

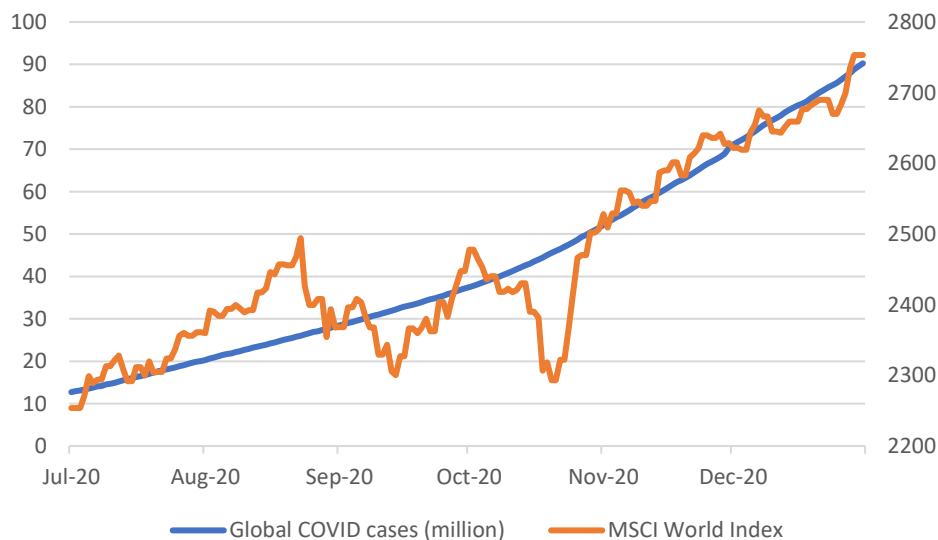
11<sup>th</sup> January 2021

## Silver Linings Even in Adversity

- Even trouble in Congress can't stop the bull run in asset prices.
- Biden's majority in both houses opens the prospect of further significant fiscal support.
- Eurozone policy makers have yet to respond to the aggravated COVID crisis.
- US inflation-linked bonds discount a lot of inflation, but we don't believe the Fed agrees.
- Good news on the Indian economic recovery bodes well for the asset markets

**Despite a sharp acceleration of COVID cases worldwide and fighting on Capitol Hill, nothing has restrained the continuing bullish tone in asset markets.** Economists who had only recently been increasing their forecast for fourth-quarter global GDP growth are now cutting back their forecasts for the first half of 2021. However, the markets look likely to continue to look through the near-term challenges and see the rosy picture in the balance of the year. The markets price a view that the vaccine's rollout will suppress the spread of the virus by the middle of this year. From there on in we can enjoy a significant boost to growth from the flow-through of pent-up consumer demand and still accommodative policies from central banks and governments.

**Chart 1: Equities positively correlated with COVID19 cases**



Source: Bloomberg

**As the past week has shown, the legacy of the Trump presidency will be a difficult challenge for the incoming administration.** However, financial markets shrugged off the events on Capitol Hill and focused instead on the positive implications of the run-off results in Georgia. The Democrat wins gave President-elect Biden control of both the Senate and Congress. The market anticipates a further \$1 trillion package early in the new Presidency to make good the damage to the economy wreaked by a further wave of trouble from COVID19. That being said, the damage is much slighter than was seen in the second quarter of 2020. Around the world, the consumer has found ways of maintaining their spending even with the lockdowns and government support programmes have limited the negative impact on employment.

While the US is responding to crisis in a number of ways, the eurozone is not showing any sign of an extraordinary policy response. There is little sign of further fiscal stimulus, and the ECB shows little appetite to surprise the market and ease further. The only potential change in Europe (and not the EU) that the Bank of England may cut in interest rates. Even an elegant exit from the EU will likely cause difficulties for trade flows, and the lockdown at hand is quite severe.

**The main attraction of European assets may be that they have lagged the broader market recovery and appear to offer value on this basis.** However, the economic numbers are still something of a mixed bag, with enough there to make arguments for upside or downside from current levels. For example, the final PMI numbers were revised downwards by 0.7 points. The overall picture is still one of a rebound in December, but with potential weakness, especially ex-Germany. The overall level of the PMI index is now at 49.1. The area of deepest concern would still be retail sales which dropped 6.1% in November. On balance, the outlook for Europe is still on the fragile side, with the severity of the new outbreak a concern.

### **Does the reflation trade have legs?**

Equity markets have started 2021 in a positive mood, but the bond market has been selling off. US 10-year Treasury, yields have risen quickly to 1.11% at last Friday's close. This is its highest level over the past quarter, and up 34 basis points from the low of 0.72% in Q420. The bond market has a different view of the path of inflation compared to most economists, who tend to view higher inflation as a low risk for 2021 and beyond.

