the day after

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How will Central Banks impact the equity markets in the post-Covid world?

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The essential

Interest rates are at an all-time low, and even if inflation eventually picks up, it could take some time. Central banks, the first pillar of the investment cycle, are adjusting and are resolutely accompanying governments in this final battle against deflationary threats, at the risk of losing some of their independence.

The resulting low level of real interest rates boosts risk premiums, supports equities over bonds, and leads to growth stocks being overvalued vs. value stocks. Reducing this excess will be achieved by a rebound in value stocks, which will notably benefit from the steepening of the yield curve in the recovery phase. However, as interest rates will remain low and disruption is now part of our daily reality, it is likely that growth stocks will eventually surprise upwards again in this cycle.

Several risks could disrupt this optimistic reading of the impact of central banks on equities: central bankers' willingness will be tested at the first signs of inflation. Their communication will have to be particularly pointed. A premature about-face on fiscal accommodation by some governments would also raise doubts in the markets. Finally, a failure of stimulus and reflationary policies remains possible; the low interest rate environment is part of the solution, but is also a symptom.

Introduction

In this document, we will examine how central banks are influencing equity markets now that interest rates have tumbled from a record high to a record low in the space of around 40 years.

As their name suggests, central banks play a pivotal role in the economy. Once the hyperinflation of the late 1970s and early 1980s had been beaten, the economies in the world's main countries initiated massive deregulation, financialisation and internationalisation programmes that propelled central banks to the forefront in managing crises and ensuring stability. They have since gradually become an indispensable guide for the financial markets. The more financialised our economies, the greater the influence wielded by monetary policy.

Today, we are seeing another paradigm shift taking place, exacerbated by the Covid-19 crisis: technological disruption, changing consumer practices, overhaul of international relations (particularly between the US and China), growing inequalities, a sharp rise in debt and extremely low interest rates. Monetary policy has become a more crucial source of support than ever, but it is not enough. It now has to shore up budget policy, with all the risks that entails, especially in terms of independence.

It is worth bearing in mind that the development of central banks is far from linear. At the end of World War II for example, we saw a wave of central bank nationalisations, setting aside what Napoleon had to say, which so well captured the complexity of central bank relations with the government: "I want the Bank to be sufficiently in the hands of the government, but not too much." Now the cursor may be moving once again.

So just how do we interpret central bank actions in this context and assess their influence to come on the equity markets?

1. Main central bank channels of influence over the equity markets

To begin with, we would point out that **equity investors and central banks are interested in the same economic indicators** and that there is a special relationship between equity markets and central banks.

The difference is that central banks play a guiding role when it comes to interest rates, and thus have the power to influence the economy. As far as equities are concerned, they have two main characteristics: 1) they anticipate company profits, and thus economic growth. Stock trends thus tend to diverge with economic trends at cycle extremities. Equity market behaviours are in fact among the leading indicators tracked by central banks; 2) equities amplify the signals they receive, and especially central bank signals.

In practice, central banks influence the equity markets in different ways:

- **They can take direct action by purchasing ETFs, for example.** This practice was instituted as early as 2010 by the Bank of Japan (by Governor Haruhiko Kuroda), with the primary goal of lowering risk premiums. This move **stimulated the equity market while also reducing volatility,** as the purchases were made when prices were down. Investing among others in ETFs made up of companies working to reform the government, this measure provided incentive for businesses to trigger a virtuous circle. Especially considering that pension funds were encouraged starting in 2013 to incorporate more equities in their portfolios to generate the returns needed to pay retirement benefits. Given the questions raised by this practice (with the government automatically becoming a major shareholder in a large number of companies, how do you get out of this type of policy?), it has yet to become widespread in the rest of the world.
- **Central banks also influence equity markets indirectly, via policy rates and bond or credit purchase programmes.** Quantitative Easing (QE) has become a classic mechanism of "unconventional" monetary policies since the Great Financial Crisis of 2008. QE acts on equities like a continuous interest rate decline, by inflating liquidity and compressing the profit discount rate, which is supportive for equities as a whole, and **above all for long-duration equities** (growth stocks).
- **Furthermore, because they are at the heart of the banking system, their monetary policy also impacts banks of course,** which serve as one of the key transmission channels of their policy. In addition to their key rate policy or bond buying programmes, they can pressure banks when it comes to their capital ratios, for example, or their dividend policy as regulatory authorities, as we saw this year in Europe during the pandemic, which **weighed on banks' share prices in 2020.**
- **Central banks also play a role as "lenders of last resort",** guaranteeing liquidity in the event of a crisis and thus restoring calm. Acting this time on a preventative basis during the Covid-19 crisis, their hefty intervention was once again predominant, as demonstrated by the **highly positive reaction of the equity markets,** which set a record for both how quickly and extensively it occurred. The role of "lender of last resort" also comes in to play, to some extent, when central banks massively buy up debt to fund governments.
- **Lastly, communication has, over time, become the main channel for disseminating central bank policy.** They became especially aware of the importance of communication in 1994, when the Fed's rate hike played a role in triggering the Mexican crisis. Up to that point, as William McChesney Martin[1] put it, "leaning against the wind" had been the rule of thumb. However, the new implied mission of serving as the guardian of financial stability also means that central banks must avoid taking investors by surprise. Alan Greenspan is famous for once saying "If I've made myself too clear, you must have misunderstood me." The point being to strongly suggest one thing, while leaving oneself a way out. Subsequently, "inflation targeting" and "forward guidance" as used by Ben S. Bernanke and then Janet Yellen went one step further in terms of transparency. Lastly, Jerome Powell very clearly understood that the markets would react to the slightest sign of the central bank's withdrawal after its massive

