Assessing the impact of the Blue Wave

- **The conclusion of the two Georgia Senate run-off elections has likely ensured that the Biden administration can move forward with its agenda. The Democrats control the Presidency, the Senate and the House**
- **The net effect will be more fiscal stimulus over 2021 with increase in payments to households, higher infrastructure spending and possible extension of the increase in funding for unemployment benefits beyond the March-2021 deadline that was previously set**
- **We also think that US corporate taxes and taxes on high income earners could go up. However, it remains unclear on whether this will happen immediately in 2021**
- **US economy should benefit from a fiscal push but the effects of that could show up with a lag once a greater portion of the population receives the vaccine. Ultimately, the outlook for the economy will be shaped by the manner in which the pandemic pans out**
- **US core PCE inflation could also trend higher but end-2021 below the 2% mark**
- **We believe that US monetary policy will remain on a pre-set accommodative course with the next step likely to be a lengthening in the maturity profile of the Fed's QE purchases**
- **The effect of a 'Blue Wave' has already been seen in lifting US yields at the longer-end higher as inflation expectations rise. We see a further acceleration of a steepening bias over 2021**
- **We keep our bearish projections on the DXY intact for 2021 reflecting low US real yields and the global reflation trade. However, we see some consolidation in the near-term**

The Georgia Senate results culminates in to the 'Blue Wave': The outcome of the Senate run-off elections in Georgia does have important implications for local policymaking in the US economy. Prior to the outcome, the Republicans had a lead of 50-48 over the Democrats in the Senate. With the two Georgia Senate elections going to the Democrats, it means that the balance has tipped to 50-50 between the two parties. However, the Vice President operates as the Chairperson of the Senate and can subsequently cast the deciding vote if required tilting the balance to the Democrats. **The upshot is that there appears to be a complete Democratic leadership—President, House and Senate—in the US House of Congress resulting in a 'Blue-Wave' scenario.** Hence, the 'Biden administration' can move forward with the Democratic agenda over the next two years until the next mid-term elections in 2022.

Another fiscal stimulus is on the cards: The one conviction that we have is that there is likely to be more fiscal spending in the US economy. The incoming US President and several members of the Democratic Party have already indicated that there could be an increase in the cash handout to households earning less than USD 75,000 per annum from USD 600 that was agreed by Congress in December-2020 to USD 2000 per family that would amount to USD 300 bn to USD 400 bn of additional fiscal stimulus. Further, we also expect the Democratic-led administration to move forward with more fiscal spending that could come in Q12021 or later in the year in the form of infrastructure spending. There could also be an increase in the supplemental USD 300 per week pay-out under unemployment benefits beyond the 31-March-2021 deadline that was previously set. **In short, we see at least another 4% to 5% of GDP additional fiscal stimulus that will be provided over 2021.**

Tax hikes likely but may not come immediately: The other important legislative promise of the Biden administration is that corporate taxes could be raised and an increase in the tax burden for high income earners could be considered in order to meet the higher government spending requirements. However, it remains unclear as to whether that will take place in 2021 or could be pushed to 2022.

Other areas of focus: In addition to the fiscal measures, other key policy initiatives will possibly include:
- Some form of a 'clean energy bill' that could have important implications for the supply of shale oil in the medium to longer term.
- An increase in financial regulation possibly by making appointments to key positions such as in the SEC to ensure that there is a move in this direction.
- We also believe that efforts will be made to step up the pace of vaccination that has been a lot slower than the schedule that has been provided. So far, only 6.3 mn doses of the vaccine have been administered in the US as against a target of 20 mn that was set for December-2020. This would imply that only 1.9% of the total US population has received the vaccine. Given that US authorities want to achieve herd immunity by Q32021 of providing the vaccine to at least 70% to 80% of the population by then, a step-up in the pace of distribution will likely take place.

Shivom Chakravarti
shivom.chakravart@icicibank.com
Phone number: 022-4008-6273

08-January-2021

- We also reiterate that there will be a less confrontational external policy framework with the Biden administration as compared to the Trump administration.

