United States

Delayed Inflation Risks to Be Re-Ignited by Biden Stimulus as Output Gap Closes

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EXECUTIVE SUMMARY

December economic pause was followed by a US$900 billion stimulus that will largely be spent in 1Q 2021. The output gap (still 2.8% of potential GDP in 4Q 2020) will narrow sharply this quarter, making it impossible for the Fed to sustain US$120 billion of monthly QE. Whether Biden pushes through a US$1.9 trillion stimulus (without GOP votes) or a more modest US$1.5 trillion one with some GOP votes, it will prove inflationary by 3Q 2021. With the public debt soaring toward 120% of GDP, Biden's corporate tax hike from 21% to 28% will likely be announced (even if conditionally) at his February/March 2021 speech to a joint session of Congress. We recommend being underweight equities, and long US$ on a 6-month view.

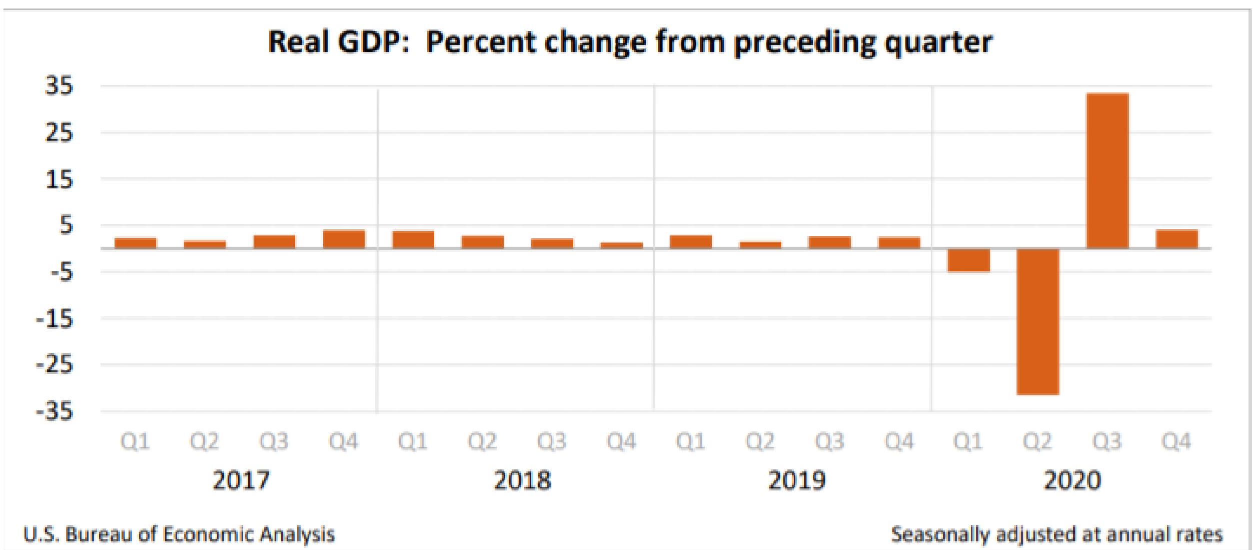
The renewed surge in Coronavirus infections in the last two months, and related restrictions on economic activity, contributed both to the December decline in non-farm payrolls and a relatively weak print for real GDP growth in 4Q 2020 (+4%QoQsaar, -2.5% YoY). The output gap, which was 3.5% of potential GDP in 3Q 2020, only improved to 2.8% of potential GDP in 4Q 2020, delaying the onset of inflation risks, keeping both core inflation gauges at 1.5-1.6% YoY at end-2020.

However, the US$900 billion fiscal stimulus was only enacted on 27 December 2020, and hence began to boost the economy only in 1Q 2021. If the full Biden stimulus of a further US$1.9 trillion is passed via a reconciliation process (without GOP support), the total of US$2.8 trillion will add 13.3% of GDP to the deficit for FY2021 (already estimated by the CBO at 9% of GDP before the two stimulus packages). That would be more than sufficient to close the output gap by mid-2021. Even a more modest stimulus (US$1.5 trillion) passed with some Republican support, would suffice to close the output gap by July 2021, pushing core CPI inflation above 2% YoY by 3Q 2021. M2 growth (which has plateaued around the 24% YoY handle over the past 8 months) will likely need to be reined-in by 2Q 2021, even if the FOMC is not immediately obliged to raise rates.

