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Rates Spark: Georgia on my mind

Senate election run-offs in Georgia could add to already-rising inflation expectations. The current reflation trend amid muted nominal yields looks to be the correct one but 5Y could rise relative to other tenors if the market brings forward its first expected Fed hike.

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Overnight: lockdown already priced in

The UK government's announcement yesterday evening that the country is to enter a new national lockdown was the latest example of a now well defined trend towards more restrictions. As most of the measures were already discussed at length in the press, we think the market impact will be muted.

Instead, the focus in financial markets remains on the adjusting US macroeconomic expectations (see discussion on that topic in the next section). Of the Fed officials speaking overnight, Bostic expressed hopes that it could taper this year. Mester argued in favour of a wait and see stance this year.

Georgia senate run-offs: high federal stakes

Today, the two senate run-offs will write the final chapter of the 2020 US election cycle that saw Biden elected as president and the Democrats hold on to control of the House of Representatives.

A twin victory for the Democrat candidates would mean an equal 50:50 split between the two parties, but thanks to VP Harris' vote, and the willingness of moderate Republicans to work with the Democrats on issues such as fiscal support, the Biden reflation trade could be back on.

The Biden reflation trade could be back on

Our view is that, if granted greater power by a double Democratic victory today, the likelihood of the Biden administration enacting pro-growth policies, be it additional funding to vaccination programmes, fiscal support to households, and government investment (for instance in renewable energy), will rise. In turn our economics team is expecting better growth momentum from the second quarter of this year. Measures that would dampen growth and sentiment, such as tax rises or additional corporate regulations, should only be discussed in the following years.

Relight my (reflationary) fire

All this would come at a time inflation is being talked about as the main risk to financial markets in 2021, no least to rates, and as the 10Y USD break-even celebrated the new year by crossing 2% to the upside. Nominal yields on the other hand have flatlined since early December, in a sign that investors believe that the Fed will continue to supress yields even as Inflation expectations normalise. We take no issue with that reasoning as long as the first Fed hike is expected for 2023 or even 2024.

Additional fiscal thrust to the economy could change that dynamic however. The Fed's inflation tolerance under average inflation targeting remains, perhaps purposely, vague. Given the removal of a number of key tail risks for global markets in December, including a fiscal stimulus package in the US, a Brexit trade deal, and the start of vaccination programmes, better growth expectations would be more relevant in setting nominal rates.

There is a risk a Democrat win compounds already rising inflation expectations

This should in theory affect the 10Y sector of the USD curve the most, and thus drive a further cheapening of the 10Y point relative to 2Y and 30Y. There is a risk a Democrat win compounds already rising inflation expectations, and that markets price an earlier Fed lift-off date. In this instance, negative real rates would rebound the most, but nominal yields should also be impacted, with 10Y US Treasuries yields finally crossing above 1%. On the curve, this would bring a cheapening of 5Y rates relative to 2Y and 10Y.

Events today and market views

Much of the economic excitement will be found on the US section of the economic calendar. December ISM manufacturing is expected to decline from elevated levels but the continued dollar fall is one factor that could offset rising covid gloom. Overall, the message sent to markets should be more upbeat than the steady drumbeat of covid news so it adds to the case for higher rates today.

If the recent polling and betting odd trends, in favour of Democrat candidates, continue today, then USD rates should imbed greater fiscal policy. This will push 10Y US Treasuries closer to 1% and widen the rates differential with the Eurozone. Further extension of European lockdown, would also reinforce this dynamic.

Primary markets are off to a busy start as usual for this time of the year. In government bonds already yesterday Ireland announced a new 10Y bond which is in line with issuance patterns seen in recent years. Slightly more unexpected was Italy announcing a new 15Y bond already this early. We expect both deals to be today's business with €3-4bn for the Irish and €8-10bn for the Italian transaction.

Also in today's business is a new 10Y from Slovenia alongside a 30Y reopening. In SSAs KFW plans a 10Y EUR bond while Land NRW is looking at a 100Y. With regards to today's scheduled supply Germany taps its 2Y benchmark bond for €6bn.

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