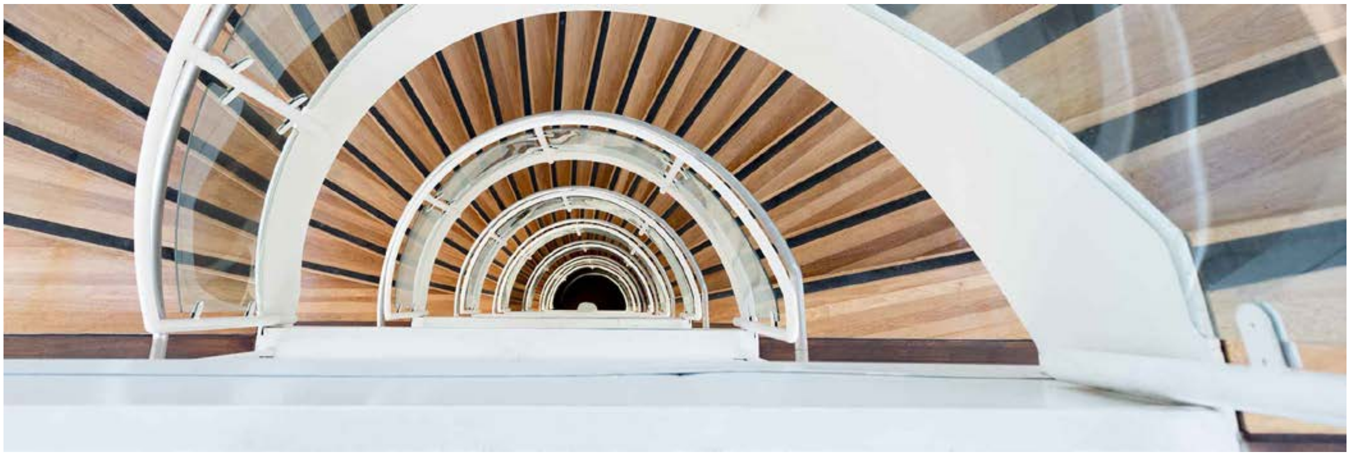
How Might Today's Stimulus Shape the Future?

Posted: 7/9/2020 by Fidelity Investments

History suggests where zero interest rates and big spending may lead.



Key Takeaways

- Since the global COVID-19 pandemic began, the Federal Reserve has lowered interest rates and bought financial assets to stimulate economic growth and help markets operate smoothly.
- The federal government is also spending trillions of dollars on economic stimulus, adding to record high national debt.
- The potential long-term impact of these government policies on inflation and economic growth will be an area of focus in the future.
- For now, inflation is not a near-term concern, due to the drop in demand for goods and services around the world.

Since economic activity began to shut down amid concerns about the spread of COVID-19, the federal government has committed to spend trillions of dollars to try to offset the impact on businesses, consumers, municipal governments, and financial markets. In response, stocks have risen, liquidity has increased in bond markets, and volatility in many markets has fallen.

The longer-term impact this massive policy response will have on markets and the economy remains unknown. To get a suggestion of how deficit spending and low rates might shape the future, though, we can look at how similar policies have shaped the recent past.