1. William McChesney Martin, Chairman of the Fed from 1951 to 1970.

intervention in the wake of the pandemic. At a press conference in June 2020, he issued a reassuring statement: "We're not thinking about raising rates, we're not even thinking about thinking about raising rates." As long as central bankers are credible, **their intentions are taken very seriously by the markets.** Hence the introductory remark on central bank independence, which is critical to their credibility.

- **Let's not forget, however, that central banks also make "mistakes",** particularly at cycle extremities. During the Great Depression of the 1930s (low point of the previous long cycle 1896-1949[2]), the Fed tightened its monetary policy twice, once in 1931 and again in 1937, much too soon, each time causing the economy and the equity markets to plummet once again. The same mistake would be repeated by the Bank of Japan in 1994, for example, during its own economic winter which began four years earlier. History will decide if the Fed's rate hikes since 2016 ultimately also prove to have been a "mistake". The decision served as a counterweight to the fiscal stimulus decided by Donald Trump, which was unprecedented at the end of a cycle. The pandemic ended up forcing fate: fiscal and monetary policies were once again aligned, dividing up roles to stimulate the recovery.

2. Specific characteristics of this cycle

Interest rate levels are at an all-time low. In Europe and Japan, rates have even ventured into negative territory, sometimes at long maturities. The disinflation initiated in the early 1980s ended up evolving into deflationary risk after the 2008 Great Financial Crisis. While the 2000 crisis (when the dotcom bubble burst) was addressed by cutting rates, the 2008 subprime crisis was dealt with by introducing unconventional monetary policies, and the 2020 crisis (pandemic) will be handled through a combination of budget and monetary policy. In some ways, it can be seen as the last battle against deflation; in any event, the authorities will pull out all the stops. Stimulating inflation expectations is an essential condition for triggering a virtuous circle. Previous major cycles were launched that way.

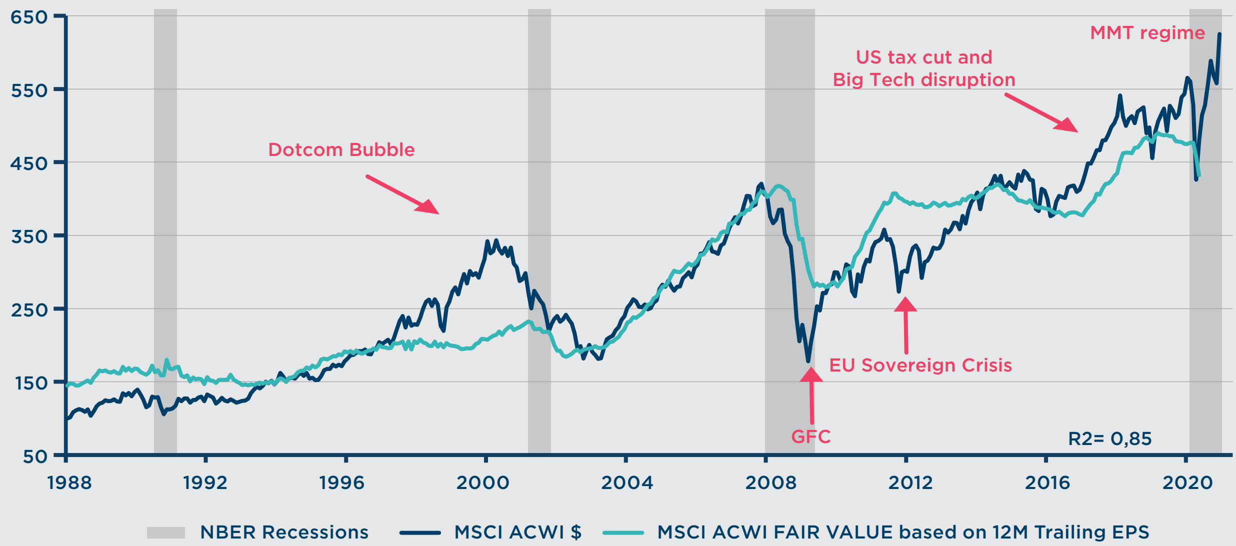
History teaches us that in cases of hyperinflation, for example during the 1970s which marked the high point of the long cycle, monetary policy is the most effective way to manage the crisis and reverse the vicious cycle. Where deflationary risk arises, at the low point of a long cycle, budget policy becomes the best weapon, as was the case in the 1930s. Today, central bankers must first and foremost support governments, which they do by purchasing debt. They also rightly consider that risks are asymmetrical and that deflation should be avoided at all costs. Jerome Powell permanently enshrined this idea on 27 August 2020 in Jackson Hole, when he set an average inflation target of 2%, thus automatically accepting that inflation would have to pass this level before the central bank would step in.

