InvestmentUpdate

29 April 2021

Biden's 100 days

Why President Joe Biden's next 100 days will be far more important than his first

In his first 100 days in office, US President Joe Biden issued many executive orders to address important issues of racial and environmental justice and, with Congressional Democrats, passed a $1.9 trillion COVID relief bill. These were widely expected: Biden simply did what he said he would on the campaign trail.

If he continues in the same vein, his next 100 days will be far more important than his first. His trillion-dollar plans for spending on infrastructure and social care, together with the trillion-dollar plans for tax increases contained in the American Jobs Plan (AJP) and the American Families Plan (AFP) would have far more profound consequences for the economy and company valuations.

The economic literature on government spending and taxation is full of debate, but not, uniquely, on the multipliers attached to infrastructure spending – around 2x, crowding-in private investment, not out. That's why both Republicans and Democrats like infrastructure programmes. The AJP contains $930bn of what is conventionally labelled infrastructure (transport, broadband, power, and so on). Assuming the other spending proposals have low but broadly positive fiscal multipliers, and that the tax increases fall harder on those with a relatively higher propensity to save, we expect Biden's full programme could lift US GDP by something between 0.25 and 0.75% a year for 10 years.

Corporation tax: don't just focus on the headline rate

Biden's proposals will do more than reverse President Trump's tax cut, even though he is only planning to reverse 50% of Trump's cut to the *headline* rate of corporation tax as part of his Tax Cut and Jobs Act 2017 (TCJA) package. They will return the effective tax rate to the 30-year average prior to the TCJA, thanks to changes to a whole mess of acronyms which stock pickers will have to get their head around this year (GILTI, QBAI, FDII, SHIELD, etc.). Collectively, the tax changes would increase corporate tax revenues by 46% over the next decade and would increase revenues as a share of GDP to levels last seen before the financial crisis.

The Trump tax cut lifted S&P earnings by an estimated 10%. Biden's proposals will cause the effective tax rate to exceed the pre-Trump level and therefore it could shave earnings by more than 10%. However, this will not hurt US companies as equally as Trump's simple tax cut to the headline rate benefitted them. Companies with intangible assets and overseas operations will be harder hit. Tech in particular, but, more so, pharma and biotech, which have a lower effective tax rate than tech. 'Big tech' actually pay a higher effective tax rate than the tech sector more broadly, and that's also something to be aware of.

Could the tax proposals get watered down by moderate Senate Democrats? We think it's highly likely the headline rate hike will – probably to 25% – but not nearly so much as the GILTI (Global Intangible Low-Taxed Income), for example. So that means an even bigger change to the distribution of corporate taxation *among* different sectors.

Big challenges of the next 100 days

Biden has two broad interest groups to placate over the next three months:

1) He needs to convince moderate Democrats that his plans for spending, taxation and increasing the government's role in social care aren't too progressive for their centrist voter bases. Key figures include Joe Manchin, Kyrsten Sinema, Chris Coons, Amy Klobuchar, and Ron Wyden. So far, these congressmen and women have towed Biden's party line, but many have a track record of siding with the Republicans, particularly on budget issues. If they do take some convincing, we may see Biden keep the momentum going by pulling out some of the manufacturing support/anti-China spending from the AJP as well as transportation infrastructure and attempting to pass them in a separate bipartisan bill.
2) A net trillion dollars of prospective spending at a time when the economy is already humming and not too far away from full employment is unnerving some investors. But we think convincing bond markets to stay calm is the easier of Biden's two main challenges. After all, for all the talk of "runaway" inflation, market measures of long-term inflation expectations have barely moved for the last two months. We think equity investors focus on the wrong bond market. They tend to look at 10-year yields. These are important for leadership *within* the market but not broad market direction – rising 10-year yields are usually accompanied by rising equity markets. It's rising short-term real rates that are more likely to choke equity bulls: even the yield on 5-year TIPS (inflation indexed Treasuries) is lower today than it was at the start of the year (see our

recent Insights article [*Who's afraid of bond vigilantes*] for more on equities and rising yields).

The big question few are asking
Is the AJP actually $2.3 trillion of federal spending on infrastructure? We don't know yet how exactly it is going to be funded, and it is absolutely central to the question of how stimulatory it may be, as well as any assessment of its impact of national debt and interest rates. Usually, federal spending only accounts for 35% of total infrastructure spending, contributing by providing grants to state and local governments. The rest is raised by municipal bonds. Both the Treasury and the Senate Ways & Means Committee have said they will revive the Build American Bond programme (BAB), which again is federal transfers underwriting debt linked directly to project-based revenue streams. BAB and municipal bonds have different investor bases and run more risk of crowding out. As far as the federal government and the national debt are concerned, this could be deficit neutral when factoring in the tax offsets.

