PALOS

CONTENTS

Weekly Commentary

Issue **No. 14** | **APRIL 12, 2021**

Macro View

By Hubert Marleau

The Showdown over Taxes And the Slowdown to Goldilocks

Submitted April 11, 2021

A Snapshot of the Market for the Week Ended April 9, 2021:

The days were relatively quiet because there were few economics prints and the results were mixed. The data signalled more of a whiff of inflation with producer prices risen 4.2% y/y and the jobless claims unexpectedly rose. Yet, the Atlanta Fed's GDPNow model estimate for GDP growth (saar) in Q1 inched up 0.2% to 6.4% from last week. The market was waiting for the earning seasons to kick off next week. The Cboe Volatility Index, which is known as a fear gauge, closed at 16.95-- the lowest level since February 2020. The rapid rollout of vaccines is reassuring investors, speculators and traders that the economy is about to get out of its pandemic miseries.

Monetary and fiscal policies were the topics du jour. Comments from the Federal Reserve and the White House were encouraging. On the monetary front, Chairman Powell vowed that the Fed will not change course until the recovery is completed and the "great economy" is back on track. Also, he played down the inflation risk. Thus the mini coup that the bond vigilantes staged in Q1 which priced in a far more aggressive path of policy rate hikes than the Fed's projection, has faded. On the fiscal front, President Biden has softened his plan to raise the corporate tax rate even though the economic recovery has been fast and furious, and parts of corporate America are having profit windfalls.

The S&P 500 rose 109 points or 2.7% to end the week at an all-time high of 4121. As the Treasury was sending checks out in March, about $500 billion of cash ended up in the banks and money market funds. Given that front-end rates on money are near zero, I suspect that a lot of money flowed into the bond and stock markets over the past week.

Macro View cont.

By Hubert Marleau

The Showdown Over the Corporate Tax Overhaul

Although the economy can withstand some tax increases, which seem to be inevitable, the funding of the infrastructure plan is fuzzy on several counts. Indeed, there is no shortage of potentially contentious elements in Biden's tax plan, but none more so than the tax increases on corporations. The key point for investors is that Biden's tax propositions should be direct and quantifiable.

In the aggregate, corporate cash flows are insufficient to fund fixed business capital formation. For example, during the past three years (2018-2020) businesses invested on average $2.8 trillion per year while cash flows only totalled $2.3 trillion, a $500 million gap. If dividends are taken under consideration, the gap widens to $1.8 trillion.

The gap between spreading the cost over fifteen years to finance eight year of massive infrastructure expenditure is seriously being challenged by left and right because it is difficult to see how it equates at a time when the federal deficit is already at an historical high level. For one, the plan's spending is scheduled to end while the new taxes are intended to last forever.

Powerful and influential "think tanks" like the chamber of Commerce are publicly editorializing their objections. A new analysis of the president's plan from the University of Pennsylvania's Wharton School finds that over the next decade the scheme would reduce growth, capital stock, wages and hours worked.

It is one thing to be in favour of removing tax loopholes, introducing a global tax policy and ending profit shifting to tax havens; but raising the corporate tax rate while other competitive countries are lowering them is another. Biden's tax proposal will make the U.S. corporate tax rate among the highest in the world.

The claim that "ending the global corporate tax race to the bottom" is the name of the game, is false. The countries that really win are those who adopt competitive innovation in the mechanics of their national tax codes--such as depreciation allowances, tax credits for investments, elimination of tariffs on equipment that enhance productivity, treatment of R&D costs and preservation of intellectual property. That is where the actual race is taking place.

Bankrolling every expenditure solely by soaking corporations is easier said than done. According to an editorial piece in the Washington Post, there aren't enough ultra-rich mega corporations out there to fund the administration's massive economic investment and social services. Despite perennial progressive rhetoric that corporations should "pay their fair share," every cent of corporate tax comes from higher prices, lower wages, less investments and dividends. This is straight forward accounting--not theory.

Macro View cont.

By Hubert Marleau

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 ascertainable and measurably greater than the cost of capital. Not that difficult given the low rate of interest environment.

Significant profits and low tax liabilities usually stem from the differences between the definition of income for financial statements and taxes. For example, companies deduct many capital investments for tax purposes, but must depreciate them over time for investors, leading to lower tax payments in the short term. The practice creates a gap between taxable income and book income. What's the point of giving a depreciation allowance to incite businesses to invest if you are going to tax on reported earnings? It defeats the purpose.

Perhaps it is an oversimplification, but the aforementioned points may account for Biden's unimpressive approval rating after being in office for only 80 days. Using the FiveThirtyEight polling estimator, Biden's disapproval ratings began at 34.0% and have risen to 40.0%. The bottom line is that he is doing ok; but no better than that. Therefore, it will be a major political task for him to garner bipartisan votes or excite the left, while preserving the middle to pass the tax side of the "America Job Plan" through Congress. It won't be easy to balance his core middle of the road constituents with the progressives--a growing force in the Democratic party. The tax agenda will definitely be the debate of Biden's tenure. The numbers are huge and proposing them will not be without some cost of political capital. As a matter of fact, ample evidence, historically and globally, suggests countries with progressive tax policies are economic losers, making their politicians electoral losers.

