AA View

A big and bold White House
What is the economic and market impact?

Summary

- The new administration's flurry of massive spending and tax proposals shows that it is in a big hurry to make the most of its limited legislative space.
- The recently launched American Rescue Plan's near $2 trillion stimulus is already fuelling excess demand in an economy trying to recover from pandemic disruption. Spending on this scale was bound to raise costs and prices. Stimulus and its inflationary effects will wear off, but there is no denying the big jolt to the economy and markets it is giving.
- The equally ambitious American Jobs Plan and the American Families Plan, with a combined price tag of $4 trillion, need much higher tax revenues to avoid even larger budget deficits. We look at current White House tax proposals for financing these plans, expecting dilution in Congress. The corporation and income tax changes look absorbable, but the much higher capital gains tax rates proposed could have a more negative effect.
- The current economic reopening narrative is obscuring the less positive effects on market conditions from these emerging White House policy initiatives. We expect markets to take another look later and decide that these changes could be challenging, especially coming after earlier very favourable treatment of profits and wealth.

Why the big hurry?

The Biden administration is clearly in a big hurry to make its mark on every front of economic and public policy. Here we are only discussing the economically impacting elements, excluding other public policy areas like vaccine deployment, foreign affairs, immigration and healthcare, etc. Even after doing this, 'ambitious' appears too weak a word to describe the administration's plans launched in its first 100 days. The *American Rescue Plan* (ARP) which seeks to spur recovery from COVID-19 went first, being launched pre-Presidential inauguration day in January to get a head start. The *American Jobs Plan* (AJP) to help blue-collar job creation through an infrastructure spending program and the *American Families Plan* (AFP) to strengthen social safety nets and its related *Made in*

Market data source Factset and Bloomberg
The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

AON
Empower Results®

America Tax Plan have all followed quickly. These are all on a massive scale and scope, with huge economic implications.

Getting an early start makes sense for the new administration given its limited political capital (a majority of six in the house and just one in the Senate from using the Vice President's vote). The objectives are to get rapid recovery from the Pandemic and even modestly positive electoral success from the passing of (Senate-GOP diluted) legislation, given the soon to loom test of the November 2022 Midterms. Biden is doing all that is possible to avoid the fate of the Obama administration's first term when the 2010 Midterms scuppered its plans and brought in gridlock.

To make its mark and secure more political capital in such a short time is hard. Initial omens are not good. The American Rescue Plan passed without a single GOP vote in support. That it even did so was helped by it being unfunded by tax rises. The other spending plans are, at least on face value, mostly funded by tax rises, and so face a much more difficult ride.

Sticker shock

The cost of these ambitious White House plans - $1.9T for the Rescue Plan, $2.3T for the America Jobs Plan and $1.8T for the American Families Plan, a total sum of $6T, is producing widespread 'sticker shock'. Yes, the Jobs Plan spans a near decade, but it is still spending. The total planned expenditure is over 25% of likely 2021 US GDP, one way to put this in perspective. The ARP is already unfolding even as the US budget deficit for the last fiscal year was over $3 trillion, 15% of GDP, a peace-time record and a similar number for 2021 fiscal year is now being pencilled in. Against this deficit backdrop, it is hardly surprising that the AJP and AFP raise questions. Both appear on paper as substantially funded by taxes, but there is doubt over whether the higher revenues will fully materialise (see below). Republican and even Democratic resistance to these programs is, therefore, assured even before legislators wade into the detail of the sweeping spending and tax changes planned. Dilution to the AJP and AFP seems very likely, which we can assume the Biden administration will have allowed for.

What could go wrong?

