Rates Spark: Blue, without the wave?

The US presidential election might be too close to call for another few days. The chances of a 'blue wave' have receded considerably, which combined with the risk of legal challenge imply more downside to USD rates. Sentiment indicators have held up despite the second Covid-19 wave in Europe but we are cautious on sovereign spreads

US election day live results during a US election watch party

Source: Shutterstock

US elections update: Blue wave unlikely

At the time of writing this note, the US presidential election is still too close to call with Donald Trump winning Florida and Texas and midwestern states likely to prove decisive once more. Pennsylvania in particular might not report before the end of the week. What's more, the closer the race, the greater the odds of legal challenges and recounts. In short, the risk of a protracted period of uncertainty is significant.

In addition to the presidential race being a toss-up, the odds of Democrats taking the Senate have become limited. This conspires to creating a significant challenge to the pre-election reflation trade that saw US Treasury yields flirting with 0.90% at the end of yesterday's session. Overnight, Treasuries have retraced around 10 basis point of their pre-election move.

USD rates: Pricing out reflation

As we identified prior to the vote, the weakest link in the 'blue wave' (a win for Democrats in all three races) hopes was the Senate.

> *Nothing is standing in the way of lower government bond yields*

Whilst Republicans retaining control of the upper house of Congress does not necessarily preclude another round of fiscal stimulus, chances are it will be less generous. More importantly for interest rates, a large question mark is hanging over hopes of greater nominal growth on the back of infrastructure spending.

Pending a surprise win of the Democrats in the Senate, the risk of a gridlocked Washington (Democrats look likely to hold on to the House of Representatives) means nothing is standing in the way of lower government bond yields.

In terms of curve movements, this should leave 5-year in the front-end 'low volatility zone' with growth unlikely to lift off early enough for the Federal Reserve forward guidance to be called into question. Our main expectation is for curve flattening to extend 2s10s, but for 10s30s to remain steep.

Meanwhile in Europe, look out for PMIs

Investors could be forgiven for only giving European markets a fleeting thought today. The Spanish and Italian PMI services will provide important clues about the impact social distancing measures are having on sentiment in the tertiary sector. Looking at French and German indices released last week, there didn't seem to be (perhaps surprisingly) a sense of panic. As restrictions bite, this could be the object of downward revisions to previous flash releases however, and compound the flight to quality flow on the back of US election uncertainty.

This isn't to say that European rates can just ignore the fallout from the US election. Despite a growing tendency to diverge from their US peers, we estimate the beta of EUR and GBP rates to USD should be around 33% and 50% respectively. If only through the sentiment channel, demand for core bonds this side of the Atlantic might be impacted by the election. The economic 'contagion' is less certain due to the candidates' professed 'America first' and 'buy American' policies.

-0.70% Our target for 10Y German yields

Appears more than ever in play

Overall, our target for 10-year German yields of -0.70% appears more than ever in play. The fate of sovereign spreads will depend more on the PMIs this morning, and the latest round of restrictions announced in Italy yesterday than the US election. However, the odds are skewed wider with sentiment standing on shaky ground.

Today's Events: European PMIs, US ISM

The pace of economic releases picks up a notch today with European services PMIs in the morning. Only Spain and Italy are first readings but there is a risk of downward revisions to the other indices due to recent lockdowns. In the afternoon, US ISM services and ADP will be the highlight.

Bond supply today takes the form of Germany launching its first 5Y green Obl, and of Finland auctioning 10Y debt.

From the ECB, Pablo Hernandez and Isabel Schnabel are speaking today.

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