

Blue wave letdown makes the Fed's job much harder

By: Brian Shaw | November 10, 2020

Boston - Last week's presidential victory by Joe Biden combined with the likely retention of the Senate by Republicans set off a scramble to buy any financial asset not nailed to the floor.

Over the two days following the election, high-yield credit spreads tightened 50 basis points, EM currencies appreciated nearly 2% and the S&P 500 and 30-year US Treasury both gained a whopping 4%. Once investors judged that divided government would lead to much more moderate economic policies and lower interest rates than the consensus blue wave going into the election, valuations everywhere were given an upgrade.

Onus on the Fed

One person who might not be so thrilled by the election euphoria, however, is US Federal Reserve Chair Jay Powell. That's because Powell and the rest of his colleagues at the Fed were probably banking on a big blue-wave stimulus to bail them out of their inflation hole. The prospect of Democrats controlling all branches of government increased the likelihood of up to \$3 trillion in stimulus spending during Biden's first 100 days, and potentially even more in green infrastructure spending after that.

But post-Trump, Republican senators are expected to rediscover their conservative fiscal roots. After a better-than-forecast employment report last Friday, Senate Majority Leader Mitch McConnell commented that the good data "clearly ought to affect what size of any rescue package we additionally do." Stimulus expectations are now sub-\$1 trillion.

This puts the Fed in a pickle. The central bank has implied that it would need to see inflation consistently above 2% before lifting rates. This goal was never achieved during the last economic cycle, despite a decade of very easy monetary policy, an unemployment rate that reached 50-year lows and large, deficit-financed tax cuts from the Trump administration. Additionally, QE — the Fed's easing tool of choice last cycle — will likely be much less effective now, given that 10-year US Treasury yields are already below 1%. Without the big blue-wave stimulus, and the inflationary impulse that would go with it, the Fed will likely be waiting on that hiking opportunity for a very long time.

Still a chance for that blue wave

The blue wave isn't fully dead yet, however. Both Senate races in Georgia will go to runoff votes on January 5, 2021. If Democrats win both races, they would hold 50 seats in the Senate, with Vice President Harris casting the tiebreaker vote on any stimulus bill.

While expectations are that at least one of the Georgia seats stays with Republicans, weirder things have happened this election cycle than another Senate race upset. In fact, political betting markets currently peg the odds of a blue-wave resurrection at 25%. We wouldn't be surprised to catch a glimpse of Jay Powell in the Peach State carrying blue signs in a few weeks.

Bottom line: Without big fiscal spending out of Washington, the Fed will have a hard time generating enough monetary stimulus to hit its newly ambitious inflation goals.

S&P 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of US stock market performance.

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