A GREEN LIGHT FOR FISCAL STIMULUS

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Summary and Major Conclusions:

Investors should consider the question of whether excessive fiscal and monetary stimulus will culminate in an overheating economy. My working assumption is that the economy is unlikely to overheat in the medium term, but could become increasingly vulnerable in the years beyond 2022. The most notable signals of an overheating economy are an extended period of above-average growth in GDP, increased speculative behavior, and a sustained rise in the inflation rate.

- The outcome of the Senate runoff election in Georgia is a major game changer for the economy and financial markets. The Democratic sweep gives the party a small majority in the Senate, enabling the Democrats to control the political agenda in Washington. President-elect Biden has gained increased political capital in negotiating with a somewhat less divided government over the next two years.

- The overarching implication is that the Biden administration is more likely to be far more successful in carrying out its economic and social agenda. The economy will benefit from more aggressive government spending initiatives, thereby ensuring a strong recovery. Friday's very weak employment report for December reinforces the argument for greater fiscal stimulus.

- The initial reaction of financial markets to the election outcome was predictable. Stock prices moved higher, led by economically sensitive stock groups, such as industrials, financials, energy, and materials. Most notable was the sharp rise in government bond yields, which jumped from 0.95% to 1.12% in the space of only three days, as measured by ten-year US Treasury bonds.

- Investors should expect another COVID-relief spending package in excess of $1 trillion within the next two months. This compares with the original $2.2 trillion CARES Act passed in March of last year and the $900 billion COVID-relief package passed by Congress just prior to yearend.

- In contrast to the narrowly focused COVID-relief bill passed in late December, a new spending bill will likely be more comprehensive. Low- and middle-income individuals could receive checks of $2,000, while unemployment insurance payments will be increased and extended. Deficit-ridden state and local governments will also receive vital funding from the federal government, while spending on education, health care, infrastructure, and the environment could also be increased.

- Investors should also expect legislation that will result in higher taxes on wealthy individuals and corporations. Corporate taxes are almost certain to increase from the current 21% rate. However, because of the depressed economy, passage of tax hikes could be deferred until later this year, at a time when the economy should be on a firmer footing.

- My assumptions for economic growth over the next two years now appear too conservative. For this year, I am raising my estimate for GDP growth from 4.5% to 5.5%, and from 5.5% to 6% in 2022. I am keeping my forecast for corporate earnings intact because of two offsetting factors: Faster economic growth will lift pre-tax earnings, but will be equally offset by an increase in the corporate tax rate.

- My forecast for monetary policy over the next 12 to 18 months is unchanged. The Federal Reserve should maintain a highly accommodative policy until there are unambiguous signs of a strengthening economy along with a solid recovery in employment. However, the Fed could react to more aggressive fiscal stimulus by beginning its rate-tightening cycle somewhat sooner than previously indicated.

- Investors should consider the question of whether excessive fiscal and monetary stimulus will culminate in an overheating economy. My working assumption is that the economy is unlikely to overheat in the medium term, but could become increasingly vulnerable in the years beyond 2022. The most notable signal of an overheating economy is an extended period of above-average GDP, a sustained rise in the inflation rate, and widespread evidence of speculation.

- Although GDP growth will likely accelerate sharply beginning in the second half of this year, there is too much slack in the economy for demand to overwhelm supply over the next 18 months. However, the combination of powerful monetary and fiscal stimulus along with widespread pent-up demand in several key sectors should result in a relatively rapid absorption of resources by the second half of next year.

- Although highly premature in the short term, investors should be prepared for extreme market turbulence in the years beyond 2022 when both inflation and interest rates will likely be on the rise. A potentially overheating economy at that time will trigger an abrupt reversal in monetary policy from extreme accommodation to monetary restraint, which would jolt financial markets.

- From an investment perspective, the government bond market is the major casualty of the Georgia elections. Another large COVID-relief spending package strongly suggests that the expected normalization of long-term interest rates could occur within a shorter timeframe than previously expected.

- Currently at a rate of 1.12%, the market yield on the ten-year US Treasury could rise to 2% at the end of this year and to 2.75% by yearend 2022. These new assumptions are upward revisions from my previous forecasts of 1.75% and 2.5%, respectively, resulting in a pronounced steepening of the Treasury yield curve.

- The Georgia Senate elections have reinforced my assumptions for positive equity market returns in 2021. A more powerful fiscal response to the economic and public health crises should boost the rate of economic growth and accentuate upward pressure on stock prices. Rates of return on the S&P 500 are likely to range between 10% and 15% this year and between 5% and 10% in 2022.

- History reveals no clear pattern with respect to party control of government. Since 1950, the S&P 500 has generated equivalent annual returns of 8% (price appreciation only) both during periods of one-party control as well as periods of divided government.

- These historical market results confirm what is generally well-known: The behavior of the equity market is primarily determined by economic conditions — most notably business profitability and Federal Reserve policy — and less by domestic politics.

- Financial markets largely ignored the seditious assault on the Capitol on January 6 because of investor belief that the transfer of power scheduled for January 20 was not in jeopardy. Certification of the election on December 14 by members of the Electoral College had already assured the legal outcome of the election.

- In principle, the market impact of sudden political and geopolitical events tends to be transitory, assuming no lasting adverse implications for the economy or government policy. Financial markets do react negatively to sudden shocks when it is clear that such events will bring about durable negative consequences for economic conditions and/or economic policy.

- That said, partisan politics and the massive polarization and disunity within society in recent years could be powerful headwinds for financial markets in the foreseeable future. While it is possible that the storming of the Capitol on January 6 could potentially mark a peak in polarization, the political atmosphere will remain toxic.

- The key point is that that political stability and a return to some semblance of national unity and tranquility could require considerable time, therefore acting to depress business, consumer, and investor confidence in the interim.

- My assumptions for sector and individual stock selection have not changed but have been reinforced by the virtual certainty of further reflationary fiscal policies. Cyclical stock groups should easily outperform defensive sectors; small-cap and value stocks should also be market leaders; and non-US stocks should outperform the S&P 500.

- Recent political developments also reinforce my assumption that the US dollar will continue to decline in coming years. As a countercyclical currency, the dollar should weaken as global economic conditions improve. Continued political turmoil and instability would also be an obvious negative for the dollar.

- Other negatives for the dollar are the prospects for higher budget deficits and larger merchandise trade deficits, as US imports increase faster than exports. A weakening dollar is a distinctly pro-growth and inflationary phenomenon — a negative for Treasury securities and a positive for economically sensitive stock groups.

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