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The Blue Wave & The Bond Market

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GLOBAL FIXED INCOME

- A larger-than-expected stimulus package could drive 10-year U.S. Treasury yields towards 1.25%, absent other unexpected events occurring.
- Inflation breakeven rates will continue to rise for now, supported by the Fed's intention to let inflation run higher for now.
- Speculation that the Fed would want to extend the weighted average maturity (WAM) of asset purchases seems misplaced.

The most notable event shaping the U.S. bond market to start the New Year was the outcome of the Georgia Senate races, which created a 50/50 split between Democrats and Republicans. As many strategists expected, U.S. long-term rates are moving higher, reinforcing last year's dynamics and leading the U.S. yield curve to steepen.

On the back of this sizable steepening, we may see some corrective rally locally. New Treasury supply comes to the market this week with yields now some 20bps higher than last year and some investors may look to tactically add duration. In the medium term, however, it may make sense to lean lighter from a duration perspective and set up for a continued yield curve steepening bias as expectations of a US recovery take hold. Given the potential for corrective shifts, it may make sense to consider conditional structures to express these views.

While a "Democratic sweep" that now gives the party control of the presidency, House and Senate may be perceived to pave a smoother path to major tax or legislative changes, perhaps such policy shifts are not so certain in light of Democrats' narrow majority in the Senate and their widely varied policy views on the topics. However, it may be relatively easier for both wings to agree on fiscal expansion. Thus, in the near term, the direction and magnitude of rate moves are likely to hinge mainly on the prospects and size of fiscal stimulus. Currently, the market expects Democrats to pass further spending totaling around $750 billion; a larger package could then drive 10-year yields towards 1.25%, about 10bps above their current levels.

While rates marching higher and the curve becoming steeper could potentially be disrupted by any unfavorable headlines shifting the tone to risk-off (e.g., COVID-related downturns, tax or regulatory changes viewed as non-supportive for the economy, foreign policy or trade), the perception of nimbler fiscal expansion potential would now be more likely to counteract such headwinds. This is because weaker data or negative events would likely inspire more stimulus.

Inflation breakeven rates (the difference between the U.S. Treasury nominal and inflation-indexed security yields, a proxy for inflation expectations) have been rising over the last few months and this trend will likely continue for now. The Fed's well-publicized new policy strategy is to let inflation run above target before considering tightening monetary policy. Ten-year inflation break-evens ended 2020 just under 2% and are currently pushing towards near 2.10% (Chart).

10-YEAR TIPS BREAK-EVENS

Source: Bloomberg. As of January 10, 2021.

We recently learned in the December FOMC minutes that there was strong support for maintaining the current schedule of Fed buying. There had been speculation that the Fed would look to extend the weighted average maturity (WAM) of purchases, but only a couple committee members indicated they were open to the idea. The Fed also seems to be getting comfortable with the idea of rising rates, as they care about real rates, which are still very low. Thus, a rise of long-term nominal rates driven by solid growth expectations should not worry the Fed as long as they can be also optimistic on inflation expectations. Considering these dynamics, a return to sub 1.00% yields on the 10-year and to a flat-as-a-pancake curve out to 30 years seem unlikely in 2021.

Unlike the long end, the front end should stay anchored near zero through the course of the coming year. Democratic congressional control should increase the size of additional COVID stimulus early in the year and there is potential for a larger spending package to implement President-elect Joe Biden's agenda (infrastructure, green energy and health care expansion) later in the year. The additional spending will increase Treasury Bill supply and provide support for front-end rates. However, the large amount of excess reserves should continue to exert downward pressure on front-end rates. There is still too much cash chasing too few assets. A yield curve steepening is in progress.

**As of September 30, 2020*
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