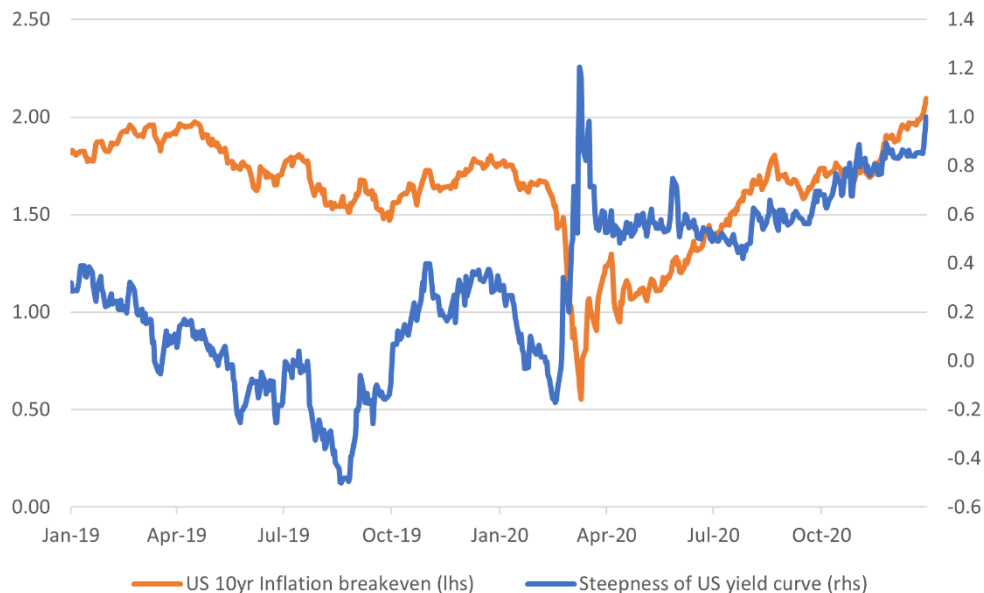
A persistent move higher in government bond yields threatens to up-end the policy objective of the Fed's highly accommodative policy stance in the first place. If rates move up fast, the effect on the economy is negative, offsetting the accommodative stance implied by quantitative easing.

In chart 1, the recent moves show that the slow drift higher in yields that started in July spiked suddenly at the start of 2021. We show the steepness of the yield curve slope, measured in basis points. With the long end selling off and moving higher, the curve has steepened to 105 basis points (10Y versus the 3-month rate) because the short end is anchored.

Simultaneously, one measure of the market's view of inflation expectations, the breakeven rate in the TIPS market, has also been on the rise. By the close last week, it had reached

2.1%. This is the highest level in the previous two years. The Fed has an informal target of 2% for US inflation, but it changed the game last year by going instead for a 2% average rate over an unstated period, presumably some years at least. The current US CPI level is running at 1.2% on an annualised basis, as at the end of November.

**Chart 2: US TIPS price a lot of Inflation**



Source: Bloomberg

The big gap between actual and anticipated inflation (as priced by the TIPS) is a conundrum for the policymakers. By pricing in a much higher inflation outcome, the market is, in effect, challenging the Fed to have another look at its policy settings. The whole point of lower rates for much longer is to provide continued support for a perceived weak economy. The large QE program of buying long-dated bonds is of the same ilk: keep lending rates low across the curve and provide easy credit for firms and consumers.

With the fiscal side of policy swinging into a fully-active mode in response to the pandemic, the Fed probably has little choice now but to play a waiting game. If it extends the QE program even more with the view to suppressing, once more, the long end of the curve, it may be counterproductive. If the view has taken hold in the market that inflation is indeed a risk, the extra stimulus will scarcely sway the argument the other way. Leaving things alone does run the risk of seeing rates rise anyhow, causing a danger to the recovery. The wait-and-see approach will have to rely on the forces of disinflation to hold sway for a long time to come. These would be, among others, the weakness in the labour market, no real sign of capacity constraints in the industrial sector, and the continued long-term drag of demographics and technological advances lowering prices of goods and services.

### **India better than feared**

**India is seeing a sharper than expected economic recovery. Better growth, lower inflation and further accommodation from the central bank are a cocktail that should support Indian assets.**

Several factors are combining to create this effect. Government spending has risen, and the economy is simply recovering faster from the initial pandemic shock than initially

feared. Activity indicators suggest that overall economic activity in October and November was running at about 95% of the pre-COVID run-rate. It is to be expected that the pace of further recovery will moderate to some extent, but the government's forecast of -7.7% growth for 2021 looks too pessimistic, nonetheless. A smaller contraction is on the cards.

Furthermore, a sharp decline in inflation was recorded in December, from 6.9% YoY to 4.9%. The decline was driven almost entirely by a drop in vegetable prices, which decline from very elevated levels. This will leave the Central Bank in a position to be less concerned about accommodative policy if required in the near future. In the past, it has signalled its concern about inflation when setting monetary policy.

### Chart 3: Indian equities perform broadly in line with global EM

*SENSEX index relative to MSCI EM equity index*



Source: Bloomberg, MSCI

The Indian equity market has performed largely in line with EM equity index over the past year but has been weak of late. From an international investor's perspective there's potentially some room for modest outperformance particularly given the recent stabilisation of the INR.

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