## Fidelity Connects

**The Global Macro View**

**Jurrien Timmer**, Director of Global Macro

**Pamela Ritchie**, Host

**Voiceover:** Hello and welcome to Fidelity Connects – by Fidelity Investments Canada - connecting you to the world of investing and helping you stay ahead.

Building on early February's strong performance and full-employment possibilities for next year, we are seeing equity markets also rising. So, is the economic recovery in fact on the horizon? Today we're joined by Fidelity's Director of Global Macro, Jurrien Timmer, for his global macro and markets update.

In speaking with host Pamela Ritchie, Jurrien notes that small-caps and value have been strong as of late, and that emerging markets are leading the charge on the international front.

Jurrien also comments on cryptocurrencies and gold, inflation, stimulus, and possible risk on the horizon.

This podcast was recorded on February 8, 2021. Also, Jurrien has a chart or two, so head to @TimmerFidelity on Twitter to follow along.

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**Pamela Ritchie:** To help us analyze all the data about the economy and the markets and to weigh in on other important stories like rising inflation expectations, we're happy to be joined by Fidelity's director of global macro, Jurrien Timmer. Jurrien, great to see you. Happy Monday.

**Jurrien Timmer:** Good morning, Pamela. Nice to see you.

**Pamela Ritchie:** Let's touch just on inflation discussions right now. We're seeing yields, this on the bond market side, move, some will say for the right reason, higher, which is growth rather than monetary stimulus. Can you unpack that for us 'cause there's a lot of voices going on in here?

**Jurrien Timmer:** The reflation trade as we call it is in full force. The only indicator that's not quite moving or confirming all of this narrative is the dollar, which is a little bit moving counter to other indicators. Generally speaking interest rates are rising on the long end, so that's causing what we call a bearish steepener in the yield curve. The short end actually is making new lows in yield because there's a shortage of T-bills because the Treasury, with Janet Yellen in charge, instead of issuing new bonds to pay for the fiscal stimulus that we're about to get, pretty big and pretty soon, and we'll talk about that in a moment, but the Treasury Department is actually going to run down its cash balance at the Fed, which it has over a trillion dollars in cash sitting at the Fed, so it's going to run down that balance which means it doesn't have to issue a lot of new paper. That's creating a little bit of a shortage. If you look at the two-year yield, it's actually going down, but the 10-year yield is going up and it's around 1.17% right now. Real rates are kind of still negative, and that's probably the most important reflation indicator. So if nominal yields were rising and inflation expectations were not rising, then real yields would be rising or they would become less negative.

That would be an important negative story or bearish story for the reflation trade, but that's not happening. Inflation expectations are rising along with nominal yields, and I think from the market's perspective and the Fed's perspective that's an okay development. So a bearish steepener, as long as it doesn't push real rates up is okay, it's allowed as part of the reflation narrative. That's certainly what we're seeing along with rising commodity prices, more growth-to-value rotation and a very strong tape in the stock market, ongoing positive earnings revision. The bullish narrative is running on all cylinders right now.

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**Pamela Ritchie:** Let's go to all of those pieces. First of all you mentioned a much bigger, much faster stimulus program. We saw Janet Yellen talking on all the Sunday shows yesterday. What amount of stimulus do you think was priced into the market to get us here today, and where does it go over that amount, in your opinion?

**Jurrien Timmer:** This gets a little technical, but the market was expecting or allowing for this scenario where Joe Biden, or the Biden administration would try to engage with the Republican side of Congress and come up with a bipartisan deal. Biden's plan is for $1.9 trillion, and it goes without saying that if there was a bipartisan deal, it would be significantly less than that. The Republicans came up with $600 billion, and maybe they split the difference and you get to a trillion or something. But it looks like the Biden administration is trying not to make the mistakes of the Obama administration — of course, Joe Biden was the vice-president back in '09 — where they went too small on the fiscal stimulus after the financial crisis, or during the financial crisis. They are apparently vowing not to make that mistake. Just to go big, can't go big enough, and so as a result the Biden administration is going to bypass the bipartisan efforts and just basically push this through the reconciliation process, which is more of a technical process where you only need any majority, so the Democrats have 50/50 between Democrats and Republicans, but Vice-President Kamala Harris would then have the tie-breaking vote as opposed to needing 60 votes which would require Republicans to come on board.

It looks like they're going to cram this through as part of still the 2020 reconciliation process. So this is actually still open from the last fiscal year. It looks like it's going to be 1.9 trillion or something very close to that, and more importantly, it's going to happen fast. This could happen in March, next month. We could get another 8, 9% of GDP in terms of fiscal stimulus, and when you add the rest of the fiscal relief from COVID, the CARES Act, we're looking at over $5 trillion in less than a year. That's 20, 25% of GDP. Those are enormous numbers.