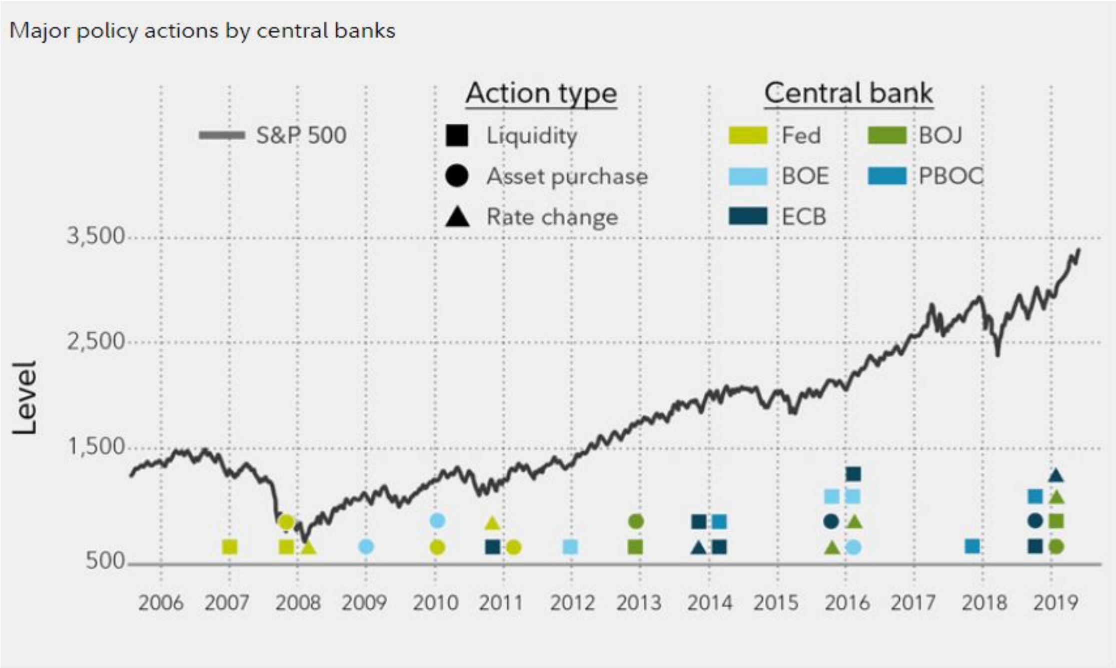
Monetary stimulus: Good for stocks

As the global financial crisis unfolded in 2008, central banks around the world cut interest rates and purchased bonds to stimulate economic growth, increase liquidity in financial markets, prevent deflation, and avoid a second great depression.

While growth eventually recovered in most countries and industries and prices of assets such as U.S. stocks rose to record heights, many financial crisis-era policies were never abandoned. In some cases, such as the European sovereign debt crisis in 2011 and 2012, policymakers expanded these policies to include purchases of a wider variety of assets and even the adoption of negative interest rates under which investors effectively paid central banks for the privilege of lending money to them.

Stocks have benefited from unconventional monetary policies. The recovery of the S&P 500® that accompanied the revival of asset purchases, liquidity injections, and interest rate cuts since March echoes its performance following the financial crisis. In March of 2009, the S&P began what would become a record-setting bull market after the Fed cut rates to between zero and 0.25% and began adding what would eventually be trillions of dollars' worth of liquidity into the financial system.

Stocks have generally benefited from unconventional monetary policies



Fed: Federal Reserve. BOE: Bank of England. ECB: European Central Bank, BOJ: Bank of Japan. PBOC: People's Bank of China. Source: Official government statistics, Fidelity Investments Asset Allocation Research Team (AART), data as of 2/13/2020. All indices represented are unmanaged. **Past performance is no guarantee of future results.**

But while central bank interventions support stocks, they also contribute to a more modest outlook for bond returns, uncertainty regarding long-term inflation, and greater risk-taking by investors. Due to these policies, the total global value of bonds with negative yields rose from zero in 2015 to $17 trillion in 2019. These negative and low yields on high-quality bonds that traditionally attract savers have pushed conservative investors into stocks and higher-risk, higher-yielding bonds.

Besides setting super-low rates, central banks are making large-scale purchases of not only government but corporate bonds, even some with below-investment-grade credit ratings.

These bond purchases also raise questions about whether inflation will eventually result from governments injecting more money to fund continued asset purchases.

Fidelity Managing Director of Research Lisa Emsbo-Mattingly believes investors need to account for risks from both inflation and deflation. "The long-term ramifications of extraordinary policies are highly uncertain, but we see a rising probability of an unprecedented regime shift in economic growth, inflation, or both," she says.

Lars Schuster, Fidelity Institutional Portfolio Manager, says, "For now, we have very few concerns of inflation being a near-term concern for the economy, due to the drop in demand for goods and services. But the potential long-term impact on inflation will be an area of focus as we emerge from the pandemic."

How low for how long?

Does the expansion of central bank balance sheets and government spending mean the U.S. will follow Europe and Japan in keeping rates near zero or even negative?

Fidelity Sector Strategist Denise Chisholm says, "Rates in Europe have a higher probability of being negative, given the higher probabilities of deflation. This can impact the U.S. as well, through increased demand for Treasurys, but the extreme level of stimulus relative to the rest of the world may decrease the likelihood of permanent deflation and negative rates in the U.S."

But while negative rates may be unlikely in the U.S., higher rates that would benefit savers may be unlikely as well. Emsbo-Mattingly points out that central banks have already struggled trying to unwind their extraordinary policies and raise rates. "The Fed's interventions into markets have reinforced investors' perception that central banks will routinely provide liquidity to quell volatile markets," she says.

