It may have to hurt

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Key points

- The Senate passed the fiscal stimulus bill with little concession from Biden. This is likely to lift US long-term rates further, while the Fed remains silent on that front. It would probably take some turmoil on the equity and credit markets to shift the Fed. Conversely, we expect the European Central Bank (ECB) to stand against contagion from the US, with an explicit acceleration in the pace of Pandemic Emergency Purchase Programme (PEPP) to be announced on Thursday, while refraining from triggering the "nuclear options" (raising the PEPP's envelope or cutting the depo rate again).

Joe Biden managed to get his emergency stimulus plan through the Senate with minimal concessions on the substance of the fiscal measures. While the Democrats had to accept the removal of the minimum wage hike from the bill, the overall quantum of government spending and tax relief is landing very close to their opening gambit. Assuming – as is very likely – the House endorses the Senate version of the bill on Tuesday, the whole process has been swift. The fiscal push will magnify what is shaping up to be a spectacular post-lockdown recovery anyway, given the good progress on the pandemic front in the US. It may not have much impact beyond the end of this year and dealing with "scarring" would be better done via an investment plan for the long-haul which may have become a tough sell. Indeed, the ongoing rebound in market interest rates is making it more difficult to argue the big infrastructure programme would "pay for itself".

The Fed still does not want to stand in the way of the bond market re-pricing. We suspect many Fed officials believe in a "hump shape" recovery. Once the impact of the fiscal push fades, the economy would start to slow down as 2022 would get in sight, reducing the risk of a lasting surge in inflation. If this scenario turns out right, then the bond market is "wrong" and the ongoing tightening in financial conditions is merely a "bad moment" which will stop spontaneously. It would thus make little sense for the Fed to waste a policy bullet with an operation twist now. The risk is that, left to its own device, the market goes "too far, too quickly", resulting in an excessive tightening in financial conditions which would smother the recovery after the short stimulus-induced overheating episode. Still, there probably is no "free option": it's unlikely that the market can get Fed action – in the form of operation Twist – without first some turmoil on risky assets. In the meantime, if risky markets continue to focus on the improving macro outlook, US long-term rates will continue to rise.

On the other side of the Atlantic, the ECB press conference will focus on how to avoid contagion from the US. We expect the central bank to refrain from using the "nuclear options" (raising the PEPP quantum, cutting the depo rate further), choosing instead to be more explicit in the prepared statement about the need to accelerate PEPP purchases in the current circumstances. The verbal pledge is likely to be strengthened by the publication of data later today reporting, after last week's negative surprise, an actual rise in the buying pace.

The deed is (nearly) done

Biden's fiscal stimulus has just made a decisive step towards implementation by passing the Senate hurdle this weekend and the US administration did not have to offer significant concessions on the purely budgetary aspects. We already knew that the minimum wage hike to USD15 per hour was dead in the water anyway after the Senate ruled that it could not be tagged onto the reconciliation process and moderate Democrats sided with the Republicans to torpedo a last-minute attempt by Bernie Sanders to find a backward door to put it back on the table. On the substance of the fiscal push, Biden got almost everything he wanted with two minor tweaks. **The stimulus is thus likely to come out towards the very top range of expectations, very close to Biden's opening gambit. This is consistent with the US economy closing its output gap this year already.**

Joe Manchin, the most moderate Democrat, brought the federal top-up to the states' unemployment benefits to USD 300 per week down from the initial proposal at USD 400. He was concerned a too generous allowance would deter too many people to take back a job post-pandemic. He has a point. The initial proposal would have brought total unemployment benefits (states+federal) to USD723 per week, i.e., 86% of previous wages on average, but since benefits vary widely across state lines a significant proportion of laid-off workers would still have received more on benefits than while being employed. Manchin's solution cuts the replacement rate to 74%, reducing the potential for these "unemployment traps".

At USD 300 per week the overall cost should fall by USD50bn relative to the initial projection, but some of it is offset by a prolongation of the measure by a month with a final payment in early October 2021. Manchin also secured tougher means-testing on the USD1,400 one off transfers to individuals. However, the Senate version of the bill went further than the House's on some items, such as extending health insurance coverage for laid-off workers (paying 100% of the premia until September instead of 85%). The package for the states and municipalities was passed in its integrity. **When taking everything on board, the final price tag will be very close to USD1,900 bn.** The House is scheduled to vote on the Senate version this Tuesday. Although some left-wing Democrats are making noises – they were pushing hard on the minimum wage - it is very unlikely they will torpedo the bill: it is highly popular across the political spectrum according to all polls, and they would be blamed for stalling Biden's momentum at a very early stage of his presidency.

