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Last week gave us a glimpse into the mindset of US business owners, the Federal Reserve, the Biden administration, and investors. I believe that much of the news we saw last week may be a harbinger of what's to come over the course of 2021.

Business optimism has picked up

US business owners are getting very excited about the economic recovery. For example, the Philadelphia Fed Manufacturing Business Outlook Survey dramatically exceeded expectations, clocking in at 51.8 vs 23.3 expected.¹ Nearly 70% of the firms surveyed expect increases in activity over the next six months (only 55% expected such increases last month), while 8% expect declines — which is an improvement over last month's 15% who expected declines.¹ I believe that business optimism will persist throughout the year as economic conditions continue to improve.

The Federal Reserve remains dovish

The Fed was very dovish in the “dot plots” released last week. Growth projections were revised upward and unemployment projections were revised downward — but there was no material change in expectations for the fed funds rate. The Fed really meant it when it said it changed its policy framework, and average inflation targeting has important implications. Specifically, the Fed has abandoned pre-emptive tightening. As Fed Chair Jay Powell underscored, the “fundamental change in our framework means we’re not going to act preemptively based on forecasts, for the most part. We’re going to wait and see actual data.”²

I believe we will continue to see this Fed dovishness on display throughout the year, with Powell insisting that any increase in inflation is transitory, and then actually treating any increase in inflation as transitory. In my view, the Fed will not tighten this year, allowing the economy to accelerate.

Investors fear inflation

Of course, the Fed again spurred investor fears of inflation last week because of its dovishness. I think these investor concerns will persist periodically throughout the year, given what I expect to be a strong economic rebound — and continued Fed dovishness. While I think it's very possible that we get a short-term increase in inflation on a surge in spending as the economy re-opens, I don't believe we will see a longer-term increase in inflation. There are powerful forces at work that are likely to keep a lid on longer-term inflation — namely demographics and innovation.

Rising 10-year Treasury yield pose a headwind for stocks

Treasuries sold off last week on this fear of inflation. Adding to the rise in yields was the Fed's announcement on Friday that it would be discontinuing the relaxation of the supplementary leverage ratio rules, which means banks will no longer be able to exclude Treasuries and deposits in the calculation of their respective leverage ratios. Re-imposing that requirement is expected to result in banks selling Treasuries.

The rising yield on the 10-year US Treasury created headwinds for stocks last week — not just in the US but in Europe and Asia as well. I believe we will continue to see this throughout the year. However, I must reiterate that I believe the stock headwinds created by rising yields are only temporary, as stocks digest higher rates.

Talk of a tax increase heats up

Last week saw a focus on the possibility of tax increases in the United States. There's continued chatter about hiking corporate taxes. An official in the Biden administration shared that the administration wants to raise taxes on any households earning \$400,000 or more. This seemed to contradict a campaign promise that the Biden administration would not hike taxes on individuals earning less than \$400,000. Also this month, Democratic Senator Elizabeth Warren proposed a tax on ultra-wealthy Americans.

I suspect there will be many more conversations about tax hikes in the US — and elsewhere — given all that needs to be paid for given the pandemic and severe economic downturn of the past year. However, I continue to believe it will be difficult for the Biden administration to actually get much in the way of tax hikes passed this year.

Volatility rises, but stays under its highs

The VIX volatility index rose last week, peaking above 22 on Friday morning. However, it is nowhere near levels seen earlier this year (slightly above 33 on Jan. 29) and far below the level seen in late March 2020 (slightly above 65).³ I expect elevated volatility to continue this year, but I also expect it to remain well below those highs as markets adjust to higher yields on the long end of the curve.

What I don't expect to continue ...

One condition that I don't expect to persist this year is that global stocks, namely the MSCI World Index, ended the week with a decline. While the second year of the stock market recovery is likely to be more challenging and volatile than the first, I believe global stocks will finish the year higher. I can't help but be positive on risk assets given monetary accommodation, fiscal stimulus and a strong global rebound in the offing once vaccines have been broadly distributed.

A note from Kristina

I finish this blog on a somber note. Last week eight people, most of whom were Asian-American women, were senselessly murdered in the Atlanta area. My prayers are with the victims' families.

Source

¹Source: Federal Reserve Bank of Philadelphia, March 18, 2021

²Source: Bankrate.com, "Fed keeps rates near zero with bounce back from pandemic in sight," March 17, 2021

³Source: Bloomberg, L.P.

Important information

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The Philadelphia Fed's Manufacturing Business Outlook Survey is a monthly survey of manufacturers in the Third Federal Reserve District. Participants indicate the direction of change in overall business activity and in the various measures of activity at their plants: employment, working hours, new and unfilled orders, shipments, inventories, delivery times, prices paid, and prices received.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The federal funds rate is the rate at which banks lend balances to each other overnight.

Average inflation targeting is a Federal Reserve policy in which the central bank may allow inflation to run above its 2% goal following periods when it has run below that goal.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

The MSCI World Index is an unmanaged index considered representative of stocks of developed countries.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity. The long end of the yield curve refers to bonds with longer maturity dates.

The opinions referenced above are those of the author as of **March 21, 2021**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.