Impact on the US economy: More fiscal stimulus in the form of spending will likely mean a more pronounced pick-up in growth than our initial forecasts. However, we still maintain our call of a very weak showing over Q42020-Q12021 reflecting second wave of infections that will keep mobility and subsequently economic activity depressed. Going in to Q22021 onwards, we expect a sharp uptick as vaccine distribution works to drive pent up demand higher. The cash infusion provided could mean a sharp surge in private consumption over the Q2-Q32021 period. We see US growth picking up from a -3.2% YoY contraction in 2020 to 4.8% YoY in 2021 with upside risks if the vaccine proves effective in building herd immunity. The outlook will continue to remain contingent on the manner in which the pandemic pans out.

The trajectory of US inflation could also be higher. We would not rule out the core PCE index overshooting above the 2% mark very briefly in Q22021 reflecting base-effects but see it ending 2021 well below the 2% mark.

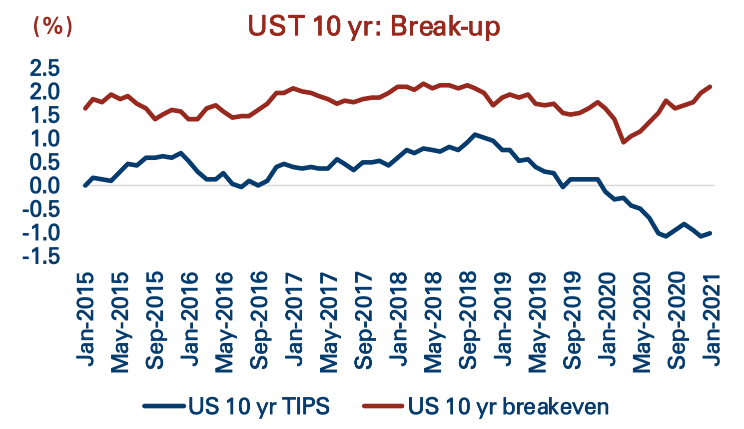
Implications for monetary policy: We do not expect a 'Blue Wave' scenario to have any effect as far as monetary policy decision making is concerned in 2021. The recently released FOMC minutes for the policy meeting that was held over 15-16 December reinforced this message. Most of the committee members have acknowledged the weakening trend in near-term growth but expect some improvement in the medium-term on back of the vaccine role out. We expect the FOMC to maintain its accommodative framework with a next step to lengthen the maturity profile of its QE purchases likely later in 2021.

A pronounced effect on the US rates market: More steepening in the curve on the cards: The major development in 2021 so far has been the sharp upside that has been witnessed at the longer-end of the US yield curve. The UST 10 year has pushed well above the 1.05 mark driven by two sets of factors:

- Pricing in of more fiscal stimulus that could drive paper supply and inflation expectations higher
- Vaccine roll-out that could lift growth in the medium term.

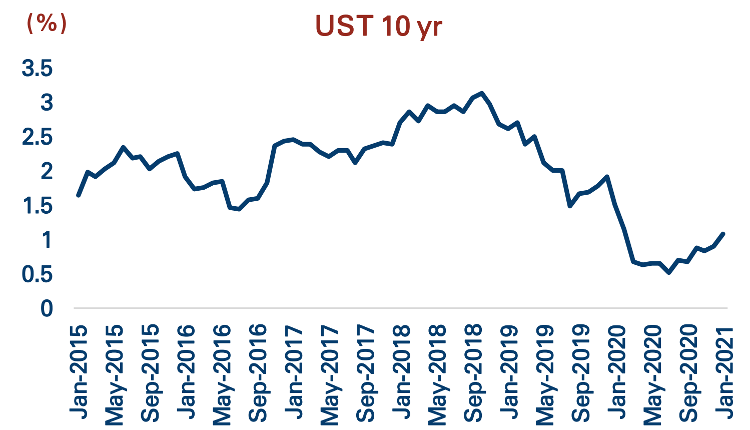
We take note of the fact that the main driving force behind the recent uptrend in US longer-end yields has been a distinct pick-up in 'break-even inflation'. The US 10-year breakeven inflation has moved above the 2% mark as investors price in the 'Blue Wave'.

