SPECIAL REPORT

A NEW ERA OF BIG GOVERNMENT?

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As always, there are potential downside risks associated with large government programs. It seems clear that the current economic expansion is unlikely to end because of a lack of demand. Rather, the greatest risk to the expansion is an emergence of imbalances typically associated with an economic boom and overheating economy. The most worrisome of these potential imbalances is a rapid rise in inflation, which would compel the Federal Reserve to aggressively tighten monetary conditions, with adverse long-term implications for financial markets.

The focal point of the Biden administration during its first 100 days was on the pandemic, most notably income support for families and distribution of vaccines. With the population moving closer to herd immunity, the administration has shifted its primary focus to long-term structural economic investments, most notably a $2.25 trillion infrastructure program.

President Biden is also proposing a $1 trillion spending plan to meet the nation's social needs and to improve the social safety net. *Taken together, these massive spending programs suggest that the US economy could be undergoing a transformational shift to an era of Big Government not seen since the 1960s and 1970s*.

- This era of unprecedented fiscal stimulus began one year ago with the $2.2 trillion CARES Act passed in immediate response to the coronavirus pandemic. This was followed by the $900 billion COVID Relief Bill passed in December of last year. President Biden's $1.9 trillion American Rescue Plan was signed into law on March 11 and will be the primary catalyst for economic growth and employment this year. Included in this legislation are direct payments to individuals, extended unemployment benefits, relief for renters, and funds for state and local governments.

- The Biden administration has also proposed an infrastructure spending plan for passage later this year. Called the American Jobs Plan, this bold initiative proposes $2.25 trillion in spending over the next ten years for both traditional infrastructure and related social programs. *Because infrastructure spending has long been a bipartisan issue, the probability of passage before yearend is very high*.

- Unlike the American Rescue Plan, this spending initiative is not designed to provide stimulus for the economy in the short term but rather to improve ***productivity*** and ***quality of life*** over the long term. It is also designed to bolster the economy's ***competitive posture*** in preparation for an increasingly combative economic, military, and technological rivalry with China in the 21st century.

- The American Jobs Act provides funds for long-term modernization and upgrading of the nation's roads, bridges, and highways; improvements to public transport, ports and waterways, airports, drinking water supplies, high-speed broadband, the housing stock, VA hospitals, and the energy grid; and funding for research and development, job training initiatives, and green energy investments.

- In a nationwide TV appearance last week, President Biden also revealed his $1 trillion American Families Plan, which expands the nation's social safety net with a focus on lower- and middle-income families. Major priorities of this plan include child care, education, and paid family and medical leave. This plan is virtually assured of facing stiff opposition from Republican lawmakers and has less than a 50% probability of passage prior to the 2022 mid-term elections.

- In terms of actual execution, President Biden will likely receive Congressional approval for most but not all his proposed spending and tax initiatives. My forecast assumes that the final bill could contain $3 trillion in spending over the next ten years, with $2 trillion in infrastructure and $1 trillion in social programs. I expect the plan to be passed later this year and go into effect in early next year.

- These ambitious fiscal programs will support spending and output over the next several years. An economic boom is assured during the remaining three quarters of this year and much of next year. US real GDP growth is likely to approach 7.5% this year — the fastest pace since the mid-1980s — followed by further growth of 5% in 2022. The impact of the infrastructure plan on GDP growth would reach a peak in the 2023-to-2025 period. Corporate earnings growth should peak this year, with an increase of 35% to 40%, followed by an estimated 10% to 15% gain in 2022.

- The global economy will also benefit from a surge in US imports associated with these government stimulus programs, all of which are designed to bolster domestic demand and increase long-term potential economic growth. US imports of goods increased at a 20% annual rate in the first quarter to the highest level on record, and further strong growth lies ahead. The US merchandise trade deficit will climb to all-time highs, as US exports lag imports.

- *A combination of strong imports from both China and the US will spark a vigorous recovery in world trade*, benefitting major export economies in Europe and Asia, most notably Germany, Japan, and South Korea. World GDP this year should expand at its fastest rate in more than a decade. Earnings of multinational corporations should also benefit from rapid global growth and a solid rebound in world trade.

- As always, there are potential downside risks associated with large government programs. It seems clear that the current economic expansion is unlikely to end because of a lack of demand. Rather, *the greatest risk to the expansion is an emergence of imbalances that typically accompany an economic boom and overheating economy*. The most worrisome of these potential imbalances is a rapid rise in inflation, which would compel the Federal Reserve to aggressively tighten monetary conditions.

- *The other major risks of massive government spending are permanently elevated federal budget deficits and a steady rise in government debt*. While not a concern under current economic conditions, a rising government debt burden has negative implications for long-term economic growth, inflation, long-term interest rates, and the US dollar. A looming record debt-to-GDP ratio will become relevant when economic growth has slowed and when government borrowing costs are in a sustained rising trend.

- Proposed tax increases should provide a partial offset to the boom in spending and rise in government debt, but only to a modest extent. The size of tax increases included in the Biden plan is unrealistic and almost certain to be watered down during Congressional debate. Similarly, investor concerns regarding a sharp increase in tax rates on long-term capital gains are also exaggerated. The latter is unlikely to be implemented prior to 2023 and could ultimately fail because of an insufficient number of votes in Congress.

- *An analysis of fiscal spending and tax multipliers also suggest that taxes should not weigh heavily on GDP growth*. ***Fiscal multipliers*** refer to the dollar change in GDP for a given increase in government spending and dollar increase in taxes. At an estimated 1.5, the multiplier on infrastructure far exceeds the estimated 0.5 negative multiplier associated with higher taxes on corporations and wealthy individuals, assuring a ***net pro-growth fiscal policy*** in coming years.

- *A new era of big government appears to be under way with potentially significant implications for investing*. Over the course of history, financial markets have demonstrated a clear preference for limited government and laissez-faire economic policies, along with a strong aversion to interventionist and highly activist economic policies.

- It is impossible to make predictions at this time regarding investment implications of a return to big government in coming years. However, investors can closely monitor future trends in the following areas as potential leading indicators of major structural economic change: Capital investment, productivity, unit labor costs, company profit margins, budget deficits, foreign exchange rates, money supply growth, and inflation.

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