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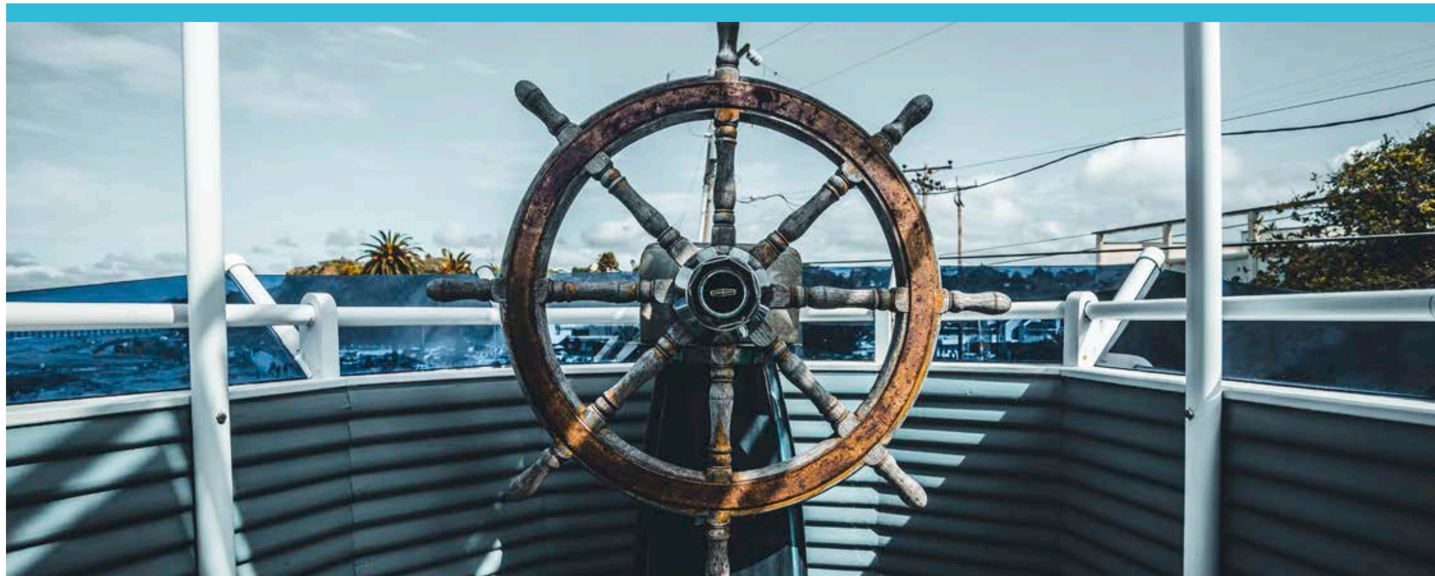
Three bull and bear cases for markets

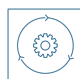
A price correction is possible



Nikolaj Schmidt
Chief International Economist
T. Rowe Price

Since the US elections, asset prices have risen steadily higher. Can the risk rally continue? I believe it can as it is underpinned by three powerful drivers. However, there are also three looming risks that could undermine it.

Three primary drivers of the rally



Refocus on the business cycle

It is tempting to attribute the rally to the outcome of the US elections. Personally, I think it has had less to do with the results of the elections than the mere fact that they have occurred, leaving the markets with one less thing to worry about. Leading up to the elections, investors had become so preoccupied with how different combinations of government would affect markets that they failed to notice that we are likely in the early stages of the next business cycle expansion.

"...the next fiscal package should be...the closest we will ever come to helicopter money..."

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Business cycle expansions are measured in years rather than months, and equities and credit tend to perform as the expansion unfolds. The passing of the elections left investors in search of a new narrative and, aided by good results from the vaccine manufacturers, their focus fell on the business cycle—and I believe this has been one of the drivers of the risk rally.

