



There is plenty of room for the terminal rate to go up and for the bond risk premium to turn positive. Starting in late 2012, the Fed began lowering its "long run" policy rate in sync with its forecast of lower long-run real GDP growth, from 2.5% to 2%, which corresponds to average headline GDP growth in this recovery. But with the drag from the government shrinking since early 2014 and private sector GDP growth running at 3%, underlying headline growth has already moved up to 2.4%. As the government sector begins to cease being a drag, headline real GDP growth should lift to 3% and the terminal rate to 4.5% (3+2-0.5). With the bond risk premium (BRP) an unprecedented negative through the Fed's calendar rate guidance, it turned positive around the taper but is back to around zero. We look at the BRP relative to the 10y as this normalizes for prevailing duration. Historically, the BRP ranged from 0% to 40% of the 10y yield, averaging 22%. That would be as additional 44 bps on the current 10y, about what the Fed seems to be assuming. The BRP has also been historically correlated with the US current account deficit as much of it was financed by the foreign official sector, which bought Treasuries for Official Reserves. The present current account deficit points to 25% of the 10y yield, so similar (55bps) but slightly higher BRP.

Credit spreads tighten with higher rates but over-allocations keep fixed income vulnerable: HY over HG. It is generally assumed that higher rates mean wider credit spreads, i.e., that the beta of credit spreads to the 10y yield is positive; the betas of both HG and HY spreads to the 10y have in fact always been negative (Credit After The Taper Reset, August 2013). HG has been the largest recipient of inflows in fixed income and with spread compression (beta less than 1) insufficient to offset the impact of higher rates, negative total returns leave them vulnerable to outflows. HY much less so.

The equity risk premium is at a 70-year high; it is perfectly negatively correlated with the 10y yield. The equity risk premium (the equity discount rate less Treasury yields) is a very hefty 8% (Cycles in the Equity Discount Rate and Risk Premium, Apr 2015). Prior to this cycle, the last time it was this high was in the 1950s post-World War II recovery period. It remains 3pp wider than it was pre-financial crisis. The equity risk premium has historically been strongly negatively correlated with the 10y Treasury yield. With a beta around -1, a rise in the 10y yield should see the equity risk premium shrink by a commensurate amount. Indeed a 3 percentage point rise in 10y yields that shrunk the equity risk premium by a commensurate amount in line with the historical pattern would take it back down only to where it was prior to the financial crisis, i.e., equities look to be priced for significantly higher yields and then some.

The dollar cycle is years ahead of the rates cycle. As US rate increases get closer and the ECB keeps rates on hold or even cuts further, rate differentials move in favor of the dollar; but the euro is two years ahead of rates and will therefore remain vulnerable to reversals. Positioning has been moving long the dollar. At 92% of April highs, there looks to be only modest room for the market to go longer. The next phase of the dollar up cycle looks to be closer to the typical 5% a year pace: (i) euro rates selloff has further to go; (ii) in the face of rapid dollar appreciation the Fed already pushed out rate hikes once marking a trough in the euro for the next six months and will likely do it again.

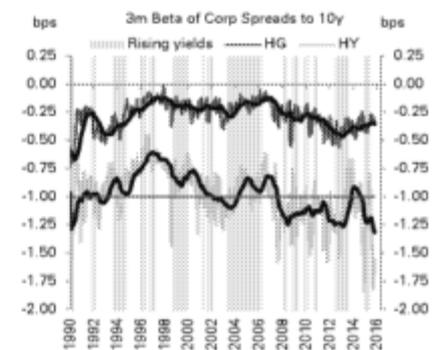
Oil will continue to be pressured by a rising dollar but unlike 2014 it looks close to fair value. Across the oil and commodities complex, prices have been driven predominantly (average 81%) by global activity (slack) and the US dollar (Trading The Commodity Underperformance Cycle, Apr 2013). But as a practical matter, they have been driven almost entirely by the dollar and valuation, as global growth has varied little over the last few years. Oil prices are now close to fair value (Closing Our Short In Oil, Dec 2014) and risk-reward argues for being modestly underweight on a rising dollar. Industrial metals, especially Copper still looks expensive.

Figure 9: Hiking cycles and 10Y

Hiking Cycle	Hiking Cycle duration (months)	Fed Rate at Trough	Fed Rate at Peak	-3m to +12m return	10y treasury price chg during the hiking cycle
1958-59	16	0.5	4.0	-11.9	-10.4
1961-65	64	0.5	6.0	-1.9	-9.6
1972-74	26	3.5	13.0	-5.6	-10.4
1976-80	37	4.8	14.0	-0.9	-23.1
1980	4	9.5	20.0	-23.9	-9.6
1983-84	16	8.5	11.5	-10.2	-12.5
1994-95	12	3.0	6.0	-12.0	-10.4
2004-05	24	1.0	5.3	-1.5	-3.1
Average	25			-8.5	-11.1
Median	20			-7.9	-10.4

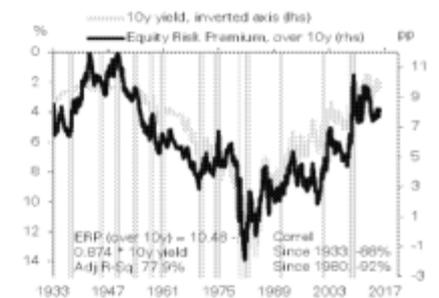
Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 10: Credit spreads and rates



Source: Factset, ML index, Deutsche Bank Research

Figure 11: Equity risk premium negatively correlated with rates



Source: Bloomberg Finance LP, Deutsche Bank Research

Figure 12: Euro is far ahead of rates



Source: Bloomberg Finance LP, Deutsche Bank Research