The promise of low rates for long and the ability of central banks to buy up bonds gives the markets a good reason not to worry for now about the level of debt, which will climb rampantly at least until a sustainable economic recovery takes hold.

Inflation will end up climbing, but it could take a while. Central banks have made the bet that the Philips curve no longer applies. Nevertheless, the share of wages in added value, which has fallen to its lowest level since the 1950s, tends to suggest that an inflation reversal is on the way. The social risks accompanying the rise of inequalities (populism, yellow vest movement in France, etc.) will ultimately force it to happen. According to our research, however, there is a delay of several years before this would structurally give way to inflation. Until then, infrastructure investments in the broadest

2. Investment Cycles and Asset Allocation, Eric MIJOT, Economica, 2018.

Figure 1. MSCI ACWI vs. Fair Value



Source: Refinitiv, Amundi Research. Data as of 1 December 2020.

sense of the term (5G, hydrogen, clean construction, etc.) and the echoes of the baby boom era (children of baby boomers having reached the age of major purchases), especially in the US, should generate a positive impact on growth in the next five years, or at least keep this hope alive. It should be noted that long rates, capped at 2.5% from April 1942 to March 1951, gradually made their way back up at the time, but it took 5 years for them to top 3% and 8 years to reach 4%. If the road is at all the same this time, it promises to be a long one.

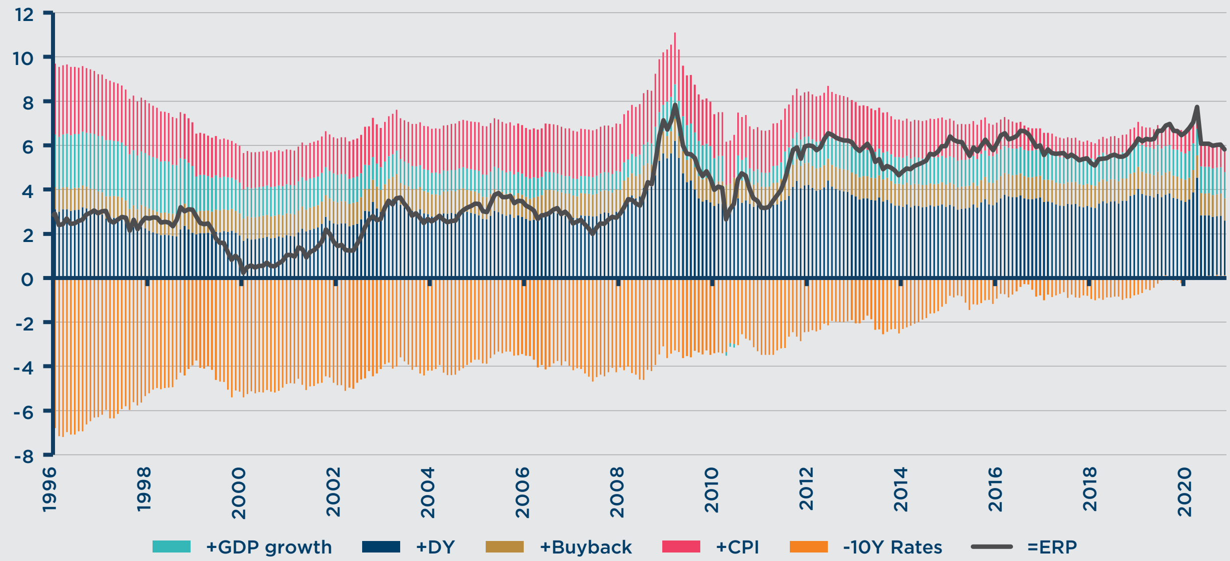
With rates so low, the question is what is the fair valuation level of equities? Judging by the regression between market indices and corresponding earnings per share, the absolute valuation of the equity markets is high (figure 1). It is fairly common for equities to exaggerate trends, thus veering away from their fundamental fair value, upward towards the end of the cycle and downwards at the start of a new cycle. Such was the case, for example, during the dotcom bubble (end of cycle) or at the lowest point of the 2008 crisis. We can thus see that the divergence created today, with the equity markets climbing even though a new cycle has just started, is rather unusual and can be attributed to the low interest rate environment, which is itself unusual.