US stimulus measures

The second driver has been the prospect of major stimulus in the US Last year, the Federal Reserve adopted a "flexible form of average inflation targeting" that will enable it to keep monetary policy loose until there is a substantial improvement in the performance of the economy. Accordingly, given the ongoing challenges posed by the coronavirus, we believe there is little risk of policymakers even talking about tightening monetary policy until the second half of the year. Combined with the outcome of the Georgia senate election (which gave the Democrats control of Congress, making it easier for President Joe Biden to drive through major spending plans), the outlook for fiscal support has improved significantly.

Throughout 2020, the US Treasury significantly raised the amount of cash it holds on its account at the Fed. In effect, this meant that the Fed was implementing quantitative easing while the US Treasury engaged in quantitative tightening. We see significant scope for the US Treasury to reduce its cash holdings at the Fed in order to finance the next spending package, and amid the winter wave of the coronavirus, we do not think the Fed will take any steps to sterilize this operation. In effect, the implementation of the next fiscal package should be fiscal expansion along with quantitative easing—the closest we will ever come to helicopter money (or modern monetary theory).

Vaccine rollout

The last driver of asset prices has been the vaccine rollout. Investors live in the hope that by June we will—at long last—glimpse the coronavirus pandemic in the rearview mirror. Should we be so lucky, this would reduce uncertainty, set free the household animal spirits, and with that create an economic boom.

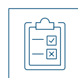
"...there is a risk that we will not be able to put the coronavirus behind us in 2021."

Three key risks that warrant investor caution

Although the three drivers described above provide a strong foundation for risky assets, there are three lurking risks that should make us cautious.

Inflation pressures could build

First, the Biden administration's planned fiscal expansion is extraordinarily large by any historical standard, and a big portion of the stimulus appears slated to filter through to the real economy in the late spring—exactly the time when we expect an organic bounce as coronavirus seasonality allows policymakers to roll back mobility restrictions. Could this lead to a rapid buildup of inflation and financial stability pressures, bringing forward monetary policy tightening? It's possible, but I believe that the Fed will first pause and consider whether any increase in prices is a temporary bounce related to bottlenecks as the economy reopens, or genuine inflationary pressure from an economy that operates at full capacity. In any case, when central banks accommodate anything but very temporary inflation pressures, the currency tends to depreciate. This does not bode well for the dollar—a prime gauge of risk appetite.



Vaccines may not be the panacea

The second major risk relates to the efficacy of the vaccines. On this front, the recent news flow has not been encouraging. There have been multiple mutations of the original coronavirus strain, prompting doubts over the efficacy of the current vaccines. Given that the virus will continue to mutate, there is a risk that we will not be able to put the coronavirus behind us in 2021. In my view, given the rapid buildup of long risk positions in the market, the exceedingly loose fiscal and monetary policy is unlikely to paper over cracks that originate from inefficacy of vaccines due to mutations of the virus. Indeed, should the need for additional fiscal support come to pass, the market likely will challenge the sustainability of the fiscal position of at least a few sovereigns in the emerging markets.

China's stimulus measures may not persist

Our third concern is China. The Chinese economy has staged a spectacular rebound from the coronavirus recession, and we have reached the point where policy stimulus is being rolled back. China is the world's second-largest economy by GDP and easily the largest economy if measured by real resource absorption. On the economic side, one of the key focuses of the decision-makers is to gradually bring the country back onto the deleveraging path to reduce any financial risks that, should they be mismanaged, could present challenges to the incumbent leadership. The authorities have indicated that they will be cautious to ensure that the tightening happens at a measured pace, but given the combination of the change in the credit impulse and historical track record of stop-go policies, we keep a keen eye fixed on China to make sure that indeed the pace of policy tightening is at a measured pace.

"...the path of least resistance is...for prices to continue rising."

An extension of the rally is the most likely outcome

Risk markets have rallied a long way, and rallies come with inflated valuations and a buildup in investor positioning. Overall, however, I believe the drivers of asset prices outweigh the risks and that the path of least resistance is therefore for prices to continue rising. And although it is possible that such a buildup of risk positions will lead to a rapid price adjustment, I would be inclined to see a price correction—provided it is not accompanied by a worsening of one of the risk factors described previously—as an opportunity rather than a sign of something worse to come.

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