

# U.S. Rates Weekly

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# U.S. Rates

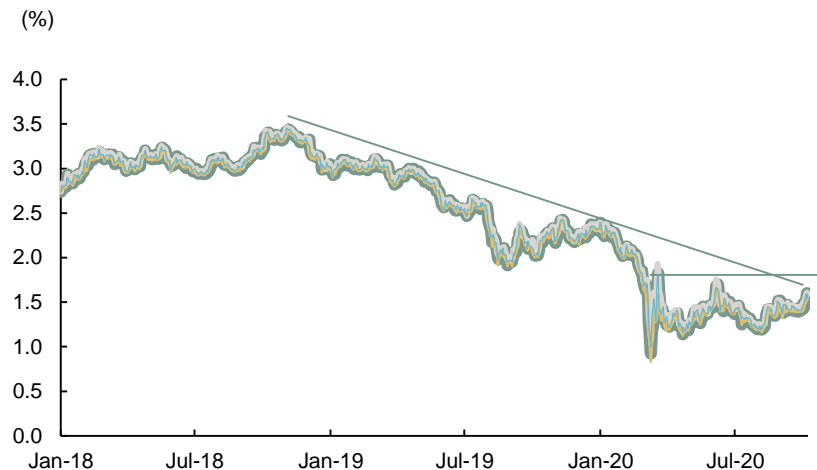
Election scenarios to be the key drivers for markets going forward even as we see risk that the early June high in yields will be tested

**Treasury yields continue their march towards the early June highs:**

30y Treasury yields are near the early June highs, in line with our expectations. There is room to test the 1.75% high from June and break above the downtrend line (*Figure 1*). If the downtrend line is broken convincingly by the end of the month, the technical damage may be large. However, whether we get there or not may depend on how the market adjusts the chances of a blue wave. The Committee for a Responsible Federal Budget (CRFB) estimates similar increases in Federal debt under the agenda of either candidate – US\$5.6Tr and US\$4.95Tr increases in debt in (10 years) for a Biden and Trump agenda, respectively. Yet, expectations remain high for a large increase in debt under a blue wave but less so under President Trump. Markets may be assigning a higher probability of a Republican Senate under a Trump win, which would not allow for large spending increases. We caution that these scenarios are just the beginning; the actual numbers and timing of the policies are only likely to be better estimated when the teams are chosen, and the key players signal the agendas. Yet, markets are likely to react in a knee-jerk fashion, constantly adjusting the probabilities based on the latest information and assessing the outcomes.

**Election scenarios:** We assess what chances of a blue wave may be priced in by the markets, given its importance. Iowa Electronic Markets currently show the odds for a Democratic Congress near 60%. Biden's odds are also near 60%. While joint probabilities are not available, odds of 33% for a blue sweep according to the prediction markets seems reasonable. Markets may be pricing less than that given incorrect signals in the 2016 election. We estimate that a 20%-25% probability of a blue sweep may already be in the price. In *Figure 2*, we estimate the impact on rates from the potential scenarios. One important scenario not in the table is a contested election, which could come in a variety of forms. We would expect a 15-25bp rally in this case, and possibly more depending on tensions or protests. Besides that, the makeup of the Senate may be important, particularly whether it remains under the current leadership or a new one. Besides the elections, the impact from COVID-19 as well as the stimulus deal are likely to remain among the key drivers for rates.

**Figure 1: 30y Treasury**



**Figure 2: Market Impact Under U.S. Election Scenarios**

	Biden Win		Trump Win	
	Democrat	Republican	Republican	Democrat
Senate	Democrat	Republican	Republican	Democrat
House	Democrat	Democrat	Democrat	Democrat
30y Treasury	-15bp to -25bp	+20bp to +40bp	+10bp to +15bp	No trade war +10 to +15bp
Curve	Flatter	Steeper	Steeper	No trade war Steeper
EURUSD	+2% to +3%	+3% to +5%	+2% to +3%	No trade war -2% to -3%

Source: Bloomberg, Iowa Electronic Markets, Predictit.org;

