From a market perspective, a potential tapering discussion will help support a partial normalization of core euro rates sometime next year. The timing of the repricing could depend on several factors, including the risk from EM countries and oil prices, which we discuss below. From a pure domestic perspective though, the dynamics of inflation and the unemployment rate would suggest a repricing in the second half of the year.

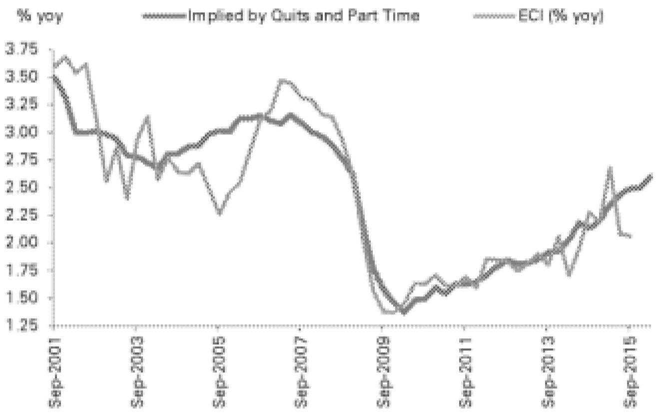
Fed: Irregular tightening

Now that a December hike seems likely, the market shifted its focus on the pace and terminal rate of this hiking cycle. It is now generally accepted that the rate cycle will be shallower than the most recent tightening cycles. Currently the market is pricing that the neutral real rate (estimated as 4Y1Y OIS minus 2%) will remain close to zero. One side of the argument for low neutral real rates is a structurally lower level of productivity (the secular stagnation argument). Productivity has indeed been close to historical lows during this recovery. However, the uptick in real wages since the trough of the recession would suggest that there could be some upside to productivity from these levels. This would be particularly the case if wages do follow the leading indicators, which suggest some improvement towards 2.5% yoy on a nominal basis (around 1% in real terms based on current core PCE forecasts).

Figure 6: Productivity at historical low levels, but the improvement in real wages suggests some upside risks

Source: Deutsche Bank Research, Haver Analytics LP, BLS, BEA, NBER

Figure 7: There is scope for a limited normalization of wages



Source: Deutsche Bank Research, Haver Analytics LP, BLS

Others (including the Fed) argue that real rates have been low because of headwinds, namely tight fiscal policy, tighter regulation and credit supply, weaker demand for credit due to balance sheet repair and general macro uncertainty (fiscal cliff, Europe, China etc...). For Chair Yellen, we expect the normalization of policy will be driven not by an increase in GDP growth, but rather by the fact that the neutral real rate will drift up. The improvement in lending conditions and the marginally more supportive fiscal policy would also argue for some upside risks for the neutral rate. Irrespective of which side proves to be correct (within our own research team, the views are mixed), given that the market is de-facto pricing secular stagnation, the risks are to the upside in yields.