A key issue now is whether this short-term stimulus will be further enhanced by an investment package. In principle the US administration can use the reconciliation process only once a year. Reaching out to the opposition is thus a pre-condition for speedy implementation, but bipartisanship completely failed on the short-term stimulus (not one Republican Senator supported it) and the Republican caucus is unlikely to be ready to offer Biden yet another political victory. Moreover, given the focus on energy transition in Biden's infrastructure plan – a much more divisive issue in the US than in Europe - reaching consensus will be difficult (including within the Democrats' own ranks).

One of the key arguments in favour of the infrastructure splurge could disappear as the window of opportunity for very cheap long-term funding is closing. On these issues, the very long end of the yield curve is the variable of interest, and 30-year yield have increased by 62 basis points since Biden's election. At 2.28% last Friday they remain low of course, but it is getting less straightforward to argue an infrastructure plan will easily "pay for itself". **Summers' concerns may well be vindicated.** The bill endorsed by the Senate over the weekend is going to magnify what is shaping up to be a spectacular post-lockdown recovery anyway, with possibly little impact beyond the end of this year, while dealing with "scarring" would be better done via an investment plan for the long-haul which may be a victim of the market reaction to the short-term stimulus.

No free option with the Fed

The ball is back in the Fed's camp. Last week market action made it obvious that the 1.50% threshold for US 10-year yield – long the central projection of most sell-side strategists – had not been broken by accident. With the weekend news on the stimulus, the expected balance of demand and supply on the US bond market is being even more tilted towards higher interest rates, while the probability of an overheating phase has risen again. The market is likely to further "test" the Fed, i.e., find the point beyond which monetary policy will be tweaked again to preserve favourable financial conditions. **There is no easy option for the Fed though, and on balance we think yields will continue to rise at least until some conclusion can begin to be drawn on the lasting effect of Biden's stimulus on the economy, which would be consistent with a very choppy spring and summer**.

Powell's statements at the Wall Street Journal Webinar last week were honest, in the sense that he was in our view right to acknowledge there is a higher probability of an inflation spike, balanced by his reiteration of the Fed's patience, but **at this stage anyway not much can soothe the market short of the announcement of an "operation twist"** which would cap the long end of the curve. It may become increasingly difficult for the Fed to make such decision – in effect add another layer of accommodation - given the robust dataflow. **Job creation improved much more than expected in February**, even though the employment rate – jobs divided by working-age population, probably the most comprehensive measure of slack on the labour market – failed to improve.

Our impression is that at this stage most of the FOMC members expect a "hump shape" recovery. The combination of post-vaccination reopening and fiscal push may bring about a spectacular rebound as early as Q2 and almost certainly in Q3, possibly briefly magnifying the base effects to trigger a transitory acceleration in inflation. Once the impact of the fiscal push fades, the economy would start to slow down as 2022 would get in sight. Moreover, the absence of any massive hike to the minimum wage has probably reassured the Fed on the probability of a sustained endogenous inflationary shock via the labour market. **If this scenario turns out right, then the market is "wrong" and the ongoing tightening in financial conditions is merely a "bad moment" which will stop spontaneously**. It would thus make little sense for the Fed to waste a policy bullet with an operation twist during this phase, beyond the communication headache of selling to public opinion another layer of monetary accommodation while signs of overheating will multiply.

The risk of course is that the market, left to its own device, goes "too far, too quickly" and the US economy ends up facing the kind of tightening of financial conditions – including an appreciation in the dollar exchange rate - which would make the post stimulus slowdown too pronounced, especially if by then no big investment plan is coming to take the baton.

From a "fundamental" point of view, we do not think there is any emergency though for the Fed to act. Yes, real yields have increased significantly these last few weeks, but they remain negative and much more so than during most of the last episode of recovery from the nasty recession of 2008/2009. Indeed, real interest rates did not fall as low as where they are today before 2013, 5 years after the beginning of the crisis (see Exhibit 1). Central banks have a long memory, and many FOMC members probably think that what they have offered in this crisis has been massive and that the market may now be a bit "greedy", especially if a spontaneous rebound is within sight (and is even well advanced, when looking at the level of the current cyclical indicators).

