Weekly Market Insights

February 8, 2021

Equities rebound, the deficit, and *in bocca al lupo* Mario Draghi!

Equity Markets

U.S. equity markets rallied strongly this past week. The Dow gained 3.89%, the S&P 500 was up 4.65%, and the NASDAQ increased 6.01%. Volatility was down, in marked contrast to the previous week's difficulties. There were a number of reasons for investor optimism. One obvious reason was the absence of volatility created by the extraordinary moves in stocks like GameStop. There was also a renewed optimism that the president's $1.9 trillion spending plan would come to fruition. Last but certainly not least was the slowdown of COVID-19 infections after strong increases over the past few weeks. This slowdown should have been expected, as the earlier rise and subsequent slowdown were predicted by most medical experts. The culprit was the holiday week where increased social gatherings gave the virus an opportunity to spread. Then, after the burst of get-togethers, the slowdown of infections occurred. The rebound in the equity markets was welcome.

The Economy

The progress of the U.S. economy continues to be dictated by the pandemic. Some are amazed that the savings rate has gone up in the face of a pandemic-inspired dramatic increase in unemployment. For the most part, this can be explained by two factors. First, when people are losing their jobs, those who are employed save more for fear they could fall victim to joblessness themselves. Second, the stimulus bill was written so that all families earning under a certain amount would receive a government check without any demonstration of need. So, those who were employed but still received a stimulus check decided to save rather than spend.

This leads us to the current debate concerning the president's proposed stimulus bill. If passed, it would be the largest stimulus bill in history, and it comes at the tail end of an earlier large stimulus bill. There is little question that further support is necessary—the question is, is it too large? The danger, of course, is it may set off an inflationary spiral. This is a possibility. It is reasonable to assume that the vaccination programs will start to inhibit the spread of the virus which will give the economy and employment a boost. We have written quite a bit about how this recession is different from past recessions in that the recovery should be much quicker. Relief checks should be targeted to those in need rather than be distributed to everyone who, in the past year, earned less than a certain amount. In an opinion piece in the *Washington Post*, Larry Summers makes some very compelling points and we will mention just a few. There is a large risk of creating an inflationary spiral, as we wrote earlier. The dilemma suggested by Summers is whether monetary and fiscal policy can be corrected quickly enough, "…if monetary and fiscal policy can be rapidly adjusted to address the problem. But given the commitments the Fed has made, administration officials' dismissal of even a possibility of inflation, and the difficulties in mobilizing congressional support for tax increases or spending cuts, there is the risk of inflation expectations rising sharply."

We think Mr. Summers makes a clear and cogent argument. One interesting point is, if the U.S. does fall into an inflationary spiral, interest rates will get much higher, bond prices will fall, and the Fed can buy back debt at a large discount. That, of course, would be small consolation, given the serious economic consequences that it would engender.

International

There is a quite a bit going on in the European Union and the United Kingdom, but we think what is occurring in Italy is the most interesting and significant. Italian President Sergio Mattarella has asked Mario Draghi to form a new government. This will be a daunting task, even for the highly respected former European Central Bank Chair, who is often credited with saving the euro.

He faces the ravages of the pandemic. Italy has had almost no real growth in twenty years, government debt is expected to be 160% of GDP, and the economy shrank 8.8% last year.[1] He will be dealing with a highly fragmented political landscape with exceptionally wide variations left to right. To top it all, Italy, as with the European Union, faces a longstanding resentment of the south versus the north. Italy is a very young country, the Kingdom of Italy was founded in 1861. The south believed, and still believes, that the north took advantage of them at unification. The south and north are also very different economically. The south is agriculturally focused, while the north is far more urban with a large manufacturing base. It will take all of Draghi's skills as a diplomat, banker, and politician to put together a working government.

We believe this to be a watershed moment because of at least three reasons. First, the obvious outcome in the event of a Draghi failure is that the future of Italy comes into question. Second, a failure can have repercussions for the euro. Third, following on the heels of Brexit, Italy may follow suit.

Conclusion

It seems clear that the world has more confusing moving parts than normal. For American citizens, the U.S. is likely to be best situated for equity investments. As always, investors should keep a close eye on asset allocation and rebalance when necessary.

[1] Statistics from the Financial Times.

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