What we are doing here is taking plans at face value as we cannot predict what final outcomes will be. We weigh up criticisms and discuss the market and investment impacts of the plans as they stand. The specific plan proposals, especially within the AJP and AFP have come for a lot of comment, but the high-level criticisms of the ARP, AJP and AFP are:

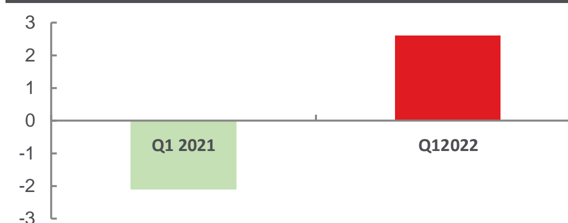
- The first is over the already implemented $1.9 trillion ARP package. The criticism is that this is too large, its timing poor, causing the economy to overheat and bringing higher inflation and hurting markets.
- The second is over the planned tax increases that are to fund the AJP and AFP. However worthy the objectives behind the plans, the criticism is that the proposed tax increases to finance them will be distortionary, raise far less revenue than expected (so raising deficits further), weaken profit motives that are key to US business dynamism, ultimately also hurting the economy and stocks.

ARP spending explored

Economy impact

The vaccination rollout in the US since January has been very successful. By the time the Biden stimulus cheques arrived in mid-March, the US had already vaccinated almost a quarter of the population with an accelerating daily vaccination rate. In December, the outgoing administration had already put through a $900bn stimulus. Adding the $1.9 trillion under the ARP and taking the December and March stimulus together, at about 13% of GDP, does look like stimulus overkill. It has clearly galvanised the growth outlook, putting the economy on steroids. Consensus 2021 US GDP growth forecasts are up from the upper 3% range at the start of the year to well above 6% currently, as forecasts shoot higher to allow for the massive additional spending.

GDP likely to exceed potential by early 2022 thanks to massive stimulus (Output gap as % of GDP)



Source: CBO, Brookings

What are the effects of such excessive fiscal stimulus? One apt phrase here is 'excess demand'. Putting so much stimulus into a reopening economy with pent up consumer demand (the personal savings rate is over 20%, three times normal), but where 'supply' in the form of production chains of labour, business and industrial capacity is disrupted from the pandemic, is a textbook recipe for excess demand. It is bound to raise costs and measured inflation for a while. A measure of spare capacity known as the 'output gap', using data on actual versus potential GDP shows GDP moving to well above potential by early 2022 (see chart above). This trend chimes with many businesses reporting cost pressures in supply chains in the last month, unable to ramp up capacity after the pandemic's disruptions (q1 2021 company mentions of these cost pressures in analyst briefings were widespread according to FactSet).

This is not higher inflation as such, which is a *sustained* period of price rises. It is more a *faster rise in the price level for a time*. For now. though, it will look and feel like higher inflation as the

Market data source FactSet and Bloomberg
The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

measured inflation rate rises. It is happening because large fiscal stimulus is colliding with an economy trying to recover from strained supply conditions. Yes, supply will eventually catch up, and stimulus effects will fade, which will reduce excess demand. Right now, however, cost and price pressures are clearly strong

Is this a major economic setback? Or just a roadblock as the economy tries to adjust to these divergent trends? It should be the latter, i.e. temporary. These supply-demand pressures are 'inflationary' in the next year or two only. The ingredients for a sustained period of higher inflation over a longer period, which would be a more serious development, one that the financial media are currently flagging as a big risk, are not in place. As we know, some parts of the economy will take much longer to heal, the stimulus effects of ARP spending will fade going into 2022, the labour market looks unlikely to generate a sustained spiral of wage inflation, and even commodity prices, firm as they are today, are unlikely to carry on moving much higher.

Market impact

Even if the ARP's economic effects are temporary, it is having important market effects and and it will likely continue to be an area of investor anxiety for a while. The impact channel is mainly, though not entirely, via interest rate markets.

