Rathbones
Look forward

Review of the week

22 March 2021

Calm in the eye of the storm

As the fight against COVID-19 continues, economies are beginning to reopen. Are we about to experience a typhoon of activity to mirror the huge slumps of 2020?

Amid steadily rising bond yields and a quickly recovering American economy, the US Federal Reserve (Fed) met last week to discuss monetary policy.

As expected, the central bank did nothing. It reiterated its plan to keep the Fed Funds interest rate between 0% and 0.25% to avoid squeezing any economic recovery by prematurely increasing borrowing costs for governments, businesses and households. Fed Chair Jay Powell went as far as saying that short-term interest rates should stay where they are until at least 2024. That's a big call. Three years is a long time, and we've seen how quickly these forecasts can change. Yet the sentiment is stark: the Fed wants to keep loose reins on the US recovery for as long as it possibly can.

This path is open as long as inflation doesn't get out of control. Many investors have quickly become concerned in recent weeks as America has started reopening and other nations follow close behind (some are ahead of the game, of course). A $1.9 trillion stimulus package has been approved and a huge infrastructure plan is in the works for later in the year. Meanwhile, even as some companies and households struggle with COVID-shuttered businesses, many others are bored and flush with cash, potentially primed for a spending extravaganza.

It seems likely that people will want to make up for lost time after a year of house arrest. Yet it will depend on whether they feel safe to get out and spend - both financially and physically - and whether they have the ability to do so. Take this hypothetical: if you assume a fifth of all restaurants were ruined by the pandemic, and that the remainder can cater to just half their usual covers because of continued COVID trading restrictions, that would leave restaurant capacity at 40% of pre-pandemic levels. Not everyone will be able to book a table. You may be experiencing this frustration yourself ahead of the UK's lockdown easing!

Given the scale of demand and the still-constrained supply, inflation in some areas like pubs, restaurants, hotels and theme parks should be expected in all nations. At least for this year. However, we believe this flurry of activity will settle down and new businesses will spring up in response to the queues of punters. The coming spike in inflation should prove transitory, in our opinion, because there are many stronger, longer-lasting economic trends that are keeping a lid on prices. These include the large amounts of debt held all round the world, technological innovation and demographic changes. And then there's rising unemployment - the latest UK measure will be released this week.

Licence to manipulate

Investors' worries about greater inflation are reflected in the swift rise of government bond yields. The benchmark 10-year US Treasury yield has leapt from 0.92% at the beginning of the year to around 1.70% today. This has happened even as government bonds maturing in a year or less have stayed grounded. The same phenomenon has happened with UK bonds and, to a lesser extent, European bonds.

Governments and central banks are both keen to keep borrowing costs low for as long as they can. They don't want economic recoveries to be cut short as higher financing costs push households and businesses to shelve plans to spend and invest. Governments are aware of just how much money they have had to borrow to support society and commerce for a year of dislocation. The higher government bond yields get, the more unaffordable those debt burdens become.

Now, traditionally, central banks control interest rates by changing the short-term rate of borrowing - the Fed Funds rate or Bank rate in the UK. However, longer-term rates are much more susceptible to market forces - to the buying and selling of countless bonds every day. This is where quantitative easing (QE) comes in. Central banks in the US, UK, Canada, Europe, Japan and even some emerging markets are buying eyewatering amounts of longer-term bonds in the open market to push up prices and thereby keep yields lower. Some bondholders are hoping that the US government will adjust its QE purchases so that it buys more longer-term bonds and fewer short-term ones. The Fed hasn't shown a willingness to do that yet, but the closer the US 10-year yield gets to 2%, the more this strategy may come to the fore. Especially as a veritable waterfall of new long-term American government bonds need to be issued in 2021 to pay for all the pandemic support programmes. All things equal, more longer-term debt would reduce its price, sending yields higher and then meaning yet more debt would be needed to pay the interest. Both governments and central banks are mindful not to allow this to happen.

As economies break out of lockdown and the world continues to shuffle towards something resembling what we used to know, economic data will become unpredictable. Sort of like the reverse of what we saw when the lockdowns were implemented last year. We think it's probably best to take these statistics with a pound of salt and a sense of adventure.

Still, these figures will spook some investors over the coming months, especially the robotic ones - the automated trading programs that proliferate these days. Faced with record-smashing moves in economic measures, these machines could easily go rogue, distorting markets with aggressive trades faster than you can blink. When this happens, it can be worrisome, but the short-term moves also give you the opportunity to buy and sell at a wider range of prices. Put simply, if you're smart and brave, you can take advantage.

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