Recent headlines in the press suggest that the Congress and the White House will conclude with a compromise and eventually settle on a corporate tax rate of 24% to 25%.

The Slowdown to Goldilocks

In spite of all the exciting and optimistic narratives that the U.S. economy is in a boomlet environment, many indicators have started to suggest that the growth rate will fall back to the trend that existed before the pandemic struck--that is two percent for growth and two percent for inflation—by Q4. The temperature is rising. Soaring prices being paid for capital, fossil fuel, dollars and commodities to produce goods and services are starting to hurt business. Surges in prices paid have often been leading indicators for a rolling over of an economic cycle. Morgan Stanley expects the current cycle to be short. Supply constraints which will cause sales to be missed and rising input costs raising consumer prices will likely squash consumer demand. There's no way that wage gains for labour will be able to keep pace with any transient surge in prices. Soc Gen's own economic diffusion index is already showing a downturn. Methodical surveys like the Chicago Fed National Activity gauge and the Citi's Macro Surprise Index suggest that economic activity is about to fall back to trend. For the first time in over a year, the

Macro View cont.

By Hubert Marleau

expansion of the world money supply seems to be heading back to its normal growth pattern of 6.0% per year. Over the past six months, its annual pace has fallen to 8.5% compared to 22% three months ago. In my judgement, it's what we need to keep the economy from overheating, to return to normalization, avoid an abrupt recession and bring back Goldilocks, a pleasant scenario for the stock market.

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Macro View cont.

By Hubert Marleau

(An English message follows)

Le Département de science économique et la Faculté des sciences sociales de l'Université d'Ottawa vous convient à la Série de conférences Marleau sur la politique économique et monétaire. Joignez-vous à notre prochain webinaire avec la professeure Emi Nakamura (Université de Californie, Berkeley).

Date : Vendredi 30 avril 2021

Heure : 15 h – 16 h 30, heure d'été de l'Est (19 h – 20 h 30 UTC)
Où : En ligne sur ZOOM
Titre : *The Slope of the Phillips Curve: Evidence from U.S. States*

Résumé

Nous estimons la pente de la courbe de Phillips avec des données transversales des États américains en utilisant des indices de prix nouvellement construits pour les biens non échangeables depuis 1978. Nos estimations indiquent que la courbe de Phillips est très plate et qu'elle l'était également au début des années 1980. Nous n'estimons qu'un modeste déclin de la pente de la courbe de Phillips depuis les années 1980. Nous utilisons un modèle multi-régions permettant d'inférer la pente de la courbe de Phillips agrégée à partir de nos estimations régionales. L'application de nos estimations à l'analyse de la dynamique récente du chômage ne produit pratiquement aucune désinflation ou réinflation manquante au cours des derniers cycles économiques. Nos résultats impliquent que la forte baisse de l'inflation de base au début des années 1980 était principalement due à des anticipations changeantes concernant la politique monétaire à long terme, plutôt qu'à une courbe de Phillips pentue, et que la plus grande stabilité de l'inflation depuis les années 1990 est principalement due à un ancrage plus solide des anticipations inflationnistes à long terme.

Macro View cont.

By Hubert Marleau

Inscription
La participation est gratuite. Il est nécessaire de s'inscrire pour obtenir le lien ZOOM. Une confirmation d'inscription sera envoyée par CITEwebi2@uOttawa.ca.

Inscrivez-vous aujourd'hui !
(l'événement se déroulera en anglais)
Nous avons hâte de vous accueillir!

The Department of Economics and the Faculty of Social Sciences of the University of Ottawa invite you to the Marleau Lecture Series on Economic and Monetary Policy. Please join our next webinar with Professor Emi Nakamura (University of California, Berkeley)

Date: Friday, April 30, 2021

Time: 3 p.m. – 4:30 p.m., Eastern DST (7 p.m. – 8:30 p.m. UTC)
Location: Online on ZOOM
Title: The Slope of the Phillips Curve: Evidence from U.S. States

Abstract
We estimate the slope of the Phillips curve in the cross section of U.S. states using newly constructed state-level price indexes for non-tradeable goods back to 1978. Our estimates indicate that the Phillips curve is very flat and was very flat even during the early 1980s. We estimate only a modest decline in the slope of the Phillips curve since the 1980s. We use a multi-region model to infer the slope of the aggregate Phillips curve from our regional estimates. Applying our estimates to recent unemployment dynamics yields essentially no missing disinflation or missing reinflation over the past few business cycles. Our results imply that the sharp drop in core inflation in the early 1980s was mostly due to shifting expectations about long-run monetary policy as opposed to a steep Phillips curve, and the greater stability of inflation since the 1990s is mostly due to long-run inflationary expectations becoming more firmly anchored.

Macro View cont.

By Hubert Marleau

Registration

Attendance is free. Registration is required to obtain a ZOOM link. You will receive confirmation of your registration from CITEwebi2@uOttawa.ca.

Register today!

We look forward to welcoming you to our virtual event!

Acknowledgement

The Marleau Lecture Series on Economic and Monetary Policy was established in 2019 through the generous contribution of Mr. Hubert Marleau (Palos Management). Please visit our website to learn more about the series.

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