Biden has already tightened environmental regulations, as promised, by rejoining the Paris Climate accord, imposing a moratorium on oil/gas drilling on federal land and water and revoking the Keystone XL pipeline permit. The two stimulus packages will boost EPS and economic growth. But with the public debt already above 100% of GDP, Biden will likely announce his promised hike in corporate taxes (to 28% from 21%) at his speech to the joint session of Congress on 23 February 2021. That too will slash EPS growth in FY2022 (Oct 2021 to Sep 2022). We recommend staying Underweight Equities, and de-risking portfolios. On a six-month view, we would be long US$.

DETAIL

Although real GDP was up 4%QoQsaar in 4Q 2020, it was still down 2.5% YoY in 4Q and declined 3.5% in 2020. Real GDP grew 4%QoQsaar (seasonally-adjusted annualized rate) in 4Q 2020, decelerating sharply from the 33.4%QoQsaar expansion in 3Q 2020 -- which partially reversed the 31.4% QoQsaar contraction in 2Q 2020. (Arithmetically, a decline of 31.4% followed by an increase of 33.4% still leaves the economy down 8.5% from where it was two quarters earlier). Given the extreme fluctuations during recent quarters, it is useful to look instead at YoY growth rates: in 4Q 2020, real GDP was still down 2.5% YoY, and full-year real GDP in 2020 declined 3.5%. In 4Q 2020, personal consumption expenditure (PCE) increased 2.5%QoQsaar, gross private domestic investment (GPDI) increased 25.3%QoQsaar, exports increased 22%, imports 29.5% (subtracting from GDP), but government spending declined 1.2%QoQsaar (in real terms). For the full year 2020, PCE declined 3.9%, GPDI -5.3%, exports declined 13.2%, imports -9%, and only government spending increased (but only a modest 1.1%) in 2020 -- with federal spending rising 4.4% but state and local spending declining 0.9%. (State and local spending continued declining QoQ in each of the last 3 quarters of 2020, declining 1.7%QoQsaar in 4Q 2020). State and local governments are subject to a balanced-budget requirement, so their spending automatically declines in recessions unless they receive federal-government support.