- *Inflation concern*: Even if we are right that rising inflation ultimately turns out to be temporary, implied inflation in bond markets is already much higher. The problem is that it currently looks and feels like higher inflation making the markets uncertain about how temporary the trend is.
- *Higher bond risk premium*: Investors are applying a higher risk premium to US government bonds, from concern that large fiscal deficits and rapidly rising public debt increases incentives for US policymakers to tolerate higher inflation, as a good way to reduce the debt burden in real terms.
- *Pressure on risk asset valuations*: Higher bond yields could pressure risky-asset valuations (credit and equities). The high valuation world we are in is a consequence of low bond yields. If these are suspect in the ARP world, a valuation challenge is likely. So far, this is only apparent in underperformance of market losers from higher yields.
- *Pressure on the Federal Reserve to tighten policy:* Economic overheating from the ARP might pressure the Federal Reserve into tightening monetary policy earlier and faster if rising prices become ongoing. Risk assets are more sensitive to short-term rates than bond yields so this is a big thing. More immediately, the Federal Reserve's rate of bond purchases would need to fall before rates rise, which poses an early challenge to bonds if deficits (and Treasury bond supply) remain large going into 2022.
- *Companies reporting cost and margin pressures.* This is coming partly from the impact of the ARP and earlier stimulus that is showing up in higher input costs and prices.

All these effects are evident from what we have seen so far already (see table below). The key question, of course, is whether they continue and for how long. It looks as though we may have a difficult ride over at least the next year, even if over time, these concerns ease. The problem here is that unlike economies, a year is quite a long time in markets, and the ARP and its follow- through impact remains a challenge from that viewpoint. More of what we have seen, shown in the table, remains very possible, even likely, a backdrop that encourages volatility spikes for markets even if they do not put markets on an outright negative course. There is support on one side from stronger economic growth and the boost to sales flowing from all this fiscal stimulus; on the other side there is the unsettling effect of higher discount rates, and cost/inflationary pressures which might eat away at profit margins.

How the ARP has changed market conditions

	End 2020	May 2021
20y breakeven inflation	2.04%	2.48%
10y bond term premium	-32bps	+48bps
Technology vs financials (MSCI World Index)	YTD tech underperformance of -24%	
1st Fed funds rise expected	None till at least end 2025	1st rate rise in mid-2023
ISM manufacturing price index	77.6	89.6 (highest since 2008)

Source: FactSet, Bloomberg

The bottom line is that the ARP has jolted both the economy and markets, and some of the criticism of too much stimulus at the wrong time is valid.

AJP and AFP tax financing explored

Here, we are referring to higher taxes on corporations, higher incomes and capital gains. However worthy the objectives on infrastructure upgrading and improving average family working and living conditions, they need financing with much higher tax revenues on an ongoing basis. These tax proposals do go at face value towards full program financing, but they raise questions on revenue delivery and side-effects. They will be diluted, possibly quite heavily as they go through Congress, but some version of higher taxes in all three areas will likely prevail.

Economic impact of higher taxes

Higher corporation tax: The proposed increase, from 21% to 28%, along with a minimum 'book' profits tax of 15%, and a doubling of taxes on global intangible incomes (GILTI) are expected to largely fund the AJP. Even if the 28% proposal went through as is, rates would be below the US average of the last three decades. Against OECD peers, even a 28% rate is more middling than high. More to the point, the effective corporate tax rate for many profitable companies in the US has been well below the headline rate thanks to profit shifting to lower tax jurisdictions (which the minimum book tax seeks to curtail), multiple other loopholes, and the way many are taxed as 'pass-through' entities attracting a lower effective tax rate. This explains why the US has a low corporation tax take (see table).

Market data source FactSet and Bloomberg
The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

The US's corporation tax take is typically low
(corporation tax revenues as a share of GDP)

	US	OECD average
2018-19	1.0	3.1
2013-2017	2.0	2.9
2000-2012	2.0	3.0

Source: OECD

Will this rise in corporate taxes hurt the economy? The role such taxes play on companies' employment and investment behaviours is complex and there is little agreement on their impact, except at very high or very low levels. The Trump administration's large corporation tax cut in 2017 did not stimulate business investment. Likewise, this partial reversal of that tax cut is unlikely to be doing that much damage, even though reported earnings will be a little lower in aggregate (see below). The bigger question is on whether the higher revenues fully materialise. Tax competition between different economies still allows scope to reduce tax liabilities. Without an international agreement to limit tax competition[1] the revenue gains may fail to come through in the way the administration hopes. Independent revenue estimates from the proposal for higher corporate taxes are currently ranging from $1.1 to $1.5 trillion over the 2021-30 period, somewhat short of what is needed to fund the AJP.

