



What Does Fiscal Stimulus Mean For Fixed Income?

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Interest rates may continue to climb, but some bonds stand to benefit.

On March 11, President Joe Biden signed into law the American Rescue Plan Act of 2021. The \$1.9 trillion stimulus package provides additional relief for the public health and economic crises of the COVID-19 pandemic. This expansionary fiscal policy and dovish monetary measure from the Federal Reserve (Fed) have economists forecasting higher growth, inflation, and higher interest rates. Since bond prices fall as interest rates rise, what does this latest round of stimulus payments mean for fixed income securities?

Simply put, this stimulus package puts more money into the pockets of many American consumers while also lowering their tax bills. The expectation is that this extra disposable income will be spent on goods and services, not saved. The personal savings rate in the United States is 20.5% at present and has averaged 17.1% during the COVID-19 pandemic. For comparison, the personal savings rate from January 2000-January 2020 averaged only 6.3%. The confluence of elevated savings, pent-up demand from a year of lockdowns, increasingly widespread vaccine distribution, and an easing of prior restrictions has set the stage for increased consumer spending.

Our [previous Key Questions article](#) discussed the difference between inflation and deflation. Both result in rising costs for goods, services, and capital. Whether due to deflation (an increase in demand for goods, services, and capital) or inflation (an increase in the money supply that outpaces such demand), rising interest rates come with increasing prices.

The Federal Open Market Committee (FOMC), the monetary policymaking body of the Federal Reserve, implements monetary policy chiefly by setting short-term interest rates and impacting longer-term interest rates by conducting open market operations such as purchasing or selling securities. The FOMC has set short-term interest rates near zero and is purchasing \$80 billion in US Treasury securities and \$40 billion in mortgage-backed securities per month.

US Treasury yields have risen this year as fixed income investors price in an expected increase in inflation, whether inflationary or deflationary in nature. Real economic growth would lessen the need for the FOMC to impact long-term interest rates vis-à-vis security purchases. An FOMC decision to taper its monthly security purchases would support higher rates, putting pressure on some facets of the fixed income markets. That said, other bonds stand to benefit.

One exciting aspect of the American Rescue Plan Act that distinguishes it from previous COVID-19 stimulus packages is its direct impact on the municipal bond market. By setting aside \$350 billion in support, this is the first stimulus package to provide direct aid to state and local governments.

Interestingly, while there had been concern during 2020 over the prospect for serious revenue declines due to lockdowns and restrictions, states closed out the year with only \$1.7 billion less revenue than they generated in 2019. With \$195.3 billion in stimulus funds earmarked for states, the 2020 revenue decline will thus be covered by a factor of 116. The remaining \$154.7 billion in state and local aid will be split between municipal, county, tribal, and territorial governments.

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The American Rescue Plan Act also includes \$170 billion in aid for education, \$30 billion for public transit, and \$8 billion for airports. The return to in-person instruction should help stabilize variable costs for education. Simultaneously, public transit ridership should increase as more people return to urban centers for business and leisure activities. Air passenger traffic has increased as vaccine distribution climbs.

Because of this support and in combination with cost-containment measures and increased revenues, municipal credit spreads are poised to tighten. Further, if municipalities choose to issue new debt, they can do so at a lower relative cost due to these factors. This direct aid allows municipalities to plug budget holes, avoid staffing cuts, and not just recover from the COVID-19 pandemic but grow stronger coming out of it.

Increasing interest rates due to the American Rescue Plan Act of 2021 would put downward pressure on fixed income prices. However, certain issuers should see credit-spread compression as a result of direct stimulus aid. While fixed income has a place in a portfolio when capital preservation and income generation are central to achieving financial goals, selectively will always be important.

For more information, [please contact your Key Private Bank Advisor.](#)



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