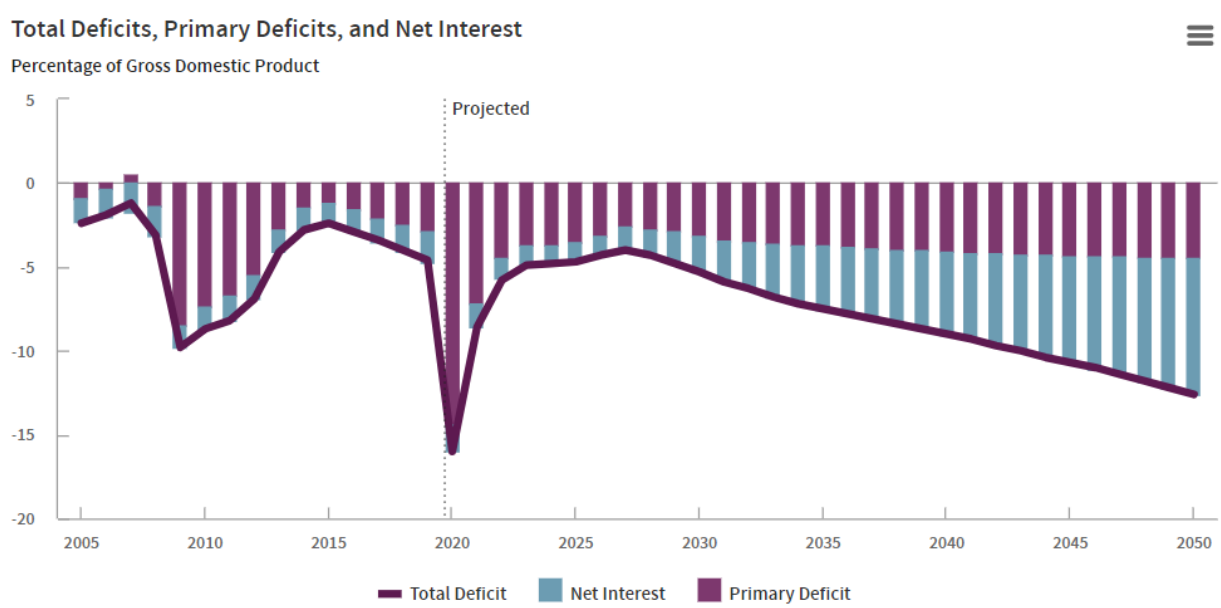


Source: US Bureau of Economic Analysis

As a consequence of the Covid-19 pandemic, **the US fiscal deficit was US$3.1 trillion in FY2020 (the 12 months ending 30 September 2020).** The deficit in 1H FY2020 (October 2019-March 2020) was US$0.7 trillion, while the deficit in the second half of the fiscal year soared to US$2.4 trillion. Using the words of the Congressional Budget Office (CBO): "The deficit in 2020 was equal to 14.9 percent of gross domestic product (GDP), up from 4.6 percent in 2019 and 3.8 percent in 2018; the deficit was the largest as a percentage of GDP since 1945. As a result of the deficit and federal borrowing for other reasons—primarily to increase the Treasury's cash balance—federal debt held by the public rose to 100.1 percent of GDP, up from 79.2 percent of GDP at the end of fiscal year 2019."

CBO projections (in September 2020) showed that the fiscal deficit in 2021 would be 9% of GDP -- before the US$900 billion fiscal stimulus enacted at the end of December 2020. That package provides unemployment insurance (US$300/week) for 11 weeks (i.e., until mid-March 2021), US$600 payments (already completed by mid-January 2021) to all individuals earning up to US$75,000 annually, targeted support (US$325 billion) for small businesses, and for educational institutions (US$82 billion). The stimulus was part of an omnibus spending bill that keeps the US federal government funded until September 2021.