In fact, these ultra-low interest rates help keep the risk premium[3] attractive, sitting at more than one standard deviation above its long-term average, on both sides of the Atlantic (figure 2). As a result, equities are more attractive than supposedly risk-free bonds; for investors it's the TINA effect (There Is No Alternative), further fuelling the rally.

High absolute valuation levels present similarities, or more accurately symmetry, with the late-1990s bubble. There is a close link between PER equilibrium levels and inflation levels (figure 3). PERs are at their highest when inflation is slightly positive. The higher inflation climbs above this ideal level, the lower PERs fall. Symmetrically speaking, the stronger the deflation, the lower PERs fall as well. And vice-versa. In the late 1990s, the infatuation for the "new economy" combined with low-level inflation led to a bubble. Today, high PER levels can be attributed to the

3. Risk premium = real potential growth + dividend yield – real interest rates
The decline in real rates will help finance debt, thus promoting the recovery and potential growth through investments in infrastructures that will structure our living environment for decades to come. If this virtuous circle is credible, real rates and potential growth help boost the risk premium. The higher the risk premium, the more attractive equities become.

Figure 2. Europe Equity Risk Premium Breakdown



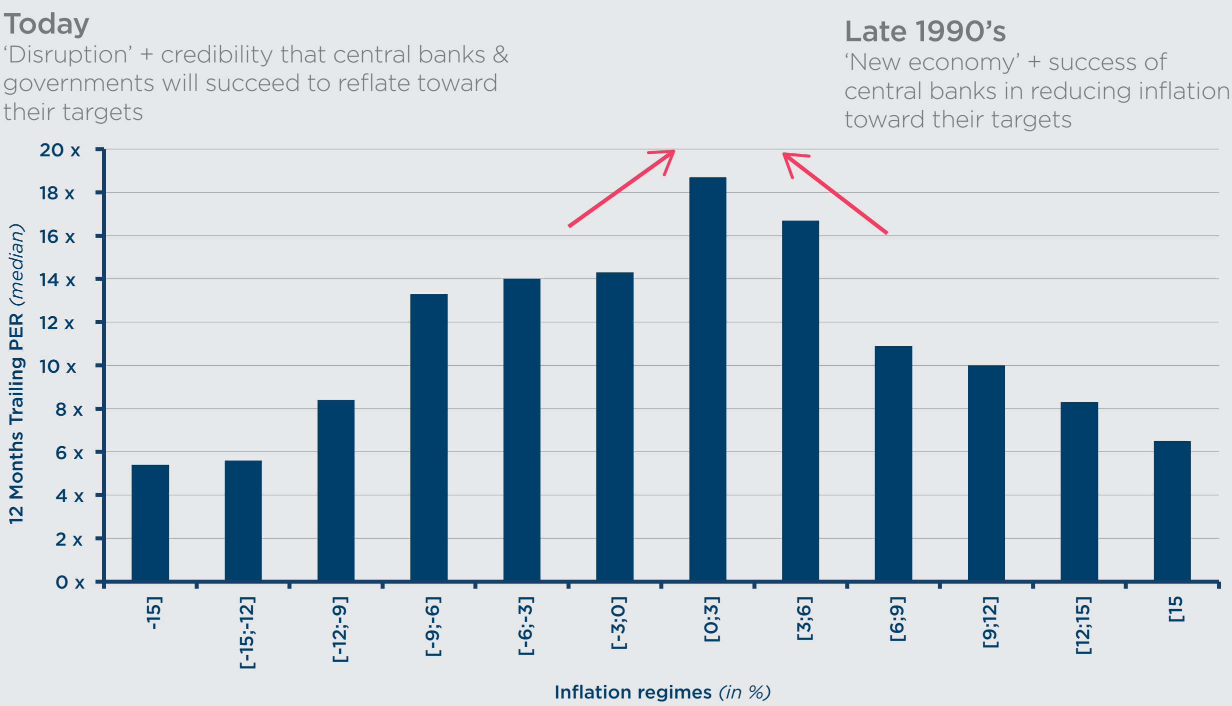
Source: Datastream, Amundi Research. Data as of 26 November 2020.