It looks like that's going to happen. It's going to be big, it's going to be fast, and then the administration will still have the 2021 reconciliation process later this year to maybe do another one, and that one more dear to environmental climate change, infrastructure. So we may be at $7 trillion before this whole thing is over. When you combine that with the vaccine rollout, we're now vaccinating 2 million people a day in the U.S., a huge increase from a few weeks ago when it was 700,000 a day. It's obviously much more coordinated now because now it's a centrally-orchestrated process, which under the Trump administration everything was left to the states. The COVID curve, I don't know if it's bending in Canada, but in the U.S. the number of new cases are collapsing.

We're now looking at 25, 26 days in a row where the number of new cases is going down off a very high level, of course, but it's coming down pretty sharply.

When you combine vaccinations, a bending COVID curve, presumably a reopening of the economy as a result of all that, and then this massive fiscal liquidity infusion, and a Fed that, in my view, and this is just my view, is likely not going to take the punch bowl away by raising rates or tapering asset purchases. When you combine all of those factors, in the second half of this year the economy could be really running hot and produce some inflation, and that's what the markets are already telling us. That's exactly what's playing out in the markets right now.

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**Pamela Ritchie:** We'll circle back to the U.S. dollar. You flagged it at the top as something to watch. Is the reflation trade right now, would you say it's broadening out to be broad enough? Tops don't usually happen in the middle of a broad market rally. Is that fair?

**Jurrien Timmer:** I think that's fair. What we're seeing is 2020 until the fall, September, October, November, as we know, it was really large-cap growth that dominated the rally, which is very unusual. If you have a bear market in a recession, and then you have an early-cycle recovery, typically the leadership broadens out to value, cyclicals, small-caps, non-U.S. That, for the first six months of the rally, did not happen, it was the FANGs, the FANG stocks. That all changed in the fall with the election and then the blue wave, so now we have the rotation. Small-caps and value now beating growth. We're seeing EM leading the charge on the international front.

What we're seeing is it's almost like the economy is being overstimulated. Normally if the economy hits a shock, you get the policy response to offset it, and then when the shock ends the policy response dissipates. That's not happening. Even though the output gap has mostly closed, it's about 80% closed to where it was a year ago. The market is being overstimulated here, and that's really putting some fire under EM, commodities, rates, value, small-caps. Like you said, that's not the sign of a peak.

What will typically happen historically during market cycles is you'll see that overheating, that's classically a late-cycle phenomenon, you see inflationary pressures, you see small-caps running, and value, and then the Fed responds to that by taking the punch bowl away. If they're doing asset purchases, they taper the purchases, maybe even reverse them, which is what they did in 2017 and 2018. Certainly they would be raising rates and changing the forward guidance.

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**Voiceover:**

So to follow along here - head to @TimmerFidelity on Twitter and look at Jurrien's "The Fed vs. The Market" slide, tweeted the morning of February 10th.

**Jurrien Timmer:** You can see that none of those things are happening, and the Fed is pretty much committing, it seems, to keep this thing going. It's actually adding rum to the punch bowl as opposed to taking the punch bowl away.

Here you see the pink line is the 10-year Treasury, the blue line is the fed funds rate and the black line, or the dark blue line, is the fed funds futures curve. What the market is expecting the Fed to do, which is often the result of the Fed telling the market what it might do. You can see that that line is as flat as a pancake, even though rates have risen by quite a bit. So the Fed is leaning against this rise in yields, and if the Fed does not tighten liquidity, usually you will not get to the end of a bull market cycle. It's always the liquidity that tightens that either kills the speculative frenzy, or it kills the bull market. It always comes down to liquidity.

If the Fed's going to keep this thing running hot, and not only not leaning into the fiscal stimulus that we're about to get, but actually absorbing it, we actually are going to get right to that analog that we've discussed so many times over the past 10, 11 months, which is the 1940s where deficits were running large as the U.S. was entering World War II. And the Fed monetized those deficits, and on top of that the Fed kept rates very low, 1% for the policy rate, and it capped bond yields at 2½%, even though inflation was starting to run hot. As a result, real rates went negative, and they kept getting more negative. That was the ultra-reflation trade. It looks to me like we may actually have a repeat of that even though the circumstances are totally different. This is an analog that nobody was discussing except for us even back in March of last year, and it certainly looks like it's been a good one to keep an eye on.

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**Pamela Ritchie:** Absolutely. I mean almost a year now, been pointing to this as a comparison to really keep an eye on. Piles of questions coming in. You've been digging deep into cryptocurrencies and Bitcoin, and we've had a special broadcast with you, which we really appreciate. Questions coming in now on your new expertise here. Just commenting within the reflation discussion, the cryptocurrency, where does it belong, SPACs, as well, these special-purpose vehicles, and hedge funds, which you've kind of pointed to a little bit earlier there. If you could just broadly address those.