The U.S. government's fiscal and monetary policy response to COVID-19

Policy initiative	Billions of dollars	Multiplier	GDP Impact
Cash to individuals	290	1.9	3%
Unemployment insurance	250	1.0	1%
Aid to state and local governments	150	1.8	1%
Public health spending	340	2.3	4%
Loans to small businesses	376	1.9	3%
Tax relief for businesses	232	0.3	0%
Targeted industry support	78	1.1	0%
Risk capital for Fed activities	454	N/A	N/A
Total*	2,170	1.7	14%

Federal Reserve policy initiatives in 2020

Increased liquidity to support banks

- Unlimited purchases of Treasury, agency, and mortgage-backed securities
- Support for US and global banks
- Repurchase agreements with global central banks
- Elimination of bank reserve requirements

Expanded or relaunched programs

- Loan facility to support consumer spending
- Primary dealer credit facility to support banks that sell Treasury securities
- Support for money market mutual fund liquidity
- Expansion of support for commercial paper market to include short-term municipal bonds

New programs

- Primary market corporate credit facility to lend to companies and buy corporate bonds
- Secondary market corporate credit facility to enable the Fed to purchase corporate bond ETFs
- Main street business lending facility
- Increase in Exchange Stabilization Fund backstop to $475 billion

*Total multiplier and GDP impact columns exclude $454 billion appropriated to provide risk capital to support the Fed's lending facilities. While these facilities are helpful for financial conditions, their impact on GDP remains unclear. **TOP:** Target industry support assumes the average multiplier for cash transfers and tax relief. The multiplier is defined as the ratio of a change in GDP over a change in fiscal deficit. Source: Congressional Budget Office, Brookings Institution, Fidelity Investments (AART, as of 3/31/2020.

This increased spending comes after the Congressional Budget Office (CBO) had forecast the government would spend $1 trillion more than it would collect in taxes in 2020. That deficit would have represented roughly 4.6% of total U.S. GDP, but the CBO now estimates virus-related spending will push that number to $3.7 trillion or 17.9% of GDP in 2020 and $2.1 trillion or 9.8% of GDP in 2021.

Opinions vary widely about how dangerous deficits are. One controversial but increasingly popular economic philosophy known as Modern Monetary Theory* even holds that countries such as the U.S., whose currencies are not backed by assets such as gold reserves, are never at risk of defaulting on their debts because they can always increase the money supply.

Schuster says, "Longer-term, higher national debt may likely lead to slower growth and low interest rates, but we believe they are extremely unlikely to lead to near-term concerns on the creditworthiness of the U.S. government."

What's next?

While the massive policy response is helping now, Director of Global Macro Jurrien Timmer says it might have unintended consequences. "It could prevent a typical early cycle recovery from unfolding in the months ahead," he says. "If businesses that would have otherwise gone insolvent during a recession survive through policy intervention, maybe the policy response perversely ends up muting the recovery."

"Perhaps the price for all this intervention," says Timmer, "is a post-COVID economy with slow growth and low interest rates. In that scenario, companies with strong balance sheets get rewarded, while financially engineered zombie companies survive but don't thrive. Only the government's footprint is much larger."

What to do

To help navigate whatever the future may hold, we believe you should have a diversified mix of investments, and should diversify your portfolio within those different types of investments.

We suggest your work with your financial representative to define your goals and time frame, take stock of your tolerance for risk, and choose a mix of stocks, bonds, and short-term investments that you consider appropriate for your investing goals.

- * Modern Monetary Theory (MMT) is a controversial idea that countries with a sovereign currency (such as the US) are not operationally constrained by debt accumulation because such monopoly issuers can always create ("print") any monies needed to pay interest on debt (action which critics believe results in inflation or even hyperinflation). A government thus is free under MMT to implement projects or policies aimed at achieving full employment of labor, physical capital, and natural resources. Once an economy reaches full employment, inflation indeed becomes the main theoretical risk; however, MMT proposes that inflation can be controlled via taxes and debt issuance that reduce the money supply. Thus, the theory goes, as long as an economy can supply sufficient labor and capital equipment to meet aggregate demand without encountering excessive inflation, a government can spend without constraint to achieve its social and political goals.
- **Before investing, consider the funds' investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.**
- Views expressed are as of the date indicated, based on the information available at that time, and may change based on market or other conditions. Unless otherwise noted, the opinions provided are those of the speaker or author and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.
- Investment decisions should be based on an individual?s own goals, time horizon, and tolerance for risk.
- *Investing involves risk, including risk of loss.*
- **Past performance is no guarantee of future results.**
- Diversification and asset allocation do not ensure a profit or guarantee against loss.

- All indexes are unmanaged, and performance of the indexes includes reinvestment of dividends and interest income, unless otherwise noted. Indexes are not illustrative of any particular investment, and it is not possible to invest directly in an index.
- Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.
- In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss.
- **The S&P 500® index** is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.