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Rates: You think you've seen it all? Wait for it...

Picture what many term the most important US election in living memory. Frame it within a global pandemic not seen in 100 years. Add massive supply to get economies off their knees to a pervasive dusting of structurally negative rates. And then try to make sense of it all for rates - US rates still look like they want to look upwards, even if they go down first

Former Vice President Joe Biden,left, and President Donald Trump

Source: Shutterstock

Plenty of distractions, but a clearer path emerges ahead

While there is confusion and uncertainty in the air in the US, we know far more now than we did before election day.

The outcome being baked into market price action looks beyond potential re-counts or election validity objections that can muddy things in the coming weeks. The focus is squarely on a Joe Biden administration outcome, but constrained, as the Republicans keep the Senate. And crucially, so far, markets are concentrating on the positives from this. Hence the buying of risky assets like equities.

> *Where congress acts as a policy bloc to Biden in the coming years, some of the more extreme policies are watered down. Such gridlock gives Wall street less to stress about*

But what about bonds? Typically when equities are in favour, bonds are not, and yields head higher in consequence. Here, the impact effect has seen the 10-year US yield lurch lower, from 95bp to 75bp. A 20bp move is a huge move in proportion to the absolute level of yield. In the bond world, these are big valuation changes over the course of 24 hours.

Now we ask a two-pronged question, why have we had this impact, and more importantly, where do we go from here.

The constrained nature of the presidential outcome is key

The rationale for the fall in yields reflects a relief factor.

An unconstrained Biden outcome had positives as it would likely come with a large stimulative package, which would then need to be financed. That combination would be good for growth, but also heavier on supply. In contrast, a constrained Biden likely means a smaller stimulus, with means less of a boost for growth and a smaller increased in supply.

This backdrop together, with an extrapolation where Congress acts as a policy bloc to Biden in the coming years, means that some of the more extreme policies are watered down.

Such gridlock gives Wall street less to stress about, which in part helps to answer the second question. The prognosis remains in place for a 2021 recovery. A boost to growth would ease supply concerns, as the economy keeps better pace with the debt. This maintains a view for a 1 handle for the US 10yr yield in 2021.

Despite the uncertainty, the US is still in the lead vs Europe

While a 1 handle for the US 10yr may not appear to be an aggressive call, it is by definition a definite separation from the negative rates world that the Eurozone continues to endure. The prognosis here is for a re-widening in the spread between US and German market rates.

Pre-Covid, the 10yr spread was over 2%. Covid took it to 1%. It should be in the 1.5% to 2% area as a theme in the quarters ahead. Resumed steepening pressure will also likely come from the US, which is good as it means that the curve is discounting reflation of the economy.

> There are near-term risks though. Calls for selected re-counts in the US presidential election will add some toxicity to the backdrop. Meanwhile, a Covid resurgence in Europe is acting to keep German rates hammered down in negative territory, and the remedy from the ECB is to buy more bonds - a double whammy keeping market rates hammered down.

Bottom line, the US remains in the driving seat when it comes to eventual resumed upward pressure on yields. But in the short term, expect election volatility to resume itself, and that together with European angst is keeping core rates under wraps generally in the coming weeks.

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