Chart 1: Break-even inflation rates have been starting to trend sharply higher….



Source: Bloomberg & ICICI Bank Research

Chart 2:…pushing the UST 10 year higher



Source: Bloomberg & ICICI Bank Research

We maintain our call of a further uptrend in US longer-end yields over 2021 while shorter-end yields could remain fairly flat resulting in a more pronounced steepening bias than we expect. We see the UST 10 year moving to the 1.15% mark by Q12021 and further to 1.4%-1.5% range by end-2021 with upside risks contingent on the fiscal policy stance of the US government.

FX framework: Unchanged: We think that the effect on the FX market is less pronounced.

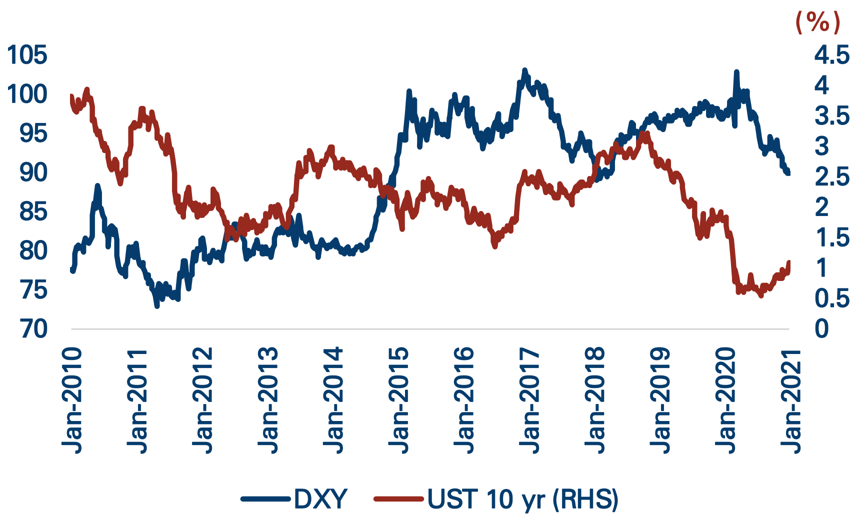
- For one, we do not find a strong positive correlation between the DXY and US yields over a long-period of time. Instead, we find that the DXY has a tighter positive correlation with swap rates and US real yields as measured by the TIPS market. Hence, we are not calling for a trend reversal in the DXY even as longer-end US yields move higher on the back of rising inflation expectations.

- Besides, the negative relation between equity markets and the DXY is likely to remain unchanged.

The upshot is that the environment of: (a) improving global growth, (b) low US real yields and (c) further upside in global equity markets could mean more downside potential for the DXY. We maintain our range of 89.50-91.50 in Q12021 followed by a move to 87.50-89.50 by end-2021 with a downside possibility of 85.00.

Indeed, the DXY has shown some degree of consolidation over the last few trading sessions. However, that can be attributed to media reports indicating that Japanese authorities could consider intervening to stem the sharp rise in the JPY. This has triggered a position unwind. Some range trading in the DXY could persist in the near-term before the next leg lower.

Chart 3: The DXY and UST 10 year: No clear relationship



Source: Bloomberg & ICICI Bank Research

ICICI Bank: ICICI Bank Towers, Bandra Kurla Complex, Mumbai- 400 051. Phone: (+91-22) 2653-1414

Economics Research Group

Economics Research

Shivom Chakravarti	Senior Economist—Global markets	(+91-22) 4008-1414 (ext 6273)	shivom.chakravarti@icicibank.com
Anushri Bansal	Senior Economist—Domestic markets	(+91-22) 4008-1414 (ext 6220)	anushri.bansal@icicibank.com
Sumedha Dasgupta	Economist	(+91-22) 2653-1414 (ext. 7243)	sumedha.dasgupta@icicibank.com
Aniket Gaikwad	Research Analyst	(+91-22) 2653-1414 (ext. 8161)	aniket.gaikwad@icicibank.com
Kaushal Aryan	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	kaushalkumar.aryan@icicibank.com
Asha Sasikumar	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	asha.sasikumar@icicibank.com
Jyoti Sharma	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	sharma.jyoti@icicibank.com
Tanisha Ladha	Research Analyst	(+91-22) 2653-1414 (ext. 7309)	tanisha.ladha@icicibank.com
Nihal Kumar	Research Analyst	(+91-22) 2653-1414 (ext. 7309)	nihal.kumar@icicibank.com

