Weekly Market Update

21 Mar 2021

US Economy Still on Track for a Robust Recovery

- Last week's data indicated that substantial slack remained in the economy, although severe weather across much of the country in recent weeks also appeared to be at work.
- Weekly jobless claims rose unexpectedly to 770,000, their highest level in a month. Industrial production fell 2.3% in February versus consensus expectations for a slight increase, while index of homebuilder sentiment fell to a seven-month low as housing starts and permits also saw declines.
- Retail sales excluding the volatile auto segment slumped 2.7% in February, the biggest decline since April's 15.2% plunge.
- A positive outlier was a current gauge of manufacturing output in the mid-Atlantic region, which surged to its highest level in nearly five decades.
- Bond markets appeared to look past the mixed economic data and focus instead on the potential for higher inflation, leaving longer-term U.S. government bond yields significantly higher for the week. Another additive factors was the BOJ decision to widen the trading band around 10-year Japanese government bonds

US Economy : Demand Push

- There has been an unprecedented surge in Los Angeles in the number of container ships bringing goods from Asia. The combined Ports of Los Angeles and Long Beach are the busiest shipping hub in US .
- In February, the number of containers handled at the combined port was up 43.3% from a year earlier, the largest annual increase in the port's more than century history and hitting a historic peak in volume. The increased volume was due to a 50.3% increase in imports and a 4.9% increase in exports. The increase also reflects strong consumer and business demand in US, partly fueled by the December government stimulus.
- US$1,400 stimulus checks that will soon be sent to 85% of Americans will obviously boost demand for traded goods even further.
- Thus, the surge in activity at ports around US is likely to grow. Meanwhile, it is reported that freight rail volume during the first week of March was up 6.7% from just before the pandemic began.1 Activity on the part of package delivery services is up substantially as well, partly reflecting increased online spending. In any event, the consumer goods sector appears to be on fire and about to get an injection of fuel.
- Still, some negative economic signals remain. In the first week of March, electricity generation in US was down 4.2% from the prepandemic level, steel production was down 9.0%, the number of vehicle trips taken by individuals was down 11.3%, and passage through airport security checkpoints remained 45.7% below the pre-pandemic level.

Politics of Stimulus

- On March 11, Biden signed the American Rescue Plan into law, a $1.9 trillion covid relief plan that should keep the economy going at least through early September. This extends the covid relief brought earlier by the $2 trillion CARES Act (March 2020) and the $900 billion covid relief package that was part of the Consolidated Appropriations Act 2021 (December 2020).
- It is Biden's first major fiscal policy success, but he is already working on fiscal policy for the coming years. However, the negotiations and votes on the American Rescue Plan show that Biden is working with fragile majorities.
- The initial House version of the American Rescue Plan passed in February with a 219-212 margin, with two Democrats and all Republicans voting against it. The final version passed the House of Representatives 220-211, with only one Democrat voting against it
- Not a single Republican voted for the American Rescue Plan and centrist Democratic senators have shown that they are willing to use their leverage in the 50-50 Senate. This will increasingly anger progressives as their left wing agenda continues to be watered down by senators of their own political party.
- Therefore, if Biden does not proceed with caution, this could already have been the high point of his administration

US Equities : Stall Speed

- U.S. equities posted a loss for the week. The equity rally stalled on Tuesday after longer-term Treasury yields resumed their rise.
- Over the next two trading days, the yield on the benchmark 10-year note soared roughly 17 bp and hit a new pandemic-era high of around 1.75% before retreating a bit. The equity market's reaction to this rise was somewhat muted, seemingly helped by Fed and Powell's post-meeting press conference
- However , On Friday ,Fed announced that it would not extend the rule that relaxed the leverage ratio for banks, which expires at the end of the month.
- March 23 marks the one-year anniversary of the stock market bottom and the end of the shortest bear market on record. - Close watch in order .
- Currently S& P 500 is running just about 3 percentage points ahead of the 2009-10 Roadmap. If the correlation holds up, the index should have about 5 more percentage points to go before it runs into upside resistance; perhaps around the 4,027 area

Rise of Yields : Crisis in the offing ?