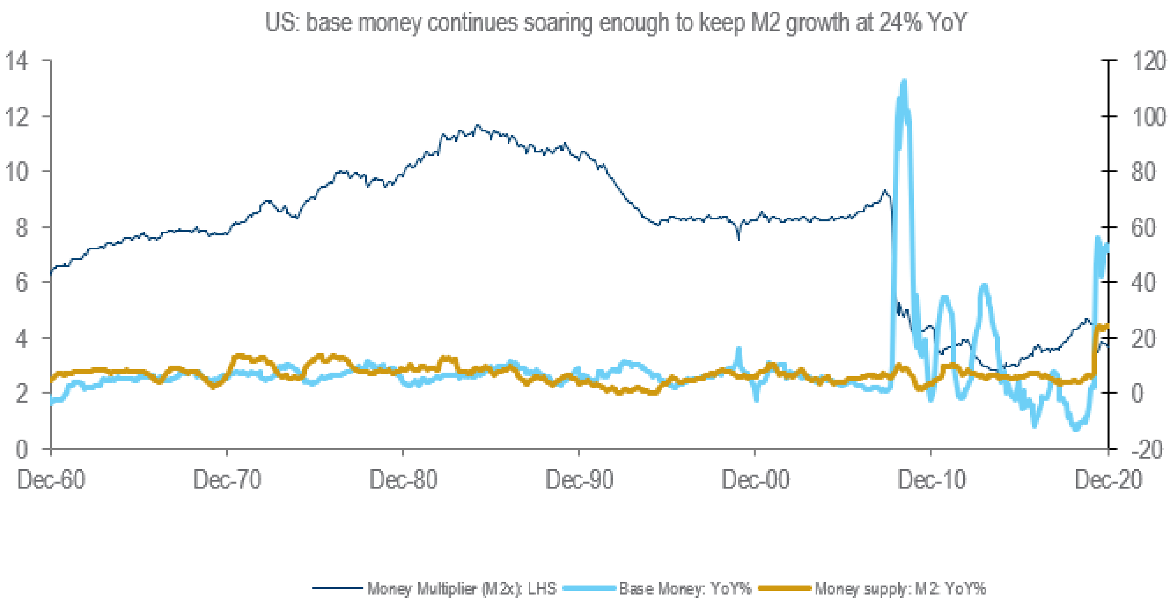
The Biden Administration's request for a further stimulus package of US$1.9 trillion could take the fiscal deficit to 22.3% of GDP -- but the size of the stimulus would also boost GDP, and thus reduce the deficit/GDP ratio to **18-19% of GDP, the largest deficit since WWII**. Although the Democrats narrowly control both Houses of Congress, Biden is unlikely to get the full package through the House and (especially) Senate, where some centrist Democrats have expressed reservations about the size of the package. But, given Democrat control of both Houses, either "reconciliation" (passage through a joint sitting of both Senate and House) or winning over a few Republican Senators and House members for a modified package of about US$1.5 trillion (while leaving out the rise in the minimum wage to US$15/hour, and not persisting with large US$400/week unemployment payments until September) would likely get through Congress. The modified package (about US$1.5 trillion) would keep moderate Republicans on side, and contribute to Biden's stated goal of uniting the nation; using the reconciliation process would narrowly get the package through, but would embitter centrist Republicans (and possibly some moderate Democrats too). A further fiscal stimulus of US$1.9 trillion would be excessive, and we think it is likelier that the Biden administration will take a middle path, in ensuring passage of a US$1.5 trillion package with the support of centrist Republican Senators.



Source: Congressional Budget Office (September 2020 projection)

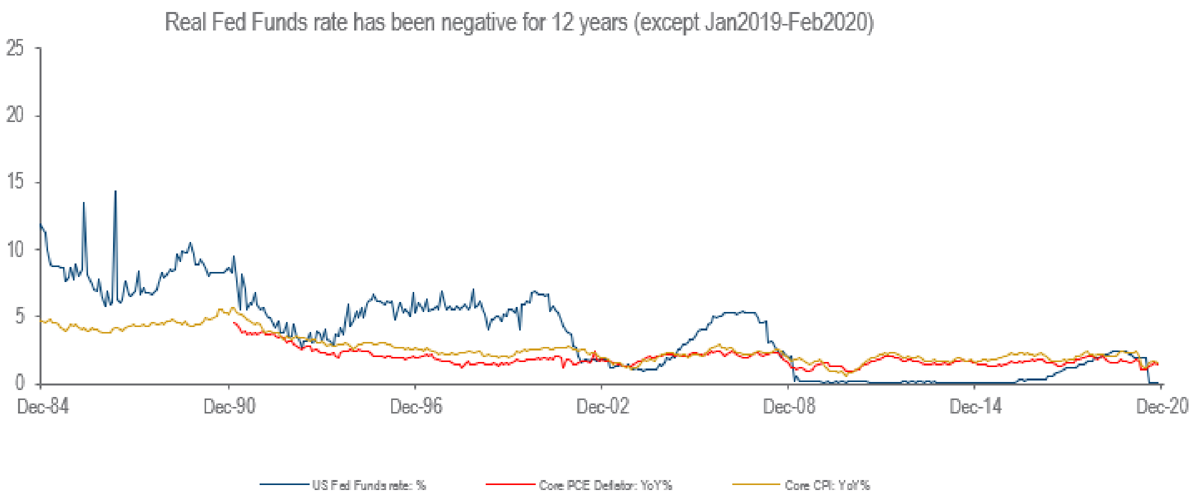
M2 growth in the US has stabilized around a 24% YoY growth handle since May 2020, having rapidly reached 13.8% YoY in March 2020, 21% YoY in April, 23.5% YoY in May 2020 and 24.4% YoY in June 2020, the same level it ended the year at (December 2020), having broadly remained around that 24% YoY plateau for the final 8 months of 2020. The pace of M2 growth over the latest

8 months remains at over double the pace of M2 growth achieved in the aftermath of the global financial crisis in 2009 (when M2 growth peaked below 11% YoY). The money multiplier collapsed in 2008-09, but was broadly stable in 2020. If the Fed continues adding to its monetary base at the promised rate of US$120 billion monthly, M2 growth will remain in double digits over the next half year. This will be inflationary if the output gap has closed.