Exhibit 1 – Real yields have been more reactive than during the GFC

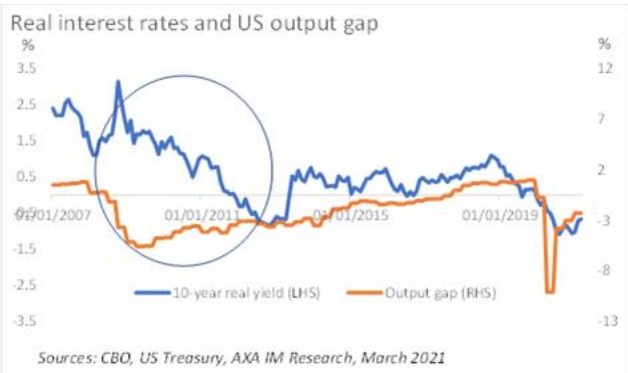


Exhibit 2 – US households have never been more sensitive to the equity market

What happened on Friday post payroll would bring some comfort to the Fed, with the S&P500 gaining 1.9%, suggesting investors may be more focused on the positive signal on future earnings of an improved labour market than on the further surge in long-term interest rates. In a similar vein, the reaction of the US markets this week to the announcement of a near-complete "Biden push" will be crucial. If investors choose to focus on the additional boost to expected earnings (at least in the short run) more than on what all this entails for the US fiscal trajectory, then the Fed will be even less prone to stand in the way of a further rise in long-term interest rates.

If however the equity market starts struggling, the Fed could be forced to change tack quite quickly. Your humble servant had a first stint at professionally "watching the Fed" in the aftermaths of the dot com bubble of the late 1990s/early 2000s. At the time, the behaviour of the equity market often featured prominently in the US monetary policy debate through two channels. One was the "cost of capital issue" – the idea that interest rates had to fall by more than usual because the post-bubble contraction in equity prices impaired corporate investment. The other was the more traditional "wealth effects", with losses on the equity market restraining households' consumption appetite. With the financial position of the business sector coming out of the pandemic quite deteriorated, there might be a case to look at the "cost of capital" channel again. On wealth effects, we suspect much of it would be drowned in the gyrations in the savings rate anyway, but politically it may well be that the Fed would be under pressure to act. Indeed**, household holdings of equity have reached an all-time record when measured against their income** (see Exhibit 2), slightly above levels seen at the time of the dot com bubble.

This reflects of course the rebound in equity prices on existing portfolios, but also significant acquisitions of equity by individuals. According to the Fed's Flow of Funds data, Americans invested USD908bn annualized in equity – the highest level since 2009 – In Q3 2020 (last available data point) after an already respectable USD 334bn in Q2. Note that over the last 20 years, flows have on average been negative (American families have sold more shares than they have bought - the rise in holdings value is purely a function of the rise in prices). The low level of interest rates probably explains some of this renewed interest in equity investing, but ease of access with the development of cheap, passive options has probably magnified the effect. In any case, there is a significant number of Americans who have joined the equity market recently while valuations were already high, which could magnify the impact of an equity market correction on consumer confidence. Another potential headache for the Fed is that the current crisis is the first one in which they have to take into consideration the massive rise in passive investment, with the risk that even a small price readjustment triggers significant drawdown through "automatic amplification".

For now, the market is likely to continue its "discovery process". Hopefully, investors in risky assets will bet on the US economy settling at a growth rate close to potential after closing the output gap post-stimulus, allowing a very gradual normalization in inflation and the Fed's "patience" to materialize. Still, for the immediate future, and with the silence of the Fed, long-term interest rates will probably continue to rise. There probably is no "free option" at this juncture: it's unlikely that the bond market can get Fed action – in the form of operation Twist – without some turmoil on risky assets.

Panetta set the bar high for Lagarde this week

Meanwhile, the list of ECB Governing Council members taking a strong view against allowing contagion from the US to the European bond market got longer in the days ahead of the next ECB policy meeting. Among board members, Fabio Panetta took the strongest stance in a speech last Tuesday. He does not take to the wires very often, but his opinions matter. We remember that he was the first one at the ECB to elaborate explicitly on the necessity for central banks to support fiscal policy in the current configuration – a line of argumentation which is now consensus at the board.

