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Daiwa's View

Time lag could cause overheated market

➢ Benefits for stocks, but headwind for yields

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Daiwa Securities Co. Ltd.

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Benefits for stocks, but headwind for yields

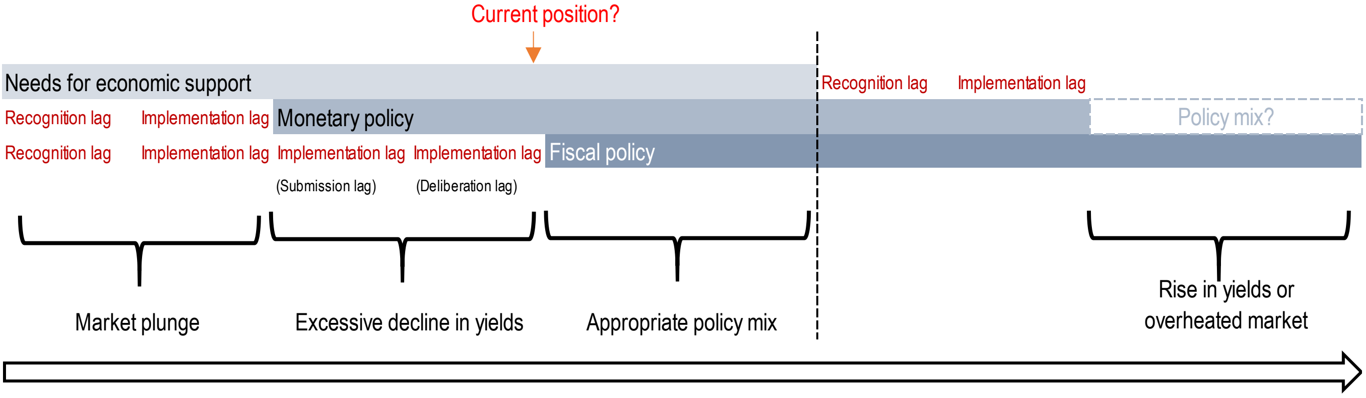
Since the economy is worsening very rapidly due to the COVID-19 crisis, time lags could serve as factors that could sway the market, although their impact is marginal under ordinary circumstances. In this report, I focus on three types of time lag. The more serious the crisis, the more an array of policy measures are implemented, but the shift towards tightening policies tends to come late. Therefore, it is highly likely that the market will eventually become overheated, which is our conclusion. This would bring benefits for stocks, but be a headwind for yields.

(1) Recognition time lag

There is a time lag until current economic changes are reflected in statistics and recognized. This recognition lag is one reason economic measures fall behind the curve in times of economic recession. Recently announced indicators have fallen into an abyss, becoming a thing of the distant past in the face of the rapid developments caused by the COVID-19 crisis.

This recognition time lag means that it is highly likely that a time lag will occur during the coming economic recovery. In the future, the authorities are likely to formulate economic measures by checking economic indicators in the rearview mirror, even after pandemic-response measures are no longer necessary. It's easy to see how this could bring about an overheated stock market. Given the speed of this pandemic and the extent of policy support, this is a particularly important point.

Chart: Time Lag



Source: Compiled by Daiwa Securities.

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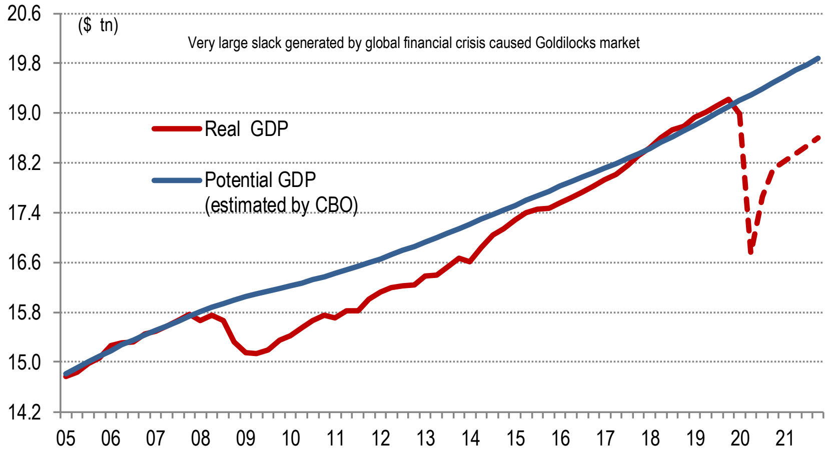
(2) Time lag between real economy and monetary easing

Since central banks place importance on infallibility and accountability, they have a strong tendency to take action after confirming economic deterioration with hard data. However, as I pointed out above, a time lag has already occurred by the time indicators have been announced, resulting in initial action for monetary easing tending to fall behind the curve.

This also means that it is highly likely that we will see a delay in measures responding to the economic recovery that will come in the future. The incentive to take cautious action tends to be strong, particularly in times when we have run out of tools for easing, such as during the global financial crisis or the current COVID-19 crisis. This cautious stance is justified by the widening of the output gap, which closely correlates with the mandate of central banks. As a result, the shift towards tightening policies tends to be delayed.

Chart: US Real GDP and Potential GDP Levels



Source: US Department of Commerce, CBO; compiled by Daiwa Securities.
Note: CBO forecast used for Apr-Jun 2020 GDP.

(3) Time lag between monetary easing and fiscal spending (further issuance of government bonds)

In an economic recession, an array of fiscal policies are utilized in order to escape from the recession. However, since political adjustments for various interests and submission and deliberation of bills are necessary for fiscal spending, the implementation time lag for fiscal policy is generally greater than that for monetary easing. The time lag between monetary policy and fiscal policy causes depletion of government bonds in the near term and a subsequent decline in yields led by supply/demand conditions.

If the public health crisis caused by COVID-19 goes away amid continuous increases in government bond issuance due to the fiscal policy time lag, the market will face a worrying turning point.

The fact that there is a time lag during an economic recession means that it is highly likely that there will also be a time lag during the economic recovery. If the winding down of monetary policy, for which the implementation time lag is small, is discussed prior to fiscal policy, upward pressure on yields is likely to be amplified. On the other hand, if fear of higher yields or YCC policy causes the withdrawal of monetary easing to be delayed in line with the timing of the withdrawal of fiscal policies, that would likely prompt a return to a Goldilocks market or generate a bubble. Currently, the market is heading towards the latter.

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February 2020

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