Marketing Material

Fiscal fight intensifies and the Fed says it plans to stop buying U.S. debt

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IN A NUTSHELL

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Objections arise to Bidenomics?: Spend now, tax later, until bond market objects

For markets, the main event this fall is the fiscal fight in Congress related to longer-term tax and spending plans of the Biden Administration and Democratic controlled Congress. These longer-term plans were delayed, despite Democratic Senate control since January, given a focus on pandemic crisis fiscal aid. But now, just as Congress wrestles with shaping its post crisis fiscal policies, the Federal Reserve (Fed) signaled that inflation is running above its target more than expected and that the time is coming for less accommodative monetary policy. Thus, Congress finds itself evaluating its grand spending plans just as the Fed is about to reduce asset purchases and contemplate the path to a normal Fed Funds interest rate. These circumstances have intensified Republican and even moderate Democrat calls for spending restraint and most importantly the bond market has issued a word of warning.

Will US Treasury default? No, but risk of unruly process or unorthodox means

If Democrats are intent on passing a $3.5 trillion spending package through reconciliation, then perhaps Republicans are willing to risk technical default. Nothing stops spending like cutting credit cards. Delayed payment on Social Security or to a Federal contractor without cause or agreement is technical default. For what it's worth, we think this is a terrible idea. But it's leverage the Republicans might use until it risks leaving lasting damage. We do not believe any Treasury bond interest payments will be missed, but