# U.S. Derivatives

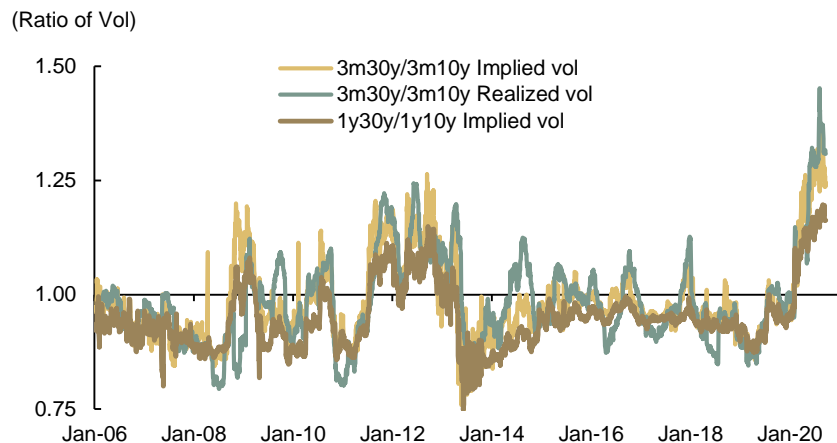
Elevated vols on 30y vs. 10y tails are following higher realized vol and may be here to stay for some time

**Vol remains under pressure but some support for 5y tails:** Implied vol for 1y-3y options on 10y and 30y tails continued to fall in October. This is likely a result of decent callable issuance (where investors sell vol to pick up yield) as well as low realized vol despite the breakout in the range. Vol selling via a variety of structures has been seen in the futures space and strangle selling has shown up in SDR data. 1m realized vol for 10y and 30y swaps stands at a meager 2.6 and 3.2bp/day, respectively. This compares to August-end numbers at 2.9 and 3.8bp/day for 10y and 30y swaps and early June numbers at 3.8 and 4.6bp/day. Early June and August-end were both periods when rates were at local highs. With elections in less than two weeks, perhaps markets may be fading the probability of a blue wave or expecting a dispute that would bring rates back in the range. Interestingly, 1y5y options have seen a small move higher, with the Eurodollar futures contracts pricing the first full hikes by the end of 2023.

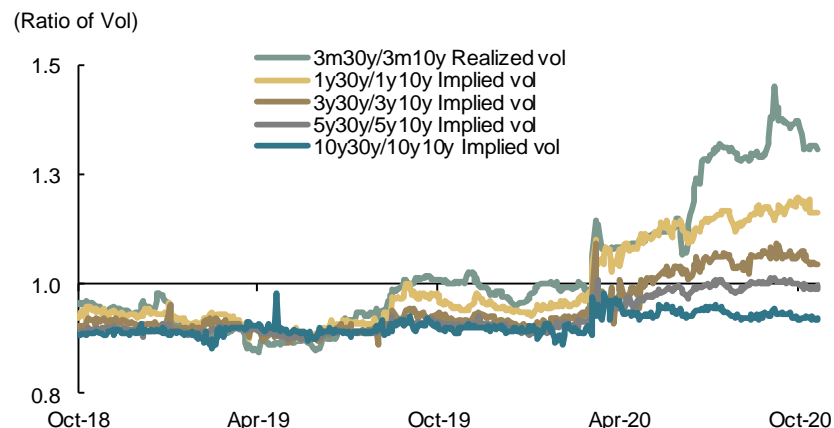
**Elevated vol on 30y vs. 10y tails are following realized vol:** Implied vol for 30y tails have remained elevated relative to that for 10y tails in the post COVID-19 environment. *Figure 3* shows that this jump since March has followed the realized vol ratio (green). Similar jumps were seen in select periods in 2009, 2010, 2011 and 2012. Even at that time, implied vol ratios largely followed the realized vol ratios. The impact of realized vol on gamma (short-dated options) is obvious, but *Figure 4* shows the pull effect of gamma on longer options too. Obviously, the longer the option maturity the lower the impact from this pull.