Higher income and capital gains taxes: This is the main funding source for the AFP**.** This is targeted specifically at individuals making over $400,000 a year - affecting the top 1% of taxpayers, and in the case of capital gains tax (CGT) changes, even higher up the income scale.

The income tax changes only restore the top personal income tax rate to where it was prior to the cut brought in by President Trump (39.6%). The CGT changes are, however, a much bigger deal. This is because the top rate of long-term capital gains would double, from the current 20% to just under 40%. Adding in the 3.8% Medicare tax and allowing for state level capital gains taxes, several states would have effective CGT rates of well above 50%. In addition, the proposed changes appear to end the exemption on unrealised capital gains passed to heirs.

What is the likely economic impact of such a sharp rise in capital gains taxes? Much like corporate taxes, the behavioural impacts of higher CGT on individuals are hard to gauge. There will probably be some adverse impact on entrepreneurship (start-ups in Silicon Valley come to mind), and some reduction in the willingness to invest at the margin. Even if the changes only impact the wealthiest 0.5m households, this is still picking up a lot of US business entrepreneurs. Against that many will find ways to reduce CGT due and pay less. The expected $142bn revenue uplift in 2022, if the proposed raising of the capital gains and dividend rate for taxable incomes of $1m+ (and unrealised capital gains left to heirs) is passed, may in fact be raising less than half of that, allowing for tax avoidance[2]. In many ways, this suggests that that the CGT proposal is more a totemic push-back against high wealth inequality than a major revenue raiser. Legislative passage will likely pull the planned CGT rate lower, but all told, a rise to anywhere near such high levels is risking at least some economic damage over time.

Market impact of higher taxes

Higher corporation taxes will likely leave some impact on after-tax profits for quoted stocks. Most analysts appear to think this impact will be modest, of the mid-single digit type variety on reported earnings. Stocks have not reacted adversely to the corporation tax proposal, arguably because other more profit sensitive factors – interest rates and the economic recovery are having a far bigger near-term impact. Judgement may be on hold until the final shape of the corporate tax regime change is clearer. However, there was a bad reaction to the CGT proposal announcement on April 23, albeit for one day's trading only. There is indeed widespread concern that the CGT proposal has raised the required rate of return for wealthier investors to buy and hold stocks, even though the profits rebound has helped override this for now.

At a high level, the change in the tax environment for companies and businesses, and for the wealthier investors who own most stocks (Federal Reserve data for Q1 show that the top 10% of households with the highest net worth held 88% of US equities), is probably more important than the current market's collective shrugging of shoulders would seem to indicate. The changes are significant, more so because it is a big shift, coming after a period when profits and individual wealth attracted, even by US standards, unusually preferential treatment.

Just as important, the market must digest not just these tax changes but several other key policies – stronger anti-trust enforcement and regulation, climate-related policies and other initiatives such as labour and family-friendly measures. All of these will increase business expense. In combination, these changes do pose market challenges in our view. Currently, the equity market is supported by the vaccine, economic recovery and the policy stimulus narrative. Once this narrative starts to have a diminishing impact, which may not be too far away, it would not surprise to see much more of a focus on these tax and other changes. This does not necessarily take the markets down, but it does potentially dampen returns.

