Opinion **Markets Insight**

‘Blue wave’ trade back on after Georgia Senate poll

Reflation hopes likely to spur investment rotation within markets as economic growth picks up

MICHAEL MACKENZIE

Raphael Warnock at a canvassing event in Marietta, Georgia, on Tuesday. He became the first African-American in the state to win an upper chamber seat © AFP via Getty Images

Michael Mackenzie YESTERDAY

The reflation trade in global markets has suddenly been given a big kicker.

With the US Senate run-off elections in Georgia close to giving control of the chamber to Democrats, investors are betting the result will deliver increased spending under president-elect Joe Biden to boost the ailing US and global economies and inflation.

That had been the consensus expectation before November’s election but uncertainty over the Senate outcome led investors to rein in stimulus hopes even as economic clouds grew darker with the spread of the new Covid-19 variant. Now the “blue wave” bets are back on.

“A sweep for the Democrats will probably lead to additional stimulus measures that would likely boost short-term economic growth,” said Steve Chiavarone, portfolio manager at Federated Hermes, in a note.

The US economy had already been expected to rebound in 2021, with the World Bank forecasting a 3.5 per cent expansion after a 3.6 per cent contraction last year.

The Georgia results further bolster the case for owning companies in sectors that can benefit from such growth such as banking, energy and industrials. Higher demand is also expected to boost commodities and emerging markets. The latter would additionally benefit from a weaker dollar if higher inflation erodes the value of the global reserve currency. And higher inflation might also drive down investor demand for US Treasuries.

“Higher growth could also push longer-term interest rates higher — something that is good for financials, but bad for bonds as well as interest rate-sensitive sectors,” said Mr Chiavarone.

The potentially inflationary consequences of greater government spending have not been ignored by the bond and currency markets in recent months.

Expectations of US inflation over the next decade implied by bond trading had risen beyond 2 per cent this week, a level last visited in 2018. In turn, the dollar weakness of late has gained momentum. The dollar index was approaching its lowest level in nearly three years on Wednesday.

But the big market development is that, for the first time since March, the 10-year Treasury yield, a crucial benchmark for financial assets, has risen above 1 per cent. The bond market anticipates more sales of debt to fund a hefty fiscal Biden spending package in the coming months that goes well beyond the $900bn package of support measures passed in December.

Economists at Goldman Sachs expect a Democratic Senate majority to seek “additional fiscal stimulus in the near term” in the region of $600bn or 2.7 per cent of gross domestic product. This would be followed by a limited amount of tax increases and spending rises later in the year.

This sets a challenge for the Federal Reserve. Central bank officials welcome the prospect of higher inflation and have said they are prepared to tolerate a period of core prices running above their 2 per cent target for a yet to be determined period.

But the Fed is also attuned to the problems created by a long period of slumbering inflation and rock-bottom interest rates. Institutional investors have been compelled to pay a premium for faster-growing companies, and aggressive retail investors have fuelled the rally in recent months.

Allowing 10-year yields to rise sharply would run the risk of triggering a big retreat from bonds and tech shares and sparking broader market turmoil.

The likelihood of stronger corporate earnings from improving underlying economic growth will support the prices of equities in general. But that must be weighed against the negative impact that higher interest rates have on expensive tech and growth stocks. The valuation of such stocks can suffer when their future cash flows are discounted by higher rates.

To some extent, this was playing out during trading in New York on Wednesday with the Russell 2000 index of small-caps up 4 per cent, while the tech-heavy Nasdaq was down 0.6 per cent.

Ian Lyngen, head of US rates strategy at BMO Capital Markets, said signals from the Fed on how comfortable it was with higher Treasury yields would be critical to the market outlook. "It's the implied willingness to allow rates to drift higher that will be in question," he added.

For now both the Fed and investors have some time on their side. But later this year, a stronger economy buoyed by Covid-19 vaccines and hefty government spending will require much higher interest rates and indications of far less monetary support from the Fed.

michael.mackenzie@ft.com