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INVESTMENT MANAGEMENT

# Exploring the 'Right-tail-risk': An Upside Surprise to Growth Expectations

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While many are consumed with calling the next recession, we feel it's important to incorporate the 'right-tail-risk,' where growth is stronger than consensus expectations and yields rise accordingly.

U.S. Treasury (UST) 10-year real yields are breaking above the range in which they recently have been fluctuating, suggesting that real growth (potential growth, the neutral fed funds rate (r*), productivity) may be in the process of "normalizing" and shifting higher. This is a *risk-outcome* that we cannot easily dismiss. The likely culprit is regulatory reform and fiscal reform (namely corporate taxes). These two policy levers were used to spur higher growth, a core part of our macro thesis. The question is whether this is just a 'sugar high,' or something more permanent? We need to consider the risk that it is in fact more permanent as these policy measures revive animal spirits, effectively kick starting economic activity that was previously dormant.

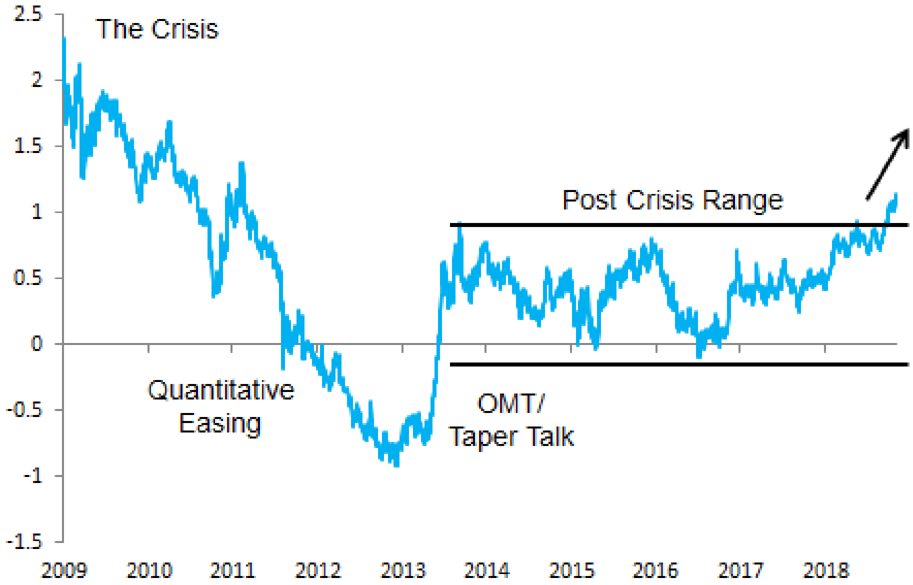
We link this thesis to an observable market metric that we can simplify as the real yield of the UST 10-year, i.e. the nominal 10-year less the average of expected inflation over the next 10 years. We recognize this is not a perfect measure – in that there are technicalities to consider – but it is a reasonable market relationship that we can easily observe. The linkage is that real yields are positively correlated with real growth, potential growth, r* and productivity. A rise in real yields suggests that all the rest are rising too.

<u>A summary history of UST 10-year real yields</u>

- Pre-crisis (2002-2007) real yields averaged ~2.00%
- Average since the global financial crisis (2009-2018 YTD) ~0.50%
- Low of ~ -1.00% in 2012
- +1.00% defined the peak post crisis range
- Today real yields are breaking that range at +1.14% as of November 2, 2018.

## Display 1

UST 10-year real yields from the global financial crisis to today

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Source: Bloomberg. US Generic Govt TII 10 Year. Data shown from January 1, 2009 through November 2, 2018.

The chart above illustrates that real UST yields are breaking to the upside and may stay there, something the market was not widely expecting. The analysis suggests that 10 years after the fall from the 2008 global financial crisis, potential growth rates may be in a process of normalizing. While most in the markets are calling for the end of the cycle and the next recession, these higher yields and growth rates are a right-hand-side tail risk that may be underappreciated. In other words, the risk of higher yields and growth – a ‘good outcome’ – is the risk.

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**R*** is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate.

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