financial community's acknowledgement of the idea of "disruption" and hopes that central bank and government initiatives to combat the pandemic will wipe out deflationary risk.

However, there are also difference with this period, in terms of sectors or factors.

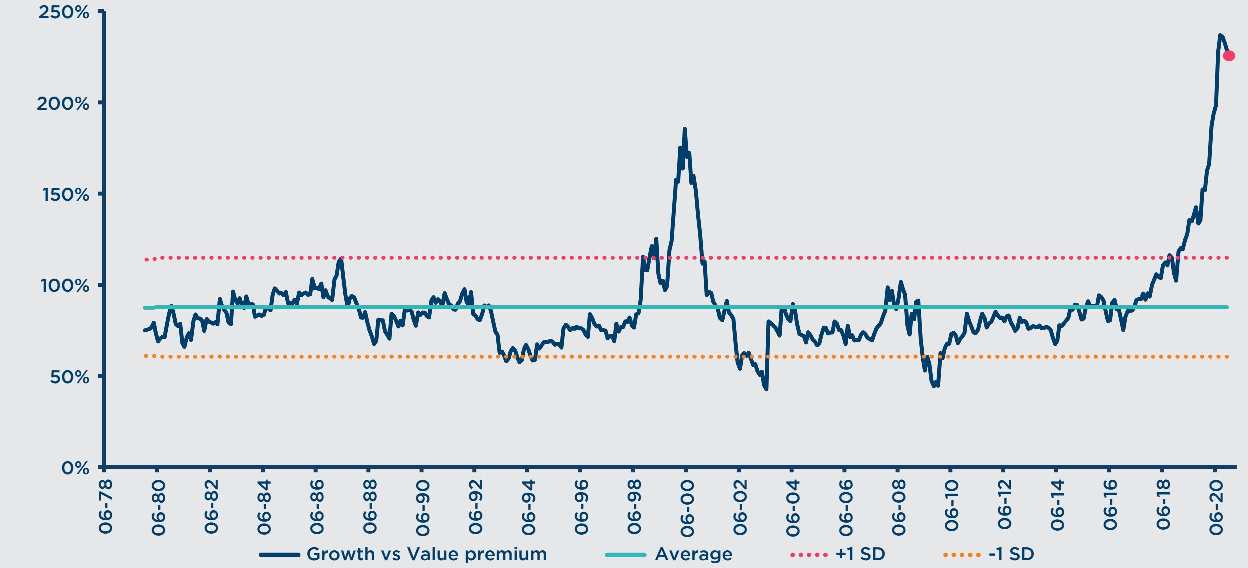
Measured using a composite indicator combining PER, PBV and dividend yield, the ratio of valuations between Value and Growth has never been higher (Figure 4), not even during the internet bubble. The same can be seen at the sector level; there is an extreme performance gap between the US tech sector

Figure 3. PER & CPI in the United States since 1914



Source: Shiller data set, Amundi Research. Data as of 1 December 2020.

Figure 4. MSCI World Growth vs. Value composite premium (PER,PBV,BY)

