



May 31st, 2021

President Biden Brings Another Bazooka

- Another huge \$6 trillion budget plan from President Biden
- A focus on infrastructure to keep the US economy competitive
- Inflation still at large and surprising to the upside
- Calls for earlier US rate rises seem misplaced; however the Fed might be wrong to suppress a rise in long term interest rates
- Europe looks forward to growth
- Nascent signs of accelerating vaccinations in Japan a source of comfort for the market

President Biden's announced budget plans dwarf anything seen since the end of WWII. For many years after the global financial crisis, many central bankers lamented the absence of fiscal policy to help support growth in struggling economies. That lament is no longer valid. If enacted in substantially the way proposed, it will have far-reaching effects. **The plan is structural, not emergency relief aimed at alleviating Covid stress.**

At the headline level, the proposal is for a budget of \$6 trillion, starting on October 1 this year. The package implies annual budget deficits of \$1.3 trillion per annum up to 2030, wealth taxes notwithstanding. Spending would rise to \$8.2 trillion per annum by 2031.

Negotiations are ongoing on infrastructure spending under the American Jobs Plan, slated for \$2.3 trillion. President Biden is on record stating he will accept \$1.7 trillion, but Republicans may balk even at this lower figure. The next three months will tell just how secure President Biden's support on the hill is to get this done.

President Biden wants the US economy to stay competitive, and infrastructure investment is one key pillar of the strategy. There is \$300 billion for repair to bridges, highways and roads, new schools, and the expansion of high-speed broadband in the infrastructure plan. Apart from a push to boost employment, the stated policy objective is to remain the globally dominant economic power in the face of the rise of China.

Other parts of the budget have a strong focus on support for families (American Families Plan) and education, which sees a 30% increase to \$103 billion. There are also generous allowances for childcare, paid leave, and universal preschool. There will also be targeted spending on climate change policies.

Immediately after the release of the proposed budget, Treasury Secretary Janet Yellen noted that the additional deficit spending will push the debt-to-GDP ratio of the USA above 100% but that it will not permanently contribute to inflation. This is perhaps not too surprising a view and echoes the Federal Reserve's stance that the current inflation pipeline pressures are transitory.

The fear of the fear of inflation.

Another sign of building near term price pressures was the release of the Fed's preferred measure of inflation, the PCE deflator (personal consumption expenditure). Core inflation (excluding food and energy) rose to an annualised 3.1% in April. The headline rate rose to 3.6%, a substantial spike from 1.4% in January.

The current debate over the Fed's reaction function to inflation is a sight to behold. Some commentators would have us worry that higher than expected inflation is a concern for the market. But isn't this precisely what the Fed is trying to contrive? Remember, the Fed's ongoing battle is to create an inflation mentality in the markets and the economy, not to suppress it.

Hence, we believe the Fed will keep interest rates anchored at close to zero. But at some stage, they must reinforce the markets raised inflation expectation by allowing long term interest rates to rise. Only at that stage will we know whether the Fed has done a good job or whether the US economy will follow the Japanese into the quagmire of low to negligible inflation.

For now, the US 10-year government bond yield has settled around 1.60%, and the measure of interest rate volatility has also begun to subside. But maybe it is only a matter of time before the 10-year bond yield is allowed out of its cage and allowed to rise. As a potential direction of travel for central banks in the future, we note that the Reserve Bank of New Zealand became the first central bank to indicate that it was charting a tightening course. It re-introduced a set of forecasts that envisage rate hikes from 2022. Quantitative easing continues but at a much-reduced rate relative to previous targets.

The pace of vaccinations remains key.

There are signs of an acceleration in Japan's vaccine rollout that could bring some welcome respite for the equity market. Although Japan has only fully vaccinated 2.4% of its population, there has been a sharp acceleration in those that have received at least one vaccination jab. In the past two weeks, **the** country has administered more than 11 million doses, most to medical workers, with around half of those coming in the past two weeks. The Japan Times reports that more than 11% of people aged 65 or over have now received at least one dose, with an average of 400,000 doses being given a day. There are 105 million adults in Japan; hence the authorities will have to continue accelerating the pace of vaccinations to catch up with other developed nations... but the direction of travel is more positive.

In recent months, Japanese equities have underperformed global benchmarks on the disappointment with the rollout of the vaccine and further lockdowns across the country. Foreigners have been selling the market again in recent weeks, and the flow of funds was not helped by news that the Bank of Japan has started to pull back on their purchases of Japanese equity market ETFs. Remember that European equities had their burst of strong performance well ahead of the easing of the lockdown. Economists expect positive quarter-on-quarter growth in the third quarter followed by 10% quarterly annualised growth in the fourth quarter.

Europe's vaccine progress is ramping up: Not too long ago, the caveat applying to the European recovery was that it was not going as quickly as it might have in its vaccine rollout. Gradually, that risk is fading, even if new COVID variants are evident. In April, extra lockdowns depressed Euro area retail sales by an estimated 3.5% (the numbers are due this coming week). The numbers for May should reflect a bounce back, and overall GDP for the second quarter could be as high as 7.5% quarterly annualised. Manufacturers

were largely spared the worst of the lockdowns. Throughout the period, strong industrial confidence numbers suggest that the hopes for a robust European rebound are not misplaced.

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