability of the economy to withstand any kind of accommodation removal. It also begs the question why have corporates relied so much on labor input to deliver the GDP rather than eking out productivity gains. Is it a technology/innovation constraint, an investment issue or simply using "cheap" labor while it is available. However while these issues are to be resolved, fair to say it is hard to argue that the fair value terminal rate needs to be very different from 2 ½ percent. Note that profits are now lower for 2014 than 2013, the first decline, since 2008.



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