

Rates: Born in the USA

While the Covid drama surrounding the White House presented a distracting background, in the foreground the rates market is sniffing an eventual stimulus bill, and week-by-week seeing macro data that has had a shinier-than-expected veneer on it. The consequent uptick in core market rates globally has a clear US stamp on it. This is good for Europe too



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A month ago we enunciated the parameters that could steepen the US yield curve, and why steeper curves generally would be a good thing. They signal a reflationary tendency, which is what you want to see in the wake of the potentially massive deflationary hit that Covid-19 has been.

Put simply, Covid generated significant output gaps, globally. These correlate with weak labour markets and through a collapse in demand imply minimal medium-term inflation pressure. Hence the collapse in both official and market rates. As we come full circle, the subsequent rise in market rates and steeper curves is a good thing, as it signals some unwinding of pain.

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And it has been made in America so far; the widening in the spread between USD and EUR market rates confirms this. Before Covid-19, the US 10yr Treasury yield typically traded in excess of 200bp over Germany. Covid took that spread down to 100bp, partly as most of the rate-cutting came from the Federal Reserve. It is now back up to 130bp. It is still closer to crisis levels than to more normal levels, but the path that the spread is on is an auspicious one. What we want to see here is a classic US recovery that helps to lift the likes of Europe in the same direction. The bond market is in the early phase of pricing in that exact likelihood.

But we still have some way to go. Macro angst remains elevated in absolute terms. That is dominating the supply risk coming from stimulus packages, on both sides of the Atlantic.

Risks remain elevated. Default probabilities are likely underestimated by current high yield spreads, masked by a myriad of government schemes to keep things afloat. The US election outcome still has the potential to stoke considerable volatility and uncertainty. And Covid itself has clearly not gone away.

A still relatively elevated VIX index is a good barometer of many of these unknowns, warning market participants to be on their guard.

European data has also begun to disappoint. German data is the best prism through which to assess wider Europe, and the evidence there had improved but has more recently lurched back.

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There has been some of this. While the macro data has not been a pleasant read in absolute

terms, the dynamics post the 2Q collapse have been a net positive. Moreover, the actual data released has tended to be almost consistently firmer than expected. That has been enough to ultimately feed through to higher market rates.

There are many obstacles ahead, and no doubt there will be setbacks. But we continue to eye a 1-handle for the 10yr US as a theme for 2021.

With the 10yr currently at 75bp that may not seem very aggressive, but it is some way from the -50bp seen on the German equivalent. If we are to get back to a 200bp spread, it will likely come from US rates ratcheting higher.

Slowly, but higher. That steepens the curve as central banks have parked official rates at current levels. It is also the clearest means to tempting 10yr Germany back up towards that holy grail of positive rates.

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