**Drivers of this regime:** Realized vol for 10y tails have been muted for a variety of reasons. The Fed on hold for a long time and not in a hurry to hike thereafter anchors the 5y. To this if we add lower real neutral rates, it reduces the scope for larger moves in the 10y. Further, markets may be weary that the Fed can embark on yield curve control (YCC). While the Fed has made its preference of not yet going for YCC, it has kept the idea alive. BOJ's targeting of the 10y and not the 30y is something that the markets may be keeping in mind. The impact of the 10y on mortgage rates is also something that favors YCC up to 10y. Lastly, lower convexity hedging needs because of Fed purchases and the above factors also support lower realized vol in the 10y.

**Figure 3: Ratio of Realized and Implied Vol – 30y vs. 10y Tails**



**Figure 4: Ratio of Realized and Implied Vol – 30y vs. 10y Tails**



# Cross-Currency Basis

## 10y30y EURUSD basis curve that is at multi-year lows could see some interesting moves post-U.S. elections

**Front-end basis remains under pressure:** Front-end basis (3m to 1y) in USDJPY, EURUSD and GBPUSD tightened in the last week as we go into the year-end. 3m USDJPY basis has remained choppy in the past few weeks after having tightened by 20bp in September-end for the turn. Downward pressure from the 3m but upward pressure from the rest of the curve kept the 1y in a tight -20.5 to -22.5bp range in October.

**Mixed performance in long-end basis:** USDJPY long-end basis was higher by 2-25bp while EURUSD basis lower by 1-2bp in the week. The trend higher in the 2y-30y USDJPY basis seems intact with strong interest in JGBs on an asset swap basis from international investors. Going into the U.S. election, we expect to see some unwinds of these longs as investors reduce risk. Separately, longer-dated EUR basis was tighter with liability-related swapping from Bank of America and Morgan Stanley's 11NC10 and 9NC8 bonds.

**Cross-gamma hedging and the 10y30y basis curve at multi-year lows:** Figure 5 shows that while the 5y and the 10y EURUSD basis has been pulled higher with abundant dollar liquidity, the 30y basis has recently been flatlined. This is mainly because any downward flow pressure is getting absorbed in the long end, which flattens the curve. The EUR strength and the EUR rates selloff this summer created delta hedging needs in the XVA/CVA books of banks, which requires them to receive the longer-dated basis (20y-30y). This has led to the flattening of the 10y30y basis curve (Figure 6). As we go into the U.S. elections, any large moves in EURUSD and G10 rates is likely to have an interesting impact on the long end EURUSD basis curve.

Figure 5: 5y, 10y and 30y EURUSD Basis

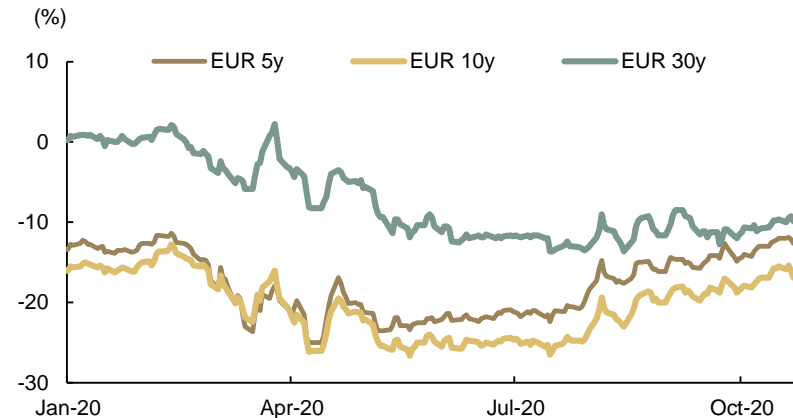
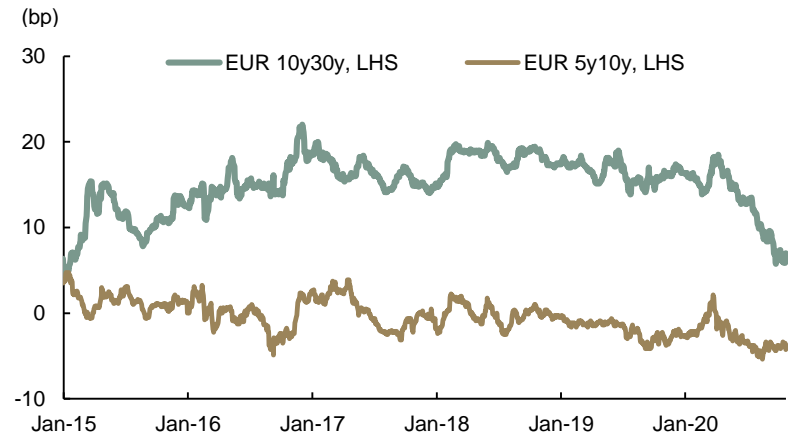