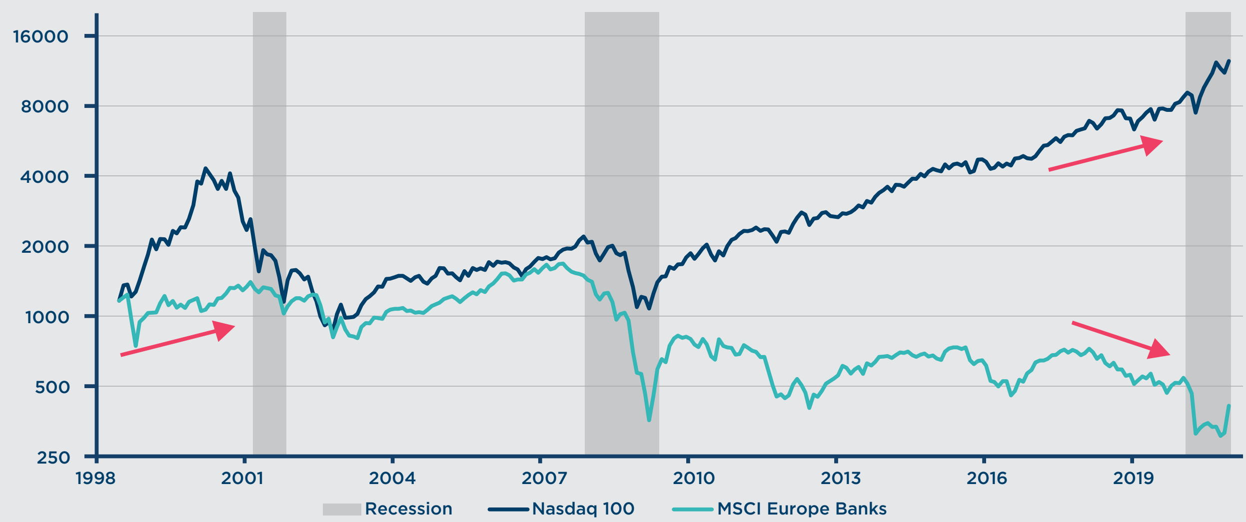


Source: Refinitiv, Amundi Research. Data as of 1 December 2020.

and European banks, for example. This trend was exacerbated by the pandemic, which benefited tech stocks and dragged banks down further.

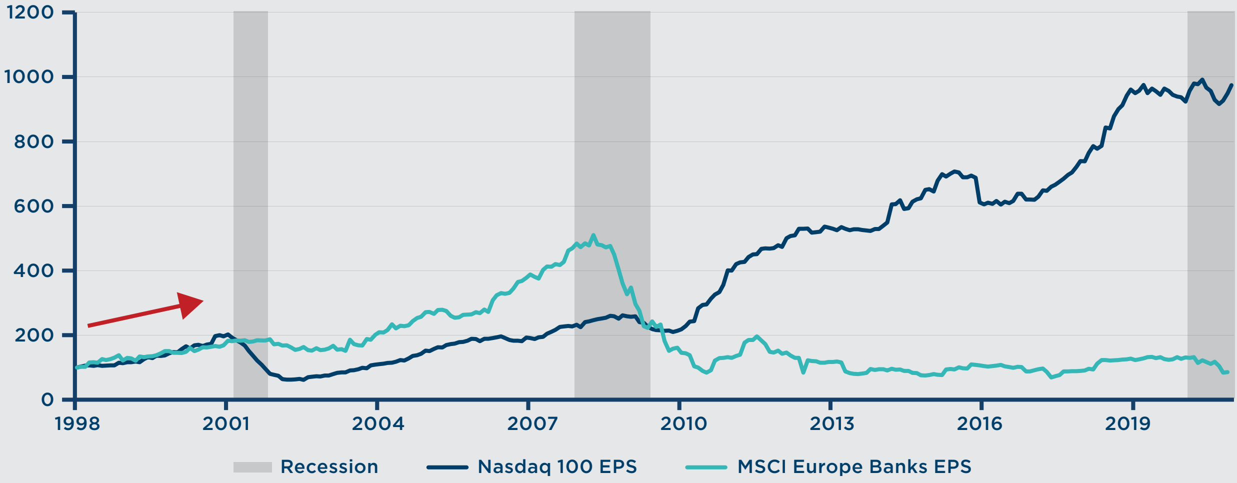
The big difference compared to the dotcom bubble period comes from the fact that in the late 1990s, tech stocks amplified the bullishness of the rest of the market (figure 5). On average, profits in the US tech sector climbed at the same rate as those of European banks (figure 6), but tech share prices deviated sharply upward; during the shock generated by the pandemic early this year, the former shot up while the latter fell, giving rise to the concept of a 'K-shaped recovery'. This gap cannot be sustained over time. Pessimists believe tech stocks are in for a collapse, along with growth stocks in general. Meanwhile, optimists predict that banks will bounce back, together with value stocks in general.

Figure 5. NASDAQ 100 and MSCI Europe Banks



Source: Refiniv, Amundi Research, Monthly data MSCI Europe Banks has been indexed to Nasdaq 100 at the starting point (June 1998) .Data as of 1 December 2020.

Figure 6. NASDAQ 100 and MSCI Europe Banks - EPS



Source: Refiniv, Amundi Research, Monthly data
Both series are Indexed to 100 in January 1998
Data as of 1 December 2020.