- Quantitative easing was designed as a tool to provide liquidity to a scared market and benefit from exceptionally attractive valuations of the lowest-risk assets, sovereign bonds
- Central banks would cut rates and purchase these high-quality, low-risk assets from banks, thus allowing financial entities to lend more and strengthen confidence in the economy. Once financial conditions improved, central banks would reduce their balance sheet and normalize policy. This never happened.
- With the global economy recovering, inflation rising, and the global economy about to get an injection of demand from the US fiscal stimulus, there has been concern that bond yields might move even higher, thereby stifling business investment and retarding the economic recovery.
- The risk of a financial crisis does not come from rising bond yields. An economy can function without a serious crisis for many years with a 2% US 10-year bond yield in normal conditions of a growing economy with 2% inflation.
- However ,It has been now created by lowering bond yields to unrealistic and unjustifiable levels with entire markets having based their valuations on inflationary policies not generating inflation and the massive level of risk built into the economy from the prior artificial depression of yields.

Growth in 2022 to slow ?

- The economy is poised to expand over 6% this year .
- This would be the best performance since1983 (8%) and would be the result of positive momentum beginning in late Q2 2020 ,unprecedented counter cyclical policy support ,and a nationwide rollout of vaccines.
- Since WWII, there have been seven instances where annual real GDP growth exceeded 6%.
- The average over these periods was 8.1% ,but it is skewed by a 13.4% increase in 1950.
- Otherwise, the mean is 7.2%. Unsurprisingly Real GDP growth slowed sharply following each boom year.
- Across the seven periods ,growth tends to halve . This is the same whether1950 is included or excluded.

Boom Cycle	Real GDP Growth, Q4/Q4	Growth in the Following Year
1950	13.4	5.5
1955	6.6	2.0
1961	6.4	4.3
1965	8.5	4.5
1972	6.9	4.0
1978	6.7	1.3
1983	7.9	5.6
Average>	8.1	3.9

Central banks : Different Drivers

- Fed sent a dovish signal, as the median 'dot' continues to signal no rate hike through 2023. However, the markets majorly expect it is a matter of months before Fed starts to move in a more hawkish direction, as Fed seemed too pessimistic on the economic outlook and labour market recovery. Such a shift may already come in June but no later than in September and force Fed to start discussing tapering in Q4 21 and actual tapering in Q1 22.
- BoJ presented its policy review. As expected, it caused no revolutions to the policy framework but it came with a few adjustments. Most notably perhaps the implicit tolerance band of +/-20bps on the 10yr JGB target was increased slightly to +/-25bps. With Japan as the last of the G7 to kick-start its vaccine programme, the pandemic will weigh on domestic demand for longer than the rest of the DMs and there is no room for BoJ to significantly withdraw stimulus.
- BOE said that global economic developments “had been a little stronger than anticipated” last month and noted that the U.S. fiscal stimulus package should provide “significant additional support.”

EM : Brewing Turmoil

- Central banks in Brazil, Turkey, and Russia raised rates during the last week in moves that were either unexpected or more than what the markets had anticipated
- Brazil's central bank surprised markets with a 75-bp rate hike to 2.75%, the first rate increase in roughly six years and signaled that another hike of the same size was likely at its next meeting.
- Turkey’s central bank lifted its key lending rate from 17% to 19%—one of the highest levels in the world—in an attempt to address growing inflation risks. Most forecasters had predicted a hike of around one percentage point. In an immediate reaction ,Erdogan who is openly averse to high interest rates announced the departure of Central bank Governor.
- Russia’s central bank raised its benchmark lending rate from 4.25% to 4.50%. Markets had expected them to wait at least one more meeting before beginning to hike rates. Similar to its counterparts in Brazil and Turkey, Russian policymakers cited rising inflation risks. Annual inflation through February had risen to 5.7%, higher than the bank’s 4% target.
- Financial markets in Russia came under pressure after Biden called Russian President Vladimir Putin a killer who will pay a price for interfering in American elections. Russia recalled its ambassador from Washington in response to Biden’s comment. While many analysts believe that any potential U.S. response will be focused on individuals in Putin’s government, the possibility of sanctions targeting Russia’s sovereign debt led investors to rotate out of Russian government bonds.