The most immediately market-relevant point in his speech, in our view, is the following: "*In December, when we recalibrated the PEPP, the Governing Council determined that the financing conditions prevailing at that time were favourable. So, that constellation of financing conditions should be seen as the reference point for our policy moving forward".* In short, Panetta doesn't think the ECB should implicitly endorse the curve steepening observed since then. Since the ECB's policy announcements on December 10, 10-year Bund yields have risen by 30 bps. **If we take Fabio Panetta's point literally, then the ECB would have to increase its purchases until yields fall back to their initial level.**

It's unlikely Panetta's view is fully shared across the Governing Council. First, the ECB's insistence on a "holistic" and "multi-faceted" definition of the "favourable financing conditions" they intend to preserve suggests that they don't want to be trapped into a too precise range. We have already discussed here why we think that the ECB, unlike the Bank of Japan, cannot go into full "yield curve control", since such approach entails the removal of any limit to the purchasing capacity of the central bank. Second, we suspect many Council members think that these financing conditions should be a "moving target", dependent on whether the economy's path is complying with their outlook. Setting December 2020 as an unmovable anchor would then be problematic.

Still, the December reference matters, because this is the latest "point of definition" of the monetary stance, based on a certain outlook for inflation and growth. Inflation in early 2021 has been stronger than the ECB expected in December, but developments in the real economy have been disappointing in the Euro area. True, GDP has been much less negative than they expected in Q4 2020 with some positive effect on the carry-over for 2021, but the central bank's +0.6% for Q1 GDP now looks very ambitious given the deterioration on the pandemic front in many member states (we are expecting a decline of 0.7%). Accordingly, the expect the ECB to revise up its inflation forecast for 2021, but we see little reason for them to expect a better macro outlook than in December which would force them to revise up their inflation projections for 2023, which at 1.4% are significantly below target. If beyond 2021 the ECB's outlook for inflation is unchanged, then massive accommodation is needed, and the ongoing tightening needs to be counteracted.

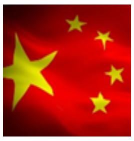
We think the ECB on Thursday will choose a "gradual response". The nuclear option would be to increase again the PEPP's envelope. We don't think there is a pressing need to do so. Yes, Euro area reference market interest rates have increased since December, but the spread with the US has widened. Moreover, the rise in core interest rates has not been accompanied by any significant widening in peripheral spreads (see Exhibit 3). This is of course helped by the improvement in the Italian political situation, but it is still a source of comfort for the Governing Council. Accelerating the purchases within the current PEPP envelope should suffice. Cutting the deposit further down in the hope it transmits throughout the yield curve would be another option – and Governing Council members have been keen to draw attention to this recently – but it would be overkill given the latest developments on the exchange rate. It may be that what we discussed two weeks ago in Macrocast – that the "overheating fear" in the US could serve the ECB's interest by triggering a dollar appreciation – might be happening. The euro fell below 1.20 dollar last Friday.

Exhibit 3 – Some fierce resistance already at play

We expect the ECB to give more prominence and precision the sentence explicitly linking the PEPP's flexibility to preserving favourable financing conditions in the prepared statement. It is currently quite far into the text, and it could be brought forward to the crucial second paragraph. The current formulation is the following: "The purchases under the PEPP will be conducted to preserve favourable financing conditions over the pandemic period. We will purchase flexibly according to market conditions and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation". It could be made more forceful by explicitly mentioning the current market situation. For instance, by stating that the "ongoing tightening in market conditions warrants an acceleration in the purchases".

Words are unlikely to suffice. Last week's release of weak purchases through the PEPP came as a negative surprise, but the data covered only the first three days of the week, while the bulk of the action may have been on the last two days. We think that another disappointment would make the market doubt the ECB's resolve. We believe the central bank knows it perfectly well and will indeed report an increase in the weekly quantum.