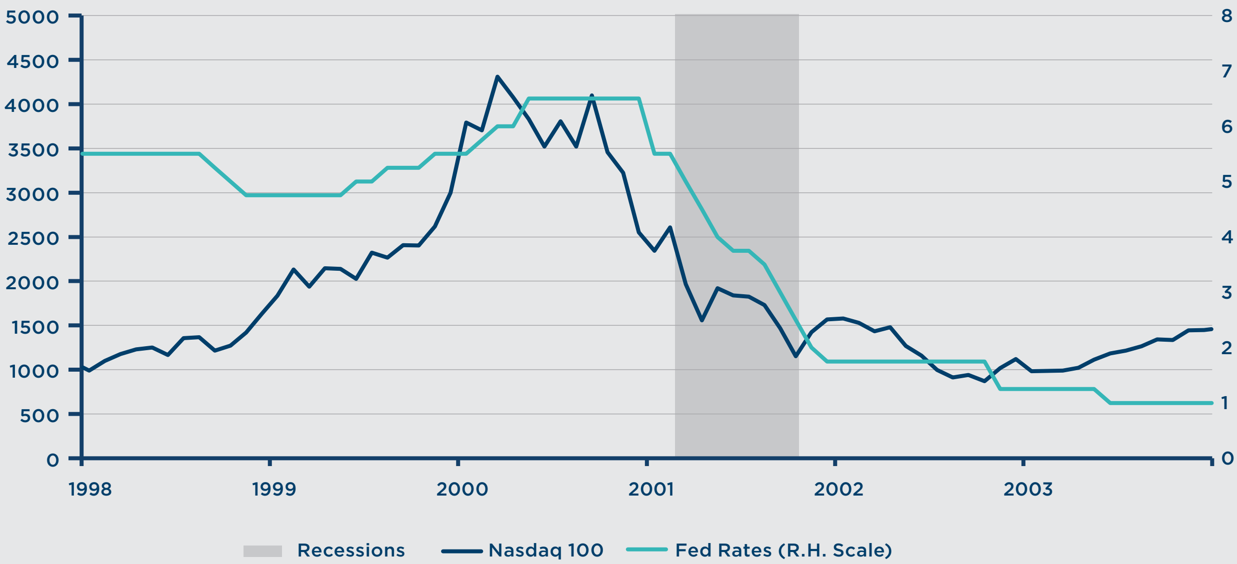
3. What is the most likely pattern for the future? And what are the risks?

The next big step will be pro-cyclical. The nature of the current crisis is unprecedented. Supposing that it comes to a natural end, thanks to a drug or vaccine, we can expect to see a sharp rebound in consumption and the economy in general, which should promote cyclical stocks, small caps and even the Value factor, which has reached an all-time high in its valuation gap with growth stocks.

Moreover, the determination of governments and central banks to promote transition is well established. More will be done if necessary. A return of volatility is possible and will be used by long term investors to increase equity positions as alternatives become scarce.

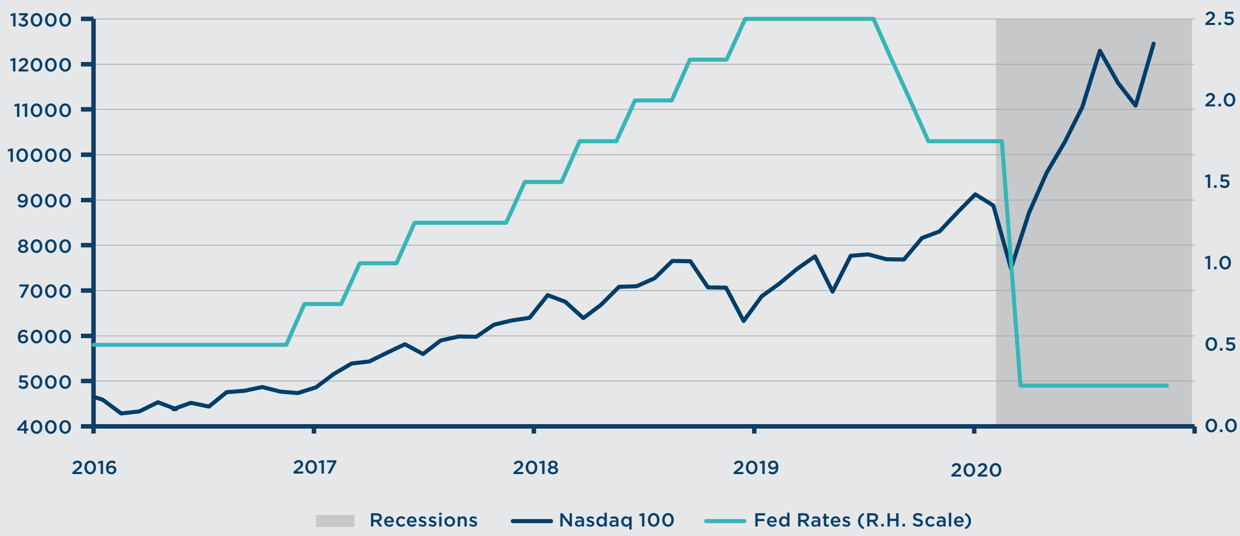
Of course, we shouldn't count growth stocks out too quickly. Bubbles are only recognised after the fact, so we need to be careful before we say it's over. In reality, they only burst when central banks withdraw

