PALOS

Weekly Commentary

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By Hubert Marleau

Commanding Heights and the Showdown Over Taxes

Submitted April 4, 2021

A Snapshot of the Market for the Week Ended April 2, 2021:

The market bought the narrative that Biden's supply-sided package would indeed raise the economy's productive potential by investing $2.3 trillion in its physical and human capital. The spend is viewed as a big positive. On Thursday, the market surged. Moreover, all the economic prints reported big increases in real economic activity, surpassing expectations by wide margins including major ones like the Consumer Confidence and the ISM manufacturing surveys. The Atlanta Fed's GDPNow model estimate for real GDP (saar) in the first quarter of 2021 jumped to 6.0% from 4.7% on March 26, after falling in prior weeks.

The U.S. is poised for a hiring spree. Indeed! March's hotly anticipated nonfarm payrolls report showed that the U.S. economy added 916,000, considerably more than the 650,000 that the consensus expected. On top of that, revisions added 67,000 and 89,000 to the totals for January and February, respectively. Put in perspective, the unemployment rate fell to 6.0% but the labour market remains 8.67 million jobs short of the pre-pandemic level. Thus, the employment situation is too far away from full employment for the Fed to change its monetary prescriptions. Yields on ten-year Treasuries rose 5 bps to 1.72% to reflect the bullish news.

Interestingly, the strength is worldwide. The South Korean exports, a leading and advanced indicator on what is going on globally, jumped 17% in March, the largest gain since 2018 in foreign shipments of Korea's 20 major export items to all markets. Overall, the data of the week is convincingly suggesting that the economic expansion is re-accelerating, pushing investors to bid the S&P 500 to a new all-time high. The index was up 55 points or 1.4 %, ending the week at 4020.

Even though the S&P 500 is up 80% since the pandemic low, it's surpassing only three of the 13 previous full bull runs. According to Bloomberg's data, investors poured $86 billion into equity funds during March, coming on the heels of a record February. The bull is alive.

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High valuations without a corresponding decrease in corporate profit as with rising interest rates without an identical increase in inflation, is not conducive to a bear market. Bear markets are usually associated with high recession and/or inflation risks. Neither exists at the present time. I showed that last week. Because extremely robust economic conditions supporting revenue growth and rising utilization rates of capacity backing operating margins, I've raised my S&P 500 operating earnings forecast for 2021 from $175 to $185, a 32% y/y increase and my 2022 forecast to $205, an 11% y/y gain. The latter takes into consideration a 25% corporate tax rate--a political compromise needed to pass Biden's "America Job Plan". I still have a target of 4350 for the S&P 500 this year and 4750 for 2022.

Commanding Heights:

President Biden wants to fundamentally reshape the U.S. economy with commanding policies aimed at tackling inequality on a grand scale. The $2.3 trillion "American Job Plan" plan is intended to emulate Franklin D. Roosevelt's "New Deal" of the 1930s, and Lyndon B. Johnson's "War on Poverty". He said, "a once in a generation investment in America, unlike anything we've seen or done since we built the interstate highway system and the space race decades ago". For all intents and purposes, Biden positioned the plan as a national security project and as a necessary investment strategy to pace with China.

There are escalating fears that China is about to overtake the U.S.. According to Graham T. Allison, an American political scientist at Harvard University, military conflicts generally result when a rising power challenges an established one. But Willam Overholt, a Harvard economist, is advancing the idea that the geopolitical game has dramatically changed because modern weaponry has become so lethal that gaining power through conquest is longer an option. Instead, the path to world dominance runs through the economy. And, a superior economy depends on first-rate and world-class infrastructures.

Thus, Biden envisions a long term-term federal spending programme that would claim its biggest share of the American economy in 80 years. Based on data from the Office of Management and Budget, the Congressional Budget Office, the Biden's Campaign Agenda, the American Rescue Plan Act of 2021, and the Pittsburgh's "American Job Plan", plus a further $2.0 trillion social program to be announced in a few weeks, federal spending as a percentage of N-GDP could reach 25%+ compared to a consistent average of 20% since the end of WW11. The GFC and the Pandemic were the only two exceptions. To sum it up, the new administration believes that the government knows best. Rather than letting the more accurate price discovery offered by the private markets determine where savings should be allocated, the government agencies will command the direction of capital.

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The “Built America Better” plan is actually two plans. One plan is about infrastructures named “America Job Plan” and the other is about societal inequities (no name yet) which together comprise what may ultimately cost as much as $4.0 trillion---$2.3 trillion one-time infrastructure investments spread over 8 years and a permanent $1.7 trillion social makeover. I have no intentions of going into lengthy detailed discussions on Biden’s big infrastructure plan. A short recapitulation of where the multi trillion-dollar investment proposal will be directed should suffice to see its enormity.

