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Markets and Economy

With Democratic Senate control, market focus shifts to fiscal stimulus

Boston - Just two months ago, the talk was about how the "blue wave" of Democratic victories failed to pan out in the general election. But in the wake of the Georgia elections and the victories of both Democratic candidates, we now have what I call a "blue wave—lite." Democrats will have unified control of the White House and both houses of Congress, but with narrow majorities in both chambers.

From a market and investment perspective, the most immediate focus is on the now-likely prospect of \$2,000 checks as part of a new stimulus package. Presumptive Senate Majority Leader Chuck Schumer said such a measure will be put up for a vote quickly.

The markets yesterday reacted as might be expected in anticipation of more growth driven by fiscal stimulus. The Treasury market sold off, the dollar fell (but recovered some ground today), the yield curve steepened and bank stocks - which historically have done well in curve-steepening environments —rallied significantly. Such moves imply higher inflation expectations and more growth in the short term — a view I believe is basically correct.

Of course, Democratic control also raises the probability of higher taxes and more regulation, which are potential headwinds to medium- and longer-term economic growth. The oscillation between the two factors of greater short-term fiscally driven growth and a new tax/regulatory regime will be a major focus. Bear in mind that relatively conservative Democrats like Joe Manchin of West Virginia could be a counterweight against the more progressive forces in the Democratic Party, especially with control of the Senate evenly split.

We may also see a test of the U.S. Federal Reserve's new policy of inflation average targeting, in which it accepts inflation higher than its 2% target, as compensation for recent years in which inflation has been lower than that. Assuming the Fed sticks to its new stated policy framework and doesn't raise rates right away in the face of rising inflation, it could push inflation into overshooting the 2% target.

Bottom line: In the wake of a Democratic "blue wave—lite," markets will have to balance expectations of fiscally driven growth, higher inflation and the potential drawbacks of higher taxes and regulations.



Eric Stein, CFA
Chief Investment Officer
Fixed Income
Eaton Vance
Management

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