Figure 7. NASDAQ 100 and Fed Rates: 1998-2003



Source: Refiniv, Amundi Research, Monthly data, as of 1 December 2020.

Figure 8. NASDAQ 100 and Fed Rates: 2016-today



Source: Refinitiv, Amundi Research. Monthly data; Data as of 1 December 2020.

liquidity (figure 8). Looking once again at 2000, liquidity injections were generous to deal with the 1998 LTCM crisis, then to guard against a potential Y2K bug. The withdrawal of this liquidity then largely contributed to the bursting of the bubble. To hear Jerome Powell tell it, since the Fed is not even "thinking about thinking" of raising rates, a cash withdrawal is certainly not on the agenda for 2021. While communication has become the primary channel for the transmission of monetary policy, Powell's statement also suggests that he grasps the subtlety of his words and will not go back on them any time soon, especially since the inflation target is now an average and it will take some time to see another structural inflation increase.

Central banks are still a key pillar when it comes to understanding future equity market trends, expected to remain buoyant over the next year. Even so, there are a number of risks we feel are worth mentioning:

- **The determination of central banks is likely to be tested when the first signs of inflation arise.** If long rates were to shoot up too fast, they would have a negative impact on growth stocks. In that regard, we would point out that growth stocks have made up a larger and larger share of market indices since the 2008 crisis, in proportion to their outperformance. A sudden shift in interest rates could thus also have repercussions on market indices.
- **A premature about-face on fiscal accommodation by some governments.** The key to resolving the crisis lies not only with the central banks, but also with the governments. In Europe, we can't rule out the possibility of some governments (the "frugal" ones, or even Germany in the run-up to the federal elections in September 2021) adopting diverging positions with others.
- **Conversely, it is still possible that stimulus and reflation policies will fail.** The scope of the plans, and the determination of authorities worldwide should ultimately prevail. But the markets may grow tired of waiting if it takes too long, with stop-and-go lockdown measures for example, which at the very least could generate strong volatility.
- **Finally, the low interest rate environment is part of the solution, but is also a symptom.** Interest rates are partly steered by central banks; they should pave the way out of the crisis and go hand-in-hand with bond purchases to finance budget deficits, which in turn helps keep their level down.

However, this also reflects persistently weak structural growth, which could limit corporate profit potential. Furthermore, low rates and government aid are fertile ground for zombie corporations, making it even more important for central banks to take a very cautious approach when they ultimately decide to change their accommodative stance.

Conclusion

Now in charge of helping governments to boost growth and stimulate inflation expectations, central banks may be seeing their role evolve, but they remain the main pillar of the investment cycle.

As long as the crisis continues, they will provide the necessary liquidity and keep rates low. They may even go as far as capping long rates if necessary, as they did to finance the war effort during WWII. This central bank "put" will prevent the equity markets from falling too low in the event they slide again due to Covid-19, or if the markets grow weary of waiting for governments - much slower than central banks - to take action.

However, the slightest indication of a change in their accommodative stance will be closely examined by the markets. The Fed and its international counterparts will have to be extremely cautious when the time comes. If they are late to act, as they have said they would, and the equity markets rally, we will conclude that central banks and governments have won the latest battle against deflation. Otherwise, we will have yet another example of a "mistake" in monetary policy.

Until then, the right combination for now on the equity markets is to focus on small caps, which always do well at the start of a new cycle, cyclical stocks in general, gradually including the Value style, but maintaining a bias on Quality; that would be one way to account for low interest rates, beyond the likely steepening of the yield curve, while limiting exposure to excessively leveraged names.

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