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USD: The glory of a 1-handle

We are upbeat for 2021. Hence the call for the US 10yr to get to the 1 to 1.25% range. If the stars align we could go higher. But there are drags coming from Europe. And also the structure of the curve is not looking very bearish for bonds. The rich 5yr valuation tells us that market rates are still vulnerable to the downside, and Covid could take us there first

Why we target a 1-handle for the 10yr in 2021, but we go lower first

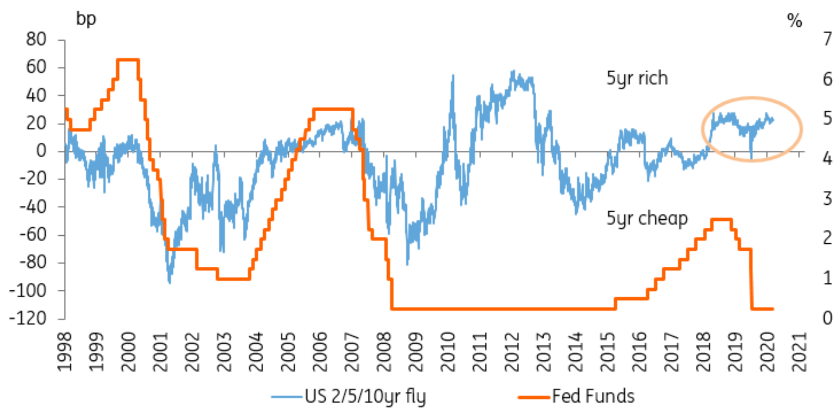
Now that we hopefully have a coronavirus vaccine, the world has a more certain prognosis. By the middle of 2021, the application of that vaccine and recovery from a likely double-dip in the first quarter mean we could see US growth in the 5% area.

> *The 1-handle is a key level, as we return to describing yield in percentage rates rather than in basis points*

This will not go on forever of course, but such an outcome would act to narrow the output gap, and there is not an inconceivable outcome which includes the buildup of inflation in the vitally important service sector. This is what underpins the targeting of a 1-handle on the 10yr Treasury yield. This would be structural in the sense that we would likely remain at 1% or higher. We view 1.25% as achievable.

The 1-handle is a key level, as it returns us back to the notion of describing yield in percentage rates rather than in basis points. It also by implication points to the targeting of key levels above 1%. But not too far above. We don't see a 2% 10yr yield as a likely scenario for 2021 for example. A move from 1% to 2% would undoubtedly be a bear market for bonds in 2021, but this is not a bear market for bonds.

US 2//5/10 year fly v Fed funds



Source: Macrobond

The richness of the 5yr mutes any ambition to term this a bear market for bonds

Our go-to here is the 2/5/10yr fly, which tells us that the 5yr remains exceptionally rich to the curve. When this has been the case historically, the bond market has been a bullish one and/or the Federal Reserve has been easing policy.

This is also a warning shot for the bond market bears, and nearer-term the set-up is for a double-dip in the economy as the third wave of Covid-19 strikes with lockdown implications. The re-elevation in macro angst over the turn of the year and well into the first quarter of next year will act as a drag on market rates. We doubt there would be enough there to pull the 10yr down to 50bp, but a pullback to the 75bp area is conceivable.

So it is 75bp to 1% for Q4 2020 through Q1 2021, and then a 1-handle for the rest of 2021, ultimately converging on the 1.25% area.

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