---

[1] This is a key incentive for Treasury secretary Janet Yellen seeking an agreement on a global minimum corporate tax rate

[2] Institute of Taxation and Economic Policy, *Income tax increases in the American Families Plan*, April 2021

Market data source FactSet and Bloomberg
The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

Contacts

Tapan Datta
Global Asset Allocation
Aon
Retirement and Investment
Global Asset Allocation Team
+44 (0)20 7086 9605

Aon's Global Asset Allocation Team

Where are we in the economic cycle? What is the relative value of different asset classes? How are technical factors, such as regulation, impacting prices?

Aon's Global Asset Allocation team continually asks and answers questions like these. We use insights to help clients make timely decisions.

With over 160 years of combined experience, the team is one of the strongest in UK investment consultancy today.

Our experts analyse market movements and economic conditions around the world, setting risk and return expectations for global capital markets.

The team use those expectations to help our clients set and, when it is right to do so, revise their long-term investment policies.

We believe that the medium term (1–3 years) has been under-exploited as a source of investment performance. Maintaining medium term views that complement our expectations for the long term, we help our clients to determine when to make changes to their investment strategy.

Copyright © 2021 Aon Solutions UK Limited
Aon Solutions UK Limited is authorised and regulated by the Financial Conduct Authority.
Registered in England & Wales. Registered No: 4396810.
Registered Office: The Aon Centre, The Leadenhall Building, 122 Leadenhall Street, London, EC3V 4AN

Legal Disclosures and Disclaimers

This document has been produced by Aon's Global Asset Allocation Team, a division of Aon plc and is appropriate solely for institutional investors. Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial advice and action should not be taken as a result of this document alone. Consultants will be pleased to answer questions on its contents but cannot give individual financial advice. Individuals are recommended to seek independent financial advice in respect of their own personal circumstances. The information and opinions contained herein is given as of the date hereof and does not purport to give information as of any other date and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice. The delivery at any time shall not, under any circumstances, create any implication that there has been a change in the information set forth herein since the date hereof or any obligation to update or provide amendments hereto. The information contained herein is derived from proprietary and non-proprietary sources deemed by Aon to be reliable and are not necessarily all inclusive. Aon does not guarantee the accuracy or completeness of this information and cannot be held accountable for inaccurate data provided by third parties. Reliance upon information in this material is at the sole discretion of the reader.

This document does not constitute an offer of securities or solicitation of any kind and may not be treated as such, i) in any jurisdiction where such an offer or solicitation is against the law; ii) to anyone to whom it is unlawful to make such an offer or solicitation; or iii) if the person making the offer or solicitation is not qualified to do so. If you are unsure as to whether the investment products and services described within this document are suitable for you, we strongly recommend that you seek professional advice from a financial adviser registered in the jurisdiction in which you reside. We have not considered the suitability and/or appropriateness of any investment you may wish to make with us. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction, including the one in which you reside.

Aon Solutions UK Ltd is authorized and regulated by the Financial Conduct Authority. Registered in England & Wales No. 4396810. When distributed in the US, Aon Investments USA Inc. ("Aon Investments") is a registered investment adviser with the Securities and Exchange Commission ("SEC"). Aon Investments is a wholly owned, indirect subsidiary of Aon plc. In Canada, Aon Hewitt Inc. and Aon Investments Canada Inc. ("Aon Investments Canada") are indirect subsidiaries of Aon plc, a public company trading on the NYSE. Investment advice to Canadian investors is provided through Aon Investments Canada, a portfolio manager, investment fund manager and exempt market dealer registered under applicable Canadian securities laws. Regional distribution and contact information is provided below. Contact your local Aon representative for contact information relevant to your local country if not included below.

Aon Solutions UK Limited
Registered office
The Aon Center
The Leadenhall Building
122 Leadenhall Street
London
EC3V 4AN

Aon Investments USA Inc.
200 E. Randolph Street
Suite 700
Chicago, IL 60601
USA

Aon Hewitt Inc./Aon Investments Canada Inc.
20 Bay Street, Suite 2300
Toronto, ON
M5J 2N9
Canada

Copyright © 2021 Aon plc