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The Fed is now behind the curve – US equity markets applause

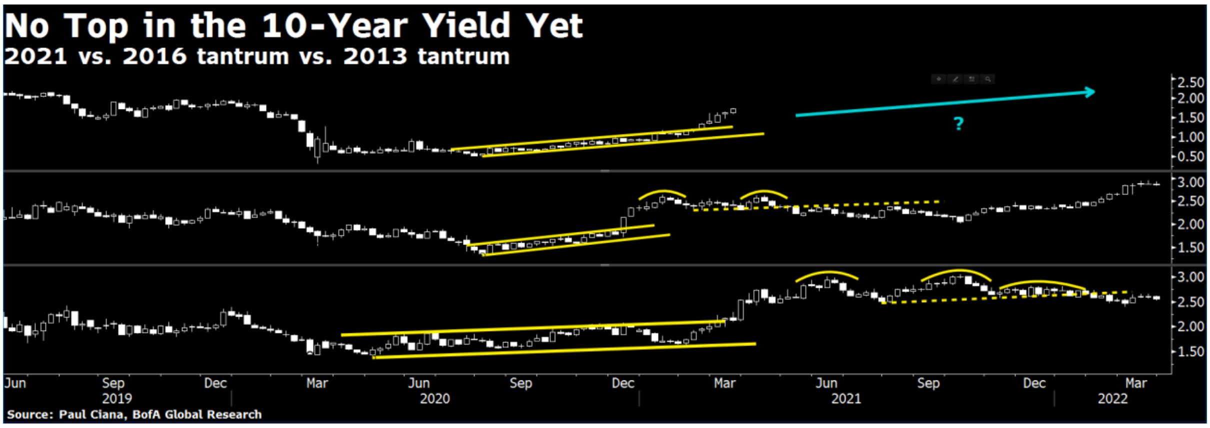
The Fed is walking on thin ice, but yesterday delivered an even more dovish statement than anticipated. They stated that Inflation might be a temporary phenomenon in 2021 but that is not a worrisome sign. Why is it so? Once the US economy opens, we will see a huge pickup in demand from the consumer. But if the US employment market recovers in a similar way like Australian just did after they have lifted all COVID-19 restrictions, we might be soon back to pre-crisis levels in terms of unemployment rates and there might be a lack of qualified workers. Nobody has this in their forecasts. As UBS chief economists Paul Donovan puts it:

While investors should not extrapolate from a single economy (i.e., Australia), *this is a reminder that the pandemic is not a conventional recession-recovery cycle. Renewal in 2021 could be faster than many expect."*

In such a case there might be wage pressure ahead of us. But the Fed clearly stated that they will react in real time to economic data. Knowing that data are lagging they deliberately have chosen to get behind the curve. This is dangerous for the mid-term outlook of inflation. An overheating of the US economy gets more likely. The recent two US stimulus packages have reached around 25% of US GDP and this will not only boost the US economy but will also impact the global economy by around 1.5%

The market reacted immediately during the Fed press conference. While the treasury yields have risen all US equity indices have rallied.