Source: REAL-Economics.com, based on data from FRB-St. Louis

Core PCE inflation (the key gauge targeted by the FOMC) edged up only slightly to 1.5% YoY in December 2020 (from 1.4% YoY in the previous two months). Core CPI inflation was at 1.6% YoY in December 2020, unchanged from the previous two months. The renewed surge in new Covid-19 cases in the US (which surged to a weekly average of 200,000 new daily cases in December 2020) led to new movement restrictions -- leading to the first decline in non-farm payrolls in 8 months (-140,000 net new jobs in December 2020). The output gap -- which closed from 9.9% of potential output in 2Q 2020 to 3.5% in 3Q 2020, narrowed only slightly further to 2.8% of potential output in 4Q 2020. However, the US$900 billion of fiscal stimulus (much of which will be paid out in 1Q 2021) should provide a large boost to the economy, helping to significantly narrow the output gap by March 2021. If, in addition, the Biden stimulus is passed -- even in a trimmed version (of about US$1.5 trillion) -- the resulting stimulus will close the output gap by mid-2021, triggering a significant rise in inflation if the FOMC continues to add US$120 billion to the monetary base every month. Although the FOMC reiterated this past week that it would allow core inflation to rise above 2% for a time (to compensate for the long periods it has been below that target), we think the Fed will be obliged to cut back on its monthly purchases of Treasury and agency securities by May 2021.



Source: REAL-Economics.com, based on data from Trading Economics

The Biden Administration will present its proposals for the 2022 Budget (for the October 2021-September 2022 period) on 23 February 2021. The detailed Budget proposals are usually debated over the next few months before being passed, but this time President Biden has the advantage of controlling both Houses of Congress (albeit narrowly). President Biden clearly campaigned on a promise to raise the corporate tax rate to 28% (from 21%), and to 30.8% (a 10% surcharge) for companies that out-source work outside the US (seemingly both manufacturing and services, which would cover most of the US corporate sector). During her confirmation hearings, Treasury Secretary Janet Yellen alluded to the higher tax rates (including raising income tax rates on the top-1%, those earning more than US$400,000 yearly) being imposed only after the economy has clearly recovered. In our view, it is highly probable that the higher tax rates will kick in at the start of the next fiscal year (1 October 2021).

President Biden could hedge his position, by only conditionally introducing the new tax rates during his February/March speech before Congress -- predicated on the success of the vaccine roll-out and clear economic recovery. But the higher tax rates are inevitable as a key step toward fiscal responsibility (a goal that many Republicans will find difficult to oppose, even if they cannot support the raising of taxes) after two years of unprecedented deficits to counter the economic impact of the pandemic. Although the past week's extreme market volatility resulted largely from the Robinhood/Gamestop shenanigans, the richly-valued equity market was primed for a fall. The markets were also incrementally squeezed by tighter regulation via the US rejoining the Paris Climate accord (within a month), suspending all oil & gas drilling (including fracking) on federal land and water areas (but, importantly, not on private land where 3/4th of all fracking occurs), and revoking the permit for the Keystone XL pipeline -- all steps that Biden had campaigned on. Going forward, the introduction of higher corporate tax rates will be a genuine further hit for equity markets, as it will erode EPS growth in FY2021. We would consequently recommend de-risking portfolios, and going Underweight Equities. Banks (and financials more broadly) will benefit from a steepening yield curve, clean energy (electric vehicles, including producers of hybrids, solar, wind), and infrastructure-related stocks will buck the downturn.