Not a 'new Marshall Plan'
A large infrastructure programme will undoubtedly see the commentariat write more articles about the benefits of a new Marshall Plan. However, all the articles we have read to date fundamentally misunderstand the current scholarship on why the original Marshall Plan was such a boon to growth. It didn't kickstart the Golden Age of growth because it built/rebuilt a load of infrastructure. The money wasn't large enough for that and arrived after most of the reconstruction had occurred anyway.

It was a success because Plan agencies on both sides of the Atlantic used it to encourage a commitment to internationalisation and trade, which provided the market expansion necessary to encourage the private sector to invest. It was instrumental in establishing an international financial system and helped mitigate financial stability risks. And it also encouraged governments to pursue policies that promoted *private* sector investment, raised economic efficiency, and discouraged central planning.

Infrastructure investment is important today, for sure, but Biden also needs to learn the *real* lessons of the Marshall Plan if we are to fend off secular stagnation, and it's not clear that Biden won't reverse America's apparent retreat from globalisation.

Is debt sustainability in danger?
At an appearance before the Economic Club of Washington, US Federal Reserve Chair Jerome Powell said "The current level of the debt is very sustainable, and there's no question of our ability to service and issue that debt for the foreseeable future" but also that the debt "is growing meaningfully faster than the economy and that's by definition unsustainable over time." We think these comments are muddled (he's a lawyer not an economist after all!).

Japan's debt has been growing faster than its economy for years: while not exactly a poster child for economic wellbeing, when do you hear anyone question its debt sustainability? The reason is that debt sustainability is about ensuring that the total cost of servicing the national debt remains below the growth rate of the economy. While interest rates are low, we think it is right for governments to take advantage of them to invest in projects that are likely to have large fiscal multipliers and boost long-term potential growth.

Any surprises in next 100 days?
Watch for a flurry of bills coming through Congress increasing defence and federal tech spending, justified *explicitly* on combatting China. This could raise the heat between Washington and Beijing again, leading to some market volatility – but, as in the Trump era, unlikely to do any lasting damage to the equity rally.

Biden is the culmination of the Democrats' anti-China shift; arguably, this realisation is not widespread among investors. Global and US companies with large revenue exposure to China did well in 2020, their share prices moving in line with Biden's polling numbers, suggesting a perception among investors that a Biden victory would be good for China. We continue to think this might be a mistake, and indeed performance has been much more nuanced this year.

Biden has pledged to honour multinational agreements, and the World Trade Organisation in mid-September judged that Trump's tariffs on China violated its rules. We may see greater use of non-tariff barriers, tax incentives for re-shoring, and carbon-border taxes. Biden may also return to President Obama's "Pivot to Asia" policy, which was about countering China with a reoriented globalisation, working with other major powers to combat China's bid for economic hegemony. In this regard he may well present more of a threat to China and China-related investments. While we expect western stocks geared into China to continue to underperform, the major beneficiary from Biden's foreign policy may be European assets.

Where Biden may be off track
At a summit of 40 world leaders, Biden pledged to halve America's greenhouse gas emissions by 2030. The AJP contains plenty of green initiatives to help get there, as have Biden's executive orders. But this target is below that enshrined in European Union law and significantly below the UK's. Furthermore, America stayed quiet on adopting the IMF's proposal that countries all need to set a minimum carbon price. And Biden's pledge to lead international efforts to decarbonise also appears tame: Australia, India, Indonesia, Mexico and Russia made no new pledges to cut down on oil, gas or coal; there have been no new multilateral funds to back the clean energy transition; the $1.2 billion of aid offered by the US to low income

countries is a drop in the (slowly warming) ocean of what is needed. We believe climate change is a material risk to financial assets and more needs to be done to address it.

What does it mean for the dollar?
Our long-term framework holds that exchange rates are a function of the terms of trade, relative rates of productivity growth, and relative savings. Insofar as Biden's huge push on infrastructure is likely to increase productivity – and possibly his push to increasing labour market opportunities for marginalised groups too – the next 100 days of his presidency could result in higher equilibrium dollar exchange rates. However, the dollar already starts from a position of overvaluation as far as this framework – and a number of others – is concerned. And insofar as investors may interpret more stimulus as supportive of equities and other so-called risk assets it may push safe havens, such as the dollar, lower.

Previous periods in which both the fiscal and current account (trade in goods and services) deficits have widened have mostly seen the dollar weaken, but the relationship is a complicated one. These periods were also associated with US monetary easing and often relative US economic weakness, making it hard to disentangle the forces truly at work. When these 'twin deficits' widened under Trump, the dollar strengthened. We conclude from this that relative monetary policy may be the dominant consideration for currency markets over the shorter-term – determining the oscillation around the long-term fair value set by the structural dynamics detailed above. We believe that market interest rate expectations are more consistent with previous Fed policy rather than the central bank's new interpretation of its employment and inflation mandates. A reappraisal could lower future expectations for rate increases and renew the dollar's weakening trend.

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