Europe : Third wave

- The situation is worsening again in EU with both Germany, France and Italy now seeing a clear rise in new cases. The takeover of the British variant is causing significant challenges in controlling the virus with cases rising on the back of an only moderate easing of restrictions. France is implementing a new lockdown in large parts of the country and around half of Italian regions are now 'red zones'
- Core eurozone bond yields ended slightly higher. Germany's 10-year bund yield climbed midweek, tracking U.S. Treasuries in response to expectations for an uptick in inflation.
- Dutch elections: Mark Rutte wins another term but fragmented results mask continuing popularity of the far right – A grim reminder for the rest of Europe.
- Merkel's panel of economic advisers warned that the recovery could be endangered by a continued lockdown
- March flash PMIs are due on Wednesday. Europe will likely continue to show the same picture of a two-speed economy with manufacturing in the lead and decelerating services activity. But in light of last month's decline also in the Chinese PMIs, manufacturing expansion pace to abate compared to February.
- German Ifo is published on Friday and will also paint a similar story of a divided economy, but in light of the continued German lockdown it will be important to watch if business expectations maintain their uptrend from last months or show some signs of weakness.

China : Sudden Shift

- New type of Cold War brewing - If anyone had hoped for a smoother relationship between US and China under the Biden administration the Alaska meeting on Thursday put cold water on that hope.
- It is clear the relationship between US and China will be very difficult in the years to come and a kind of new cold war has started, which will gradually lead to some decoupling between the two powers.
- Beyond that geo-political dimension ,A tug of war between policy tightening and growth support seems to have begun and hence there is a significant downside risks to China's cyclical growth trajectory in this year - there are clear indications that the Chinese economy is decelerating.
- Retail sales in the combined January–February period rose 33.8% year on year .The large increase was due to last year's lockdowns .Even so, retail sales still increased 6.4% over the combined January–February period in 2019.
- In other releases, industrial output rose 35.1% year on year in January–February over a year ago and 16.9% over the same two-month period in 2019.

India Bond Market : All is fair

- While the US yields remain elevated, the sharp fall in crude oil prices in the later part of the week smoothened the sentiment.
- Adding to the bond positive mindset , there are reports that Centre may review the gilt auction scheduled for Mar 26 based on the trend in the tax collection. This led markets to believe that the auction for next week may get cancelled.
- However RBI's move to exercise green-shoe option to raise an additional Rs 20 bln each through 10-year benchmark note and 2025 bond, as against the notified amount of Rs 110 bln each, respectively, also weighed on the prices
- RBI has resorted to unconventional tools to control the surge in yields-RBI platform has enabled a provision to quote bonds at negative yields, a development that will discourage traders from running short bets- allowing negative rates in the repo market would be an extension of the strategy of penalising short sellers.
- State of the Economy' paper by RBI was explicit about the current objective of RBI
- Ahead of the year end , the upside stays capped at 6.25 %

Equity : Weaker Bias

- Confluence of negatives : Firming inflation both in global and domestic levels , Decelerating growth across emerging markets , re-emergence of Covid and associated risk of lock downs ,wobbly FII sentiment , Weakening bull bias with Excessive retail speculative frenzy in IPOs.
- With last week 's move, Nifty is trying to close post budget gap that was created around 14470 – 14330 – Ability to hold this zone is deemed as positive atleast in the immediate short term
- Index is on the nervous edge of a break or make level .A decisive break below 14375 to trigger a waterfall decline which can extend till 13780 . An upmove past 14875 to negate