Treasury Desks

Treasury Sales	(+91-22) 6188-5000	Currency Desk	(+91-22) 2652-3228-33
Gsec Desk	(+91-22) 2653-1001-05	FX Derivatives	(+91-22) 2653-8941/43
Interest Rate Derivatives	(+91-22) 2653-1011-15	Commodities Desk	(+91-22) 2653-1037-42
Corporate Bonds	(+91-22) 2653-7242		

Please also note that ICICI Bank (including its branches, and affiliates) is unable to exercise control or ensure or guarantee the integrity of/over the contents of the information contained in e-mail transmissions and / or attachments and that any views expressed in this e-mail and / or attachments are not endorsed by/binding on ICICI Bank. Before opening any attachments please check them for viruses and defects and please note that ICICI Bank accepts no liability or responsibility for any damage caused by any virus that may be transmitted by this email and/ or attachments thereto.

DISCLAIMER FOR DUBAI INTERNATIONAL FINANCIAL CENTRE ("DIFC") CLIENTS:

This marketing material is distributed by ICICI Bank Limited., Dubai International Financial Centre (DIFC) Branch, a category 1 Authorized Firm and regulated by the Dubai Financial Services Authority. This marketing material is intended to be issued, distributed and/or offered to a limited number of investors who qualify as 'Professional Clients' pursuant to Rule 2.3.3 of the DFSA Conduct of Business Rulebook, or where applicable a Market Counterparty only, and should not be referred to or relied upon by Retail Clients and must not be relied upon by any person other than the original recipients and/or reproduced or used for any other purpose.

DISCLOSURE FOR RESIDENTS IN THE UNITED ARAB EMIRATES ("UAE"):

Investors should note that any products mentioned in this document, any offering material related thereto and any interests therein have not been approved or licensed by the UAE Central Bank or by any other relevant licensing authority in the UAE, and they do not constitute a public offer of products in the UAE in accordance with the Commercial Companies Law, Federal Law No. 8 of 1984 (as amended) or otherwise.

DISCLOSURE FOR RESIDENTS IN HONGKONG

*This document has been issued by ICICI Bank Limited in the conduct of its Hong Kong regulated business (i.e. type 1 license) for the information of its institutional and professional investor (as defined by Securities and Future Ordinance (Chapter 571 of Laws of Hong Kong) (the "**SFO**")) customers; it is not intended for and should not be distributed to retail or individual investors in Hong Kong. Any person who is not a relevant person should not act or rely on this document or any of its contents. This document has not been reviewed, authorized or approved by any regulatory authority.*

ICICI Bank and/or its affiliates are full service financial institutions engaged in various activities which may include securities trading, commercial and investment banking, financial advice, investment management, principal investment, hedging, financing and brokerage activities. As a result, you should be aware that a conflict of interest may exist. In accordance with the regulatory requirements and its own conflicts of interest policies, ICICI Bank has in place arrangements, internal policies and procedures to manage conflicts of interest that arise between itself and its clients and between its different clients. Where it does not consider that the arrangements under its conflicts of interest policies are sufficient to manage a particular conflict, it will inform you of the nature of the conflict so that you can decide how to proceed.

DISCLOSURE FOR RESIDENTS IN SINGAPORE

*ICICI Bank Limited, India ("**ICICI India**") is incorporated under the laws of India and is regulated by the Reserve Bank of India. ICICI Bank Limited, Singapore branch ("**ICICI**") is regulated by the Monetary Authority of Singapore.*

As mentioned, ICICI India is regulated by the Reserve Bank of India. Hence, in relation to your dealing with ICICI India, you understand that your interest will be subject to protection of local laws and regulations in India, which may offer different or diminished protection than available under Singapore laws and regulations. You also understand that the Monetary Authority of Singapore will be unable to compel the enforcement of the rules of the local regulators.