**Jurrien Timmer:** It's funny, the SPAC discussion, hedge funds are like yesterday's news, and even venture capital, and now it's all SPACs, so it's sort of like, well, give me your money, I don't know how I'm going to invest it, I'm not going to tell you, but when I find something I'll do it. That actually does, when you read some of the history from the late 1960s, it was very, very similar. In the '60s investors had been investing for income, dividends, kind of old-school investing, and then with the guns and butter events happening of the Great Society and the Vietnam war, investors started to worry about inflation, and they started to worry that they were not going to get enough on the income side of the ledger from the stock market, so they wanted growth. VC on technology companies got very big at astronomical valuations, and so the SPAC story to me is a little reminiscent of that. That's one story.

Bitcoin and gold is an interesting one. Gold hasn't been moving very much, it's been going sideways now for six months or so. I think that has to do with a couple of things. One is that real rates, even though they're negative, that's the blue line on the reverse scale on the top of the chart, even though they're still negative, which is constructive for gold, they're not getting increasingly more negative, at least not yet. That could change in the second half of the year if inflation does actually come and the Fed leans against it by suppressing rates lower, then real rates will become more negative and that will be the fuel to drive gold. It's not happening yet. Real rates are still at the same level that they were last year, August, and that's why gold is just sitting there.

But then on Bitcoin. The big news today, Twitter is breaking today because Elon Musk bought $1.5 billion worth of Bitcoin recently, and so it's big news. Bitcoin's at 43,000 right now. As we discussed a few weeks ago, the stock-to-flow model, even though it has some problems, suggests that in four years from now Bitcoin could be at half a million dollars. It doesn't surprise me that the price actually keeps going, and as more whales as they're called, big respected institutions — maybe Elon Musk is not in that group — but certainly big players as they get in on the band wagon, it lends more and more credibility to the Bitcoin story, and that will make a lot more people comfortable to get involved.

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**Pamela Ritchie:** Another question coming in is, what is the hiccup on the horizon, the risk horizon that could change? We talked about the Fed weighing its options on taking a punch bowl away, seems not unlikely at the moment, what are the other risks on the horizon that could shake things up in your mind?

**Jurrien Timmer:** I think the main risk, and by saying risk I don't want to imply that I think it's likely, but what could go wrong, one is the dollar. If that starts to tighten that would indicate a shortage of liquidity, which is the last thing we have because liquidity is abundant, so I'm not too worried about that. The other one is, if the Fed were to take the punch bowl away, which I don't think will happen, but if they said, we don't like this rise in inflation, we're going to taper asset purchases — again, I don't think that's going to happen, I think the opposite may happen, but that could trigger another taper tantrum. Remember I use a term from many years ago back in 2013 when Ben Bernanke was openly pondering reducing asset purchases, it sent shockwaves through the bond market, and it caused a very sharp rise in real rates. A sharp rise in real rates could really put the kibosh on the reflation trade. If the Fed's not going to take the punch bowl away, which I don't think they will, then the question is, if rates rise will they try to stop that, or will they let it happen, and then is the rise in rates then based on rising inflation expectations or rising real rates. That's an extremely important distinction.

Rising nominal yields, there's nothing wrong with that if inflation expectations are rising at the same time because then real rates, which is the difference between the two, will stay negative. Going back to that 1940s analog, I think that's very much a necessary condition, and how the Fed manages all of this, I think, it always creates the risk of a policy error. I don't think it's likely, but if you ask me what is a potential hiccup on the horizon, that's what it would be.

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**Pamela Ritchie:** Just as a final statement, we're all watching the movie unfold, but when you, from your perspective, watch the movie unfold of this potential amount of fiscal stimulus coming into the market, risk assets, it's hard to see how they go anywhere but up. I'm sort of reading your tea leaves. Is that about right?

**Jurrien Timmer:** I think it's bullish for the markets, and we've had such a lopsided leadership of growth, large-cap growth over everything else for the last 10, 11 years, that there's a lot of room for the markets to rotate towards value, small-caps, non-U.S. There's a lot of fuel there. That can keep things going for quite a while. I think where you could run into a problem is that if inflation really comes back, and again, we haven't had really an inflation problem in 10 years, and maybe we won't get it now, and I'll tell you, if we don't get inflation out of this perfect storm of conditions, then I don't know what will ever create inflation in our lifetimes.

But if we get inflation, and the Fed lets it happen and, say, keep rates down just like they did in the '40s, I think the market could really run hot there, but ultimately valuation, so the P/E ratio, is inversely correlated to inflation. We know that from history. So the price to be paid for all of this if we do get inflation could be lower multiples, which doesn't mean that the market goes down. It just means that earnings will have to do all the heavy lifting in that scenario which, by the way, so far is exactly what they're doing. Earnings season is now well underway, it's been a boom time for earnings, lots of upward revisions. 80% of companies are beating estimates by about 19 percentage points, so very, very strong earnings, but the market needs that. It needs upward revisions to already high expectations to keep the thing going. If rates are rising, the valuation boost will need to come from the earnings side because it's not going to come from the rates side.

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**Pamela Ritchie:** And as you say so far it is. So glad you touched on earnings there, Jurrien Timmer. We shall meet again next week. Thank you very much, have a good week.

**Jurrien Timmer:** Great. Thanks, Pamela.

*Ending: [21:06]*

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