8 February, 2021

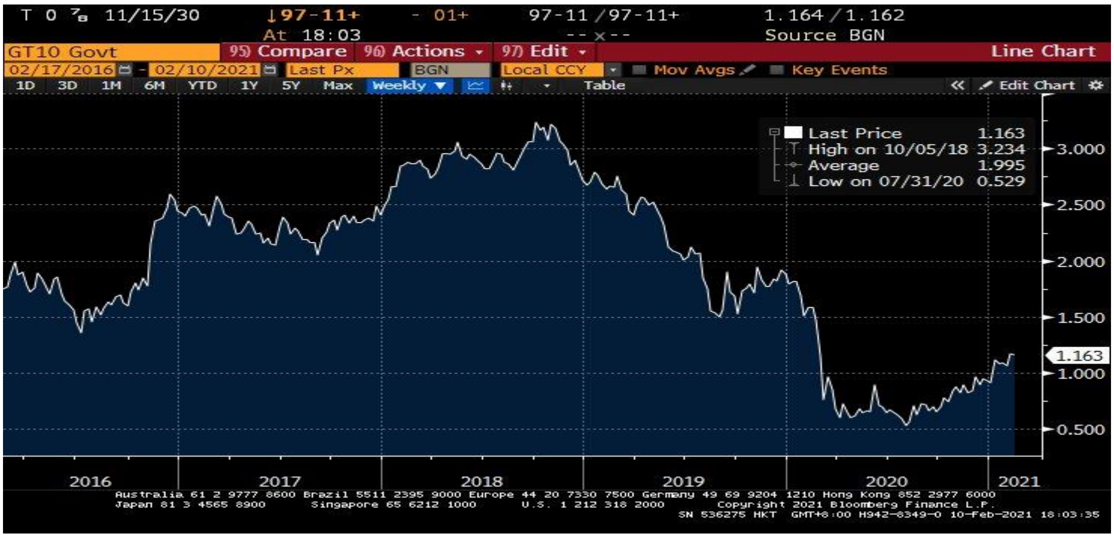
Stimulus is on its way - what is the impact to the market?

The Biden Administration proposed an additional $1.9 trillion stimulus package to address the ongoing pandemic, potentially without Republican support. The budget resolution Democrats put forward to pass from stimulus checks, unemployment benefits, vaccine distribution funds, to state and local government aid. However, the relief package can be a double-edged sword, sustaining optimism for further economic recovery while raising concerns over how the US government will pay for its huge debts. The house speaker said hopefully the package will be passed in mid-march. Treasury Secretary Janet Yellen also said the United States can return to full employment in 2022 if it enacts a robust enough coronavirus stimulus package, but otherwise risks a slower rebound in jobs and the economy.

<u>Bond Yield</u>

Since the market believes that another large scale stimulus plan will be introduced, the inflation expectation has climbed so as bond yield. The selloff in US Treasury further swung the yield curve steeper, with US 10-year Treasury bond yield rose to 11-month high at almost 1.2% (vs. 0.92% in Dec 2020), while 30-year Treasury yield exceeded 2% (vs. 1.64% in Dec 2020) for the first time since the outbreak.