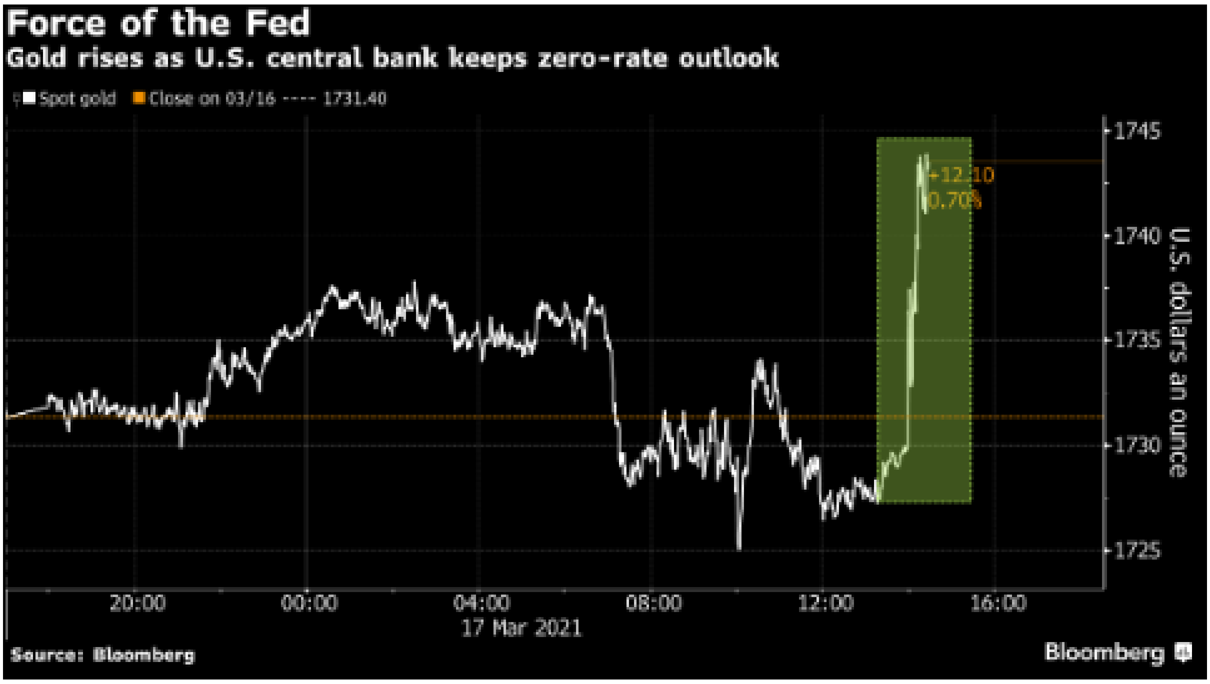
Fig. 1: The 10-year US treasury yield might rise further.



Gold has risen too; we would reckon that this is due to the expected pickup in inflation and due to technical buy signals. A gold manager whom we follow expects that the consolidation is over, and gold should reach this year USD 2'250, around 30% higher than where we currently trade.