The “America Job Plan” will concentrate on physical capital spending. Within the infrastructure plan, money goes towards roads and bridges, mass-transit systems and railroad tracks, inland waterways including ports ferries and airports. A lot of money will also be geared toward water systems, broadband access, electric vehicles including the electric grid, high voltage capacity lines, clean energy, retrofitted houses and form a national electricity standard. The plan is intended to fund workforce development programmes, expand care for the elderly and disabled and upgrade public schools. Moreover, the plan will provide $500 billion to R&D grants and subsidies for manufacturing investments.

The second part of the “Build America Better'' which will be released in a couple of weeks will focus on a $2.0 trillion program to avert societal breakdown which was brought about by the disproportionate effect of digitalization, globalization and covid-19. In this respect, it is obvious that the upcoming package dealing with redistribution will either be financed with either a more progressive taxation, an introduction of a wealth tax and/or an increase in capital gain taxes which will clearly disfavour the cohort of very wealthy people.

The Showdown Over Taxes:

Given the colossal amount of money which will be needed to fund Biden’s ambitious agenda, tax increases will be inevitable. The plan will spread the costs over an eight-year period but with the aim of paying it over fifteen years, without adding to the country’s long-term debt. The administration argues that if the corporate tax rate were to increase from 21% to 28% and foreign tax loopholes were removed, enough money would be collected to finance the totality of the infrastructure program. Unfortunately, the math is fuzzy. The disconnect between the 15 to 18 year gap is one of several controversies that Biden is facing, especially as he tries to garner bipartisan votes at a time when the federal deficit is already at an historical level.

First, Biden’s tax take will attempt to excite the left, while preserving the middle. It won't be easy to balance his core middle of the road constituents with the progressives--a growing force in the Democratic party.

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Second, the anti-tax Republicans are definitely not going to let that happen without a dog fight. Many centrists in Biden's party want some semblance of cooperation and may push to curb the proposed increase in the corporate rate to less than 28%.

Thus, the plan to rebuild U.S. infrastructure is going to have a difficult path through Congress. Although the public opinion polls show that what Biden is trying to do is extremely popular, the complexity of forthcoming negotiations and the likelihood that the package could be broken into many parts, lawmakers don't see a completion until the fall. Programs do not automatically become realities. They usually become political platforms and only give a sense of direction. Bloomberg's Jonathan Bernstein makes the point that the chances of passing the infrastructure package are enhanced by one striking factor. "It appears that the Democrats have agreed that one of the big lessons of 2019-2010 is that helping a Democratic president look like a success is more important to the re-election efforts of senators and representatives than siding with districts on individual bills or trying to differentiate themselves from the national party. In an age of partisan polarization, the president's approval rating matters more in midterm congressional elections than anything any individual member can do to please district voters. As long as they believe that, they're going to stick together to pass things". In this connection, the Democratic leaders will likely decide to pass a single reconciliation bill to avoid their members having to take two separate votes to raise taxes. Therefore, there will be a lot of public hackling, backroom deals and behind the scene bargaining.

In sum, the Biden tax package is an agenda for votes. Rest assured that the powerful Chamber of Commerce will weigh against higher corporate tax rates while the right-wing think tanks against higher marginal tax rates. Indeed, bankrolling every expenditure solely by soaking the rich and corporations is easier said than done. According to an editorial piece in the Washington Post, there aren't enough ultra-rich and mega corporations out there to fund the massive new economic investment and social services. The American middle class pays much lower taxes than all other advanced economies and the race to the bottom in corporate taxation is far from over. These trends are not slowing. The Tax Foundation reports that several countries have either recently reduced their corporate taxes or are planning to do so--France, the Netherlands, Sweden, Greece, Israel, India, Belgium and many others. By the way, China's overall corporate tax rate is 25%, compared with the combined 32.5% U.S. federal and state rate if Mr. Biden's proposal becomes law.

In Paul Frugman's words, Bidenomics is as American as "apple pie" --infrastructure spending goes back to the construction of the Erie canal in the 1820s. It is likely that the corporate tax rate will end up between 24% and 25% because the popularity of the "American Job Plan'' will engender a national mobilization plan that will be partially shouldered by the ultra-wealthy class, specific funding programs and to a lesser extent the middle class. Additionally, a corporate movement is formally afoot to finance many items in the infrastructure plan in a businesslike fashion--especially in cases where the utility benefit, substitution effect and return rate are

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ascertainable and measurably greater than the cost of capital. That's not that difficult given the low rate of interest environment.

P.S. Incidentally, there isn't much historical empirical evidence proving that changes in the tax code or in tax regimes affect stock market returns, once the initial short-term effect is over.

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