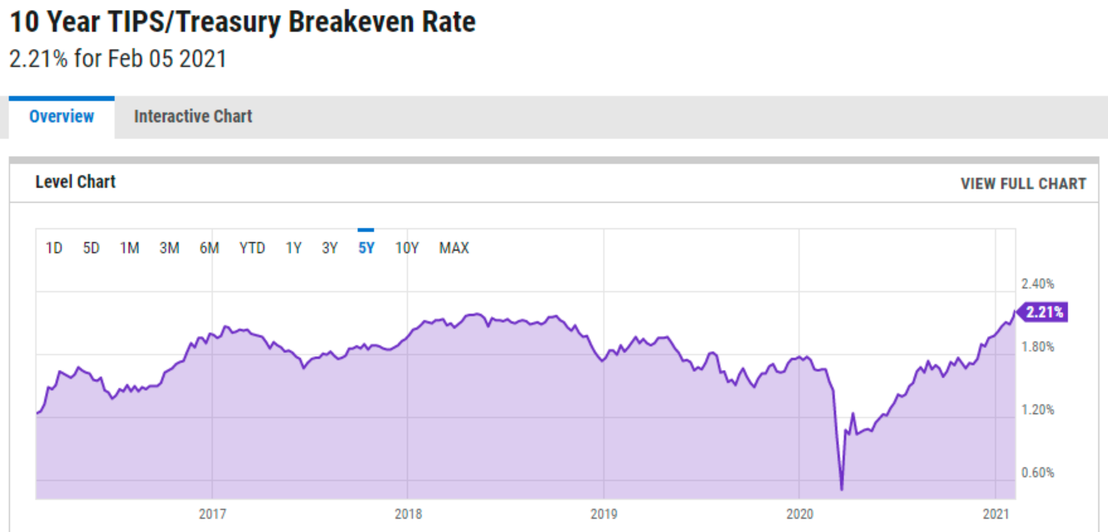
US 10-year government bond yield



Sources: Bloomberg

<u>Inflation</u>

Rising bond yields are arousing concerns of looming inflation signaling the economy begins to recover as 10-year Treasury notes yield spiked above 1% earlier in January which is a very important indicator. Inflation expectations have been steadily rising in recent weeks, 10-year TIPS/ Treasury breakeven rate rose to 2.18%, the highest since 2014 as investors priced in a quicker economic recovery thanks to US President Joe Biden's relief plan. A steeper yield curve also indicates investors are anticipating an economic rebound will occur earlier rather than later.



Sources: Ycharts

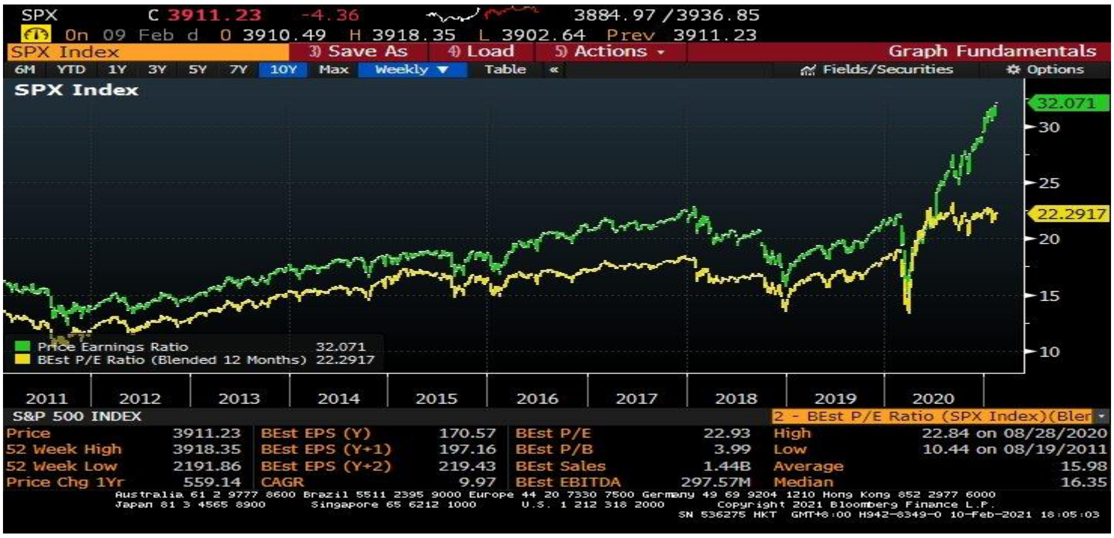
<u>Stock Market</u>

Some market watchers worry about rising bond yield will hinder the bullish of stock market, especially as the S&P 500 had rocketed from the bottom in March 2020 with a 16% gain in 2020. In contrast, some believe that current yields are still far from the level that may drag down stock market. Regarding 1.5% is the level before the pandemic, may be one of the “Game Changers” to the market.

The fluctuations of bond yields are highly linked to companies' earnings growth potential. Rising yields threaten to weigh on the companies with higher borrowing costs which will lower their profit margin. Rising yields may also lead to a downward pressure to companies' valuations and make the current high valuation less likely to sustain. Indeed, the concern for stock valuation has already been spurred that earnings will have to be exceptionally strong in the coming year to justify the lofty multiples. In other words, if yield rises further from the current level, the market concern on high valuation is more likely to burst and may lead to a higher correction risk to the stock market.

Morgan Stanley analyst Mike Wilson said that given S&P 500 index as an example, a 1% increase in 10-year U.S. Treasury yields, the S&P 500 P/E ratio will fall by 18%; for technology dominated Nasdaq 100, the P/E ratio will fall by 22.5%. Therefore, Wilson concluded that the key point is the fluctuations in US bond yields. The stock market will have a substantial adjustment if the yield goes up too fast.

Historical PE (green) & forward PE (yellow) for S&P 500



Sources: Bloomberg

Sources: Bloomberg, Reuters, WSJ, Financial Times, Ycharts

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For any comments, please send email to us at enquiries@amgwealth.com.

AMG FINANCIAL GROUP
40/F, 118 Connaught Road West, Hong Kong
Telephone: (852) 3970 9531 Facsimile: (852) 3426 2650