Christine Lagarde will have lots of questions on the definition of the "financing conditions" the ECB is seeking to preserve (the ECB had mentioned the council would have a discussion on this by March). To a large extent, we already know broadly what they are: the levels of risk-free sovereign yields, sovereign and credit spreads, lending rates to non-financial agents, credit standards as they are reflected in the ECB's Bank Lending Survey. It is unlikely the central bank will elaborate much on the respective weighting of these indicators, since their importance fluctuates with circumstances. While the market desire for transparency is understandable, on this we believe the ECB should be allowed wide discretion. Monetary policy remains an art.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls post significant surge of 379k in Feb, unemployment edges lower to 6.2% • Fed Chair Powell speech unsettles UST yields, which rise to 1.58% • ISM indices diverge – services 55.3 weakest since May, manufacturing 60.8 matches Feb 18 high • Vehicle sales slip as financing rates rise • New virus cases level as states ease restrictions	• Impact of Senate's passage of stimulus bill • Further moves in market rates without Fed guidance during purdah ahead of 17 Mar meeting • PPI inflation for February, expected to jump higher as 2020 base effects begin to impact • Weekly jobless claims, following pick-up in latest figures
	• EA HICP inflation was stable at 0.9%yoy in Feb, while core came down from 1.4% to 1.1%yoy, reversing part of the 1.2pp jump recorded in January • EC proposed to suspend fiscal rules in 2022, and until GDP return to its pre-crisis level • Italy working on a new 2% GDP fiscal package	• January industrial production to show continued support from the manufacturing sector • ECB meeting to clarify the meaning of "favourable financing conditions", with Monday PEPP numbers in the focus • EMA expected to approve the J&J vaccine
	• Chx Sunak delivered UK Budget, extending emergency stimulus of £65bn, providing £25bn investment incentives, but pre-announcing £70bn of future revenue increases from 2023 • Nationwide house price index jumped 6.9%yoy in Feb, approvals remain firm in January • Construction PMI rises to 53.3 in Feb	• UK GDP (Jan), consensus expects -4.7%, we est -4.0% but wary of Brexit effect. Includes broader sector output data for Jan • BRC retail sales monitor, looking for any rebound after Jan decline in total sales • RICS housing survey, signs of expected Stamp Duty holiday end likely to weigh
	• Jan unemployment rate was flat at 2.9% and jobs/applicants ratio rose a bit to 1.1 from 1.06 • Feb Services PMI is unchanged at 46.3, in contraction territory • February consumer confidence rose to 33.8 from 29.6, just above April 2020 level • As expected, January retail sales declined by 2.4%yoy, impacted by recent restrictions	• Feb Economy Watchers poll • Q4 GDP second estimate should be revised down after capex review • Q1 business survey index would be useful to gauge outlook optimism • March primary consumer sentiment index
	• Both China's NBS and Caixin PMI softened in Feb, in part due to suspensions of production during the CNY holidays • The NPC commenced on Friday. China sets an economic growth target of above 6% for 2021 and indicates the intention of creating 11million new urban jobs	• Export data to show moderation on the back of holiday distortions
	• PMI survey showed improvements in KO TW RS PO SA while falls were reported in TH MY ID HN TK; manufacturing indices hint to better outlook as our Asian export monitor suggests • Central banks on hold in MY PO while Ukraine hiked 50bp unexpectedly to 6.5% • Turkey GDP expanded 1.8% in 2020. Q4 2020 GDP yoy growth +0.4% in India, -1.1% in Brazil	• CB meeting in Peru (expected on hold) • Feb CPI for TW IN BZ AG MX CL HN UR • Jan IP for MY IN SA TK MX • Q4 2020 GDP for SA

Upcoming events	**US :**	Tue: NFIB small busi opimism (Feb); Wed: CPI (Feb); Thu: Weekly jobless claim; Fri: PPI (Feb), Michigan consumer sentiment (prel., Mar)
	Euro Area:	Mon: EA cons inflation exp, Ge, Sp IP (Feb); Tue: It IP (Jan), EA emp chg (Q4), EA GDP (Q4); Wed: Fr IP (Jan); Thu: ECB interest rate decision (unchg, Mar); Fri: Ge, Sp HICP (Feb), EA IP (Jan)
	UK:	Mon: BRC retail sales monitor (Feb); Wed: RICS house price balance (Feb); Thu: RICS housing survey (Feb); Fri: GDP (Jan), IP (Jan), MP (Jan), TB (Jan)
	Japan:	Sun: CA balance (Jan); Mon: Leading index (Jan), Economy watchers current index (Feb), GDP (Q4); Tue: Machine tool orders (Feb); Wed: PPI (Feb)
	China:	Sun: TB (Feb); Tue: CPI (Feb), PPI (Feb); Thu: New loans

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