Figure 6: 10y30y and 5y10y EURUSD Basis Curve



# Key Metrics and Week Ahead Preview

## Key Metrics Review

		Fri 11 am	Prev Fri Close	WoW Δ	YTD Δ	52 Wk High	52 Wk Low
Equities	DOW	28,606	28,587	0.07%	-0.14%	29,569	18,214
	S&P	3,484	3,477	0.19%	7.52%	3,588	2,192
	NASDAQ	11,672	11,580	0.79%	29.59%	12,074	6,631
Treasuries	2Y	0.14%	0.15%	-1.0 bps	-144 bps	1.71%	0.10%
	5Y	0.32%	0.34%	-1.6 bps	-136 bps	1.78%	0.19%
	10Y	0.75%	0.77%	-2.8 bps	-113 bps	1.97%	0.31%
	30Y	1.53%	1.57%	-4.3 bps	-79 bps	2.44%	0.70%
Swaps	2Y	0.23%	0.24%	-1.0 bps	-146 bps	1.75%	0.16%
	5Y	0.40%	0.41%	-1.3 bps	-129 bps	1.77%	0.00%
	10Y	0.78%	0.81%	-2.8 bps	-106 bps	1.93%	0.42%
	30Y	1.18%	1.23%	-4.8 bps	-85 bps	2.12%	0.40%
LIBOR	1m	0.15%	0.15%	0.6 bps	-165 bps	1.82%	0.14%
	3m	0.21%	0.22%	-0.6 bps	-173 bps	1.96%	0.21%
FX	EUR/USD	1.1718	1.1826	-0.0108	0.0541	1.2011	1.0636
	GBP/USD	1.2915	1.3036	-0.0121	-0.0163	1.3514	1.1412
	USD/JPY	105.40	105.62	-0.2200	-4.0400	112.23	101.19
5Y Basis	EUR/USD	-12.00	-13.00	1.0000	1.3750	-11.25	-25.75
	USD/CAD	-20.50	-20.75	0.2500	-9.7500	-8.00	-28.50
	USD/JPY	-40.63	-40.50	-0.1250	-2.1250	-38.00	-80.13

## The Week Ahead Preview

Date and Time	Economic Indicators	Period	Consensus	Previous
10/27/2020 08:30	Cap Goods Orders Nondef Ex Air	Sep P	0.60%	1.90%
10/27/2020 08:30	Cap Goods Ship Nondef Ex Air	Sep P	--	1.50%
10/29/2020 08:30	Initial Jobless Claims	Oct 24	788k	787k
10/29/2020 08:30	Continuing Claims	Oct 17	--	8373k
10/29/2020 08:30	GDP Annualized QoQ	3Q A	31.9%	-31.4%
10/30/2020 08:30	Real Personal Spending	Sep	0.70%	0.70%
10/30/2020 08:30	PCE Deflator MoM	Sep	0.20%	0.30%
10/30/2020 08:30	PCE Deflator YoY	Sep	1.50%	1.40%
10/30/2020 08:30	PCE Core Deflator MoM	Sep	0.20%	0.30%
10/30/2020 08:30	Employment Cost Index	3Q	0.60%	0.50%
10/30/2020 08:30	PCE Core Deflator YoY	Sep	1.70%	1.60%
Date and Time	Policy Events			
10/28/2020 18:00	Fed's Kaplan Moderates a Panel Discussion with Mark Carney			
Date and Time	Government Auctions			
10/27/2020 13:00	U.S. To Sell 2-Year Notes			
10/28/2020 13:00	U.S. To Sell 2-Year FRN			
10/28/2020 13:00	U.S. To Sell 5-Year Notes			
10/29/2020 13:00	U.S. To Sell 7-Year Notes			

Source: Bloomberg