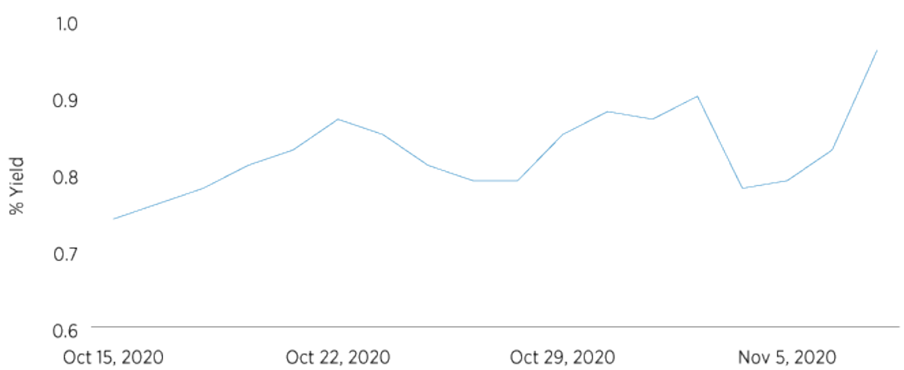
Election and vaccine news raise growth prospects and whipsaw Treasury market

By: Eric Stein, CFA | November 16, 2020

Boston - Just one week after election results that pointed to the likelihood of divided government, the news of major progress on a COVID-19 vaccine has become the dominant theme driving the markets. That sequence of events prompted a remarkable turnabout for US Treasury yields.

Prior to the election, markets had been anticipating a "blue wave" that would capture the White House and Senate — a scenario that entailed more stimulus from Washington, and corresponding upward pressure on Treasury yields. But on November 4, when divided government became the most likely outcome, yields on the 10-year US Treasury moved 14 basis points lower, as the potential for a very large fiscal stimulus was greatly reduced.

Treasury yields fell then rose as vaccine news followed the election



Source: Federal Reserve Bank of St. Louis, as of November 9, 2020. Yields are represented by the daily 10-Year US Treasury constant maturity rate.

Then last Monday's vaccine announcement prompted yet another pivot by the market, especially since the 90%-effective description qualified as a major surprise. Suddenly, the market could envision a more "normal" economy, and we have seen a generally broad "risk on" reaction. The 10-year US Treasury yield soared to just under 1% — a mark it hadn't reached since last June — EM currencies gained and credit spreads tightened. Equities were broadly higher, led by financials and cyclicals.

Of course, this raises questions about the direction of US Federal Reserve policy. The central bank has implied that it would need to see inflation consistently above 2% before lifting rates. This goal was never achieved during the last economic cycle, despite a decade of very easy monetary policy, an unemployment rate that reached 50-year lows and large, deficit-financed tax cuts from the Trump administration. The pre-election anticipated stimulus held out the hope that economic growth would augment or supplant more monetary easing by the Fed.

Yet in the span of just one week, as we have seen, the air went out of that balloon, only to have it pumped back in again. My feeling is that if the promise of the vaccine continues to pan out in terms of efficacy, distribution and acceptance, yields could continue to rise. The Fed is OK with rates going up as long as that is primarily driven by higher inflation expectations and not an increase in real rates. They can rise a little if the cyclical outlook improves with a vaccine, etc., but if real rates go up enough to choke off a nascent recovery, the Fed would likely respond.

Bottom line: We will be watching developments on the vaccine front, as well as economic data — signs of strength continue, like this month's relatively strong payroll numbers. At the same time, the current COVID-19 case growth is concerning, with levels comparable to last spring. However, it is likely that investors will look past the negative headlines if progress on the vaccine continues.

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