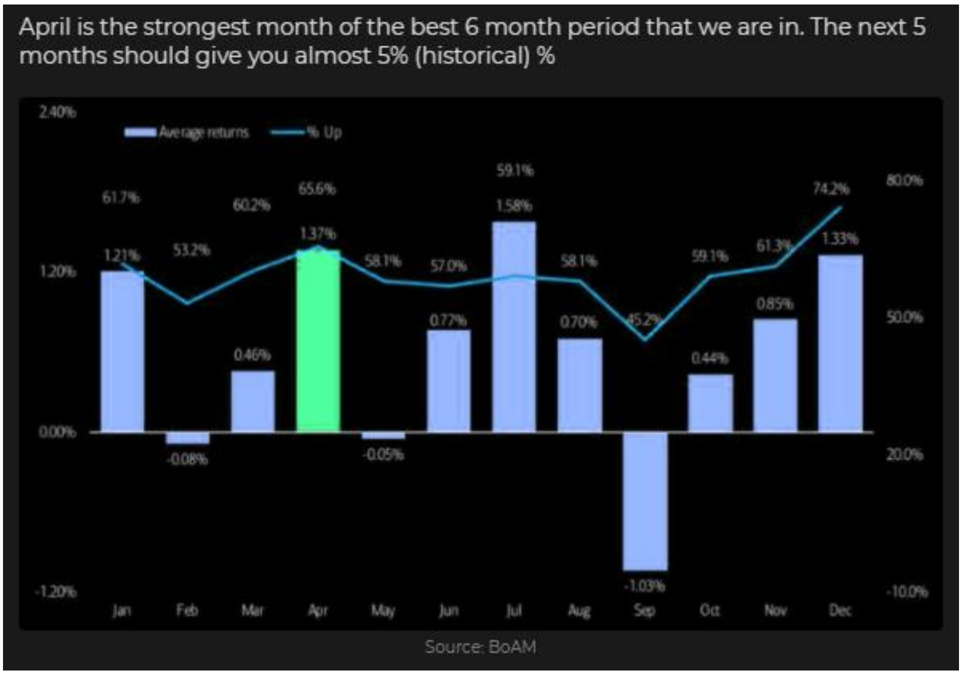
Fig. 2: S&P 500 trades at record levels

Fig. 4: Gold might restart climbing up due to inflation fears



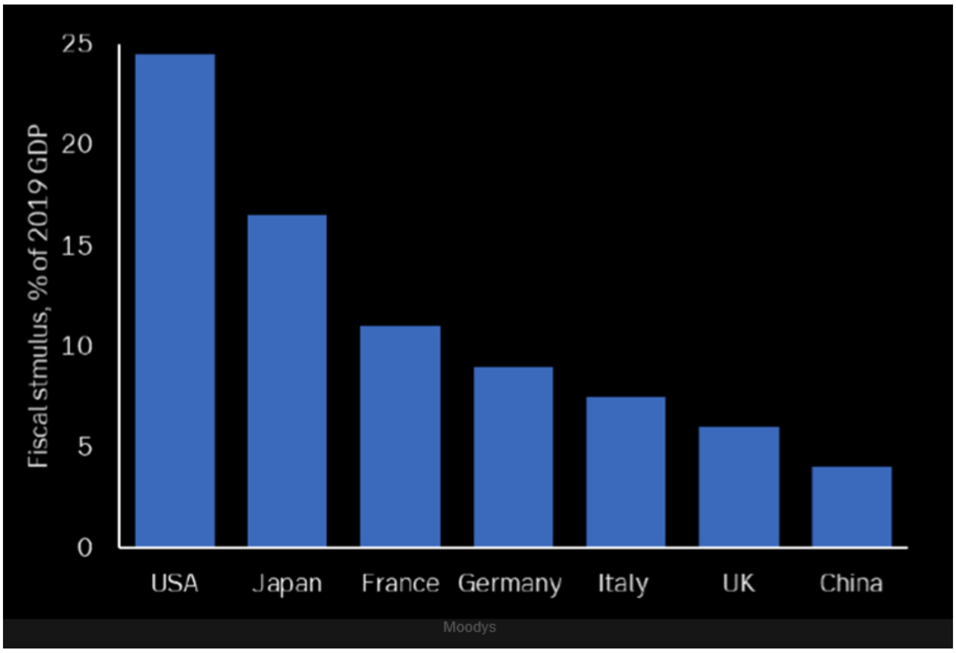
Seasonality speaks for a further rise of US and global equites in April. But also, there exists the expected pick up in earnings and the likelihood that bottom-up analysts are still underestimating the positive impact of the reopening of the economy.

Fig. 5: Seasonality speaks for April: BoAM expects higher equity markets



We would add that due to the combination of global fiscal stimulus its impact on global EPS might boost equity markets even higher.

Fig. 5: Fiscal stimulus above 24% in the US



Due to this fiscal and monetary stimulus the risk for an overheating of the economy has significantly risen.

This is mirrored in rising government bond yields and a shrinking amount of negative yielding global debt.

Fig. 6: Global negative yield debt has decreased since the beginning of 2021

But most western economies cannot finance their debt burden if government yields rise much further. Therefore, the ECB has announced to influence the yield levels by their pandemic bond buying program. Japan already controls its yield curve. And the Fed? Officially they only stated that their bond buying program will last until inflation is above 2% and full employment is reached. However, we would not be surprised to find with hindsight that also the Fed has tried to lower treasury yields via its bond purchases.

What it all means is that equity and probably gold prices will go higher. Government bonds and IG corporates will continue to deliver low or even negative returns. Corporate non-investment grade bonds should not see any significant spread widening as the economy improves, but they might adjust their price levels (i.e., higher yields) in comparison to IG bonds.

We must add that risks are getting bigger not only on the economic side but also on the geopolitical agenda. China and Russia are the new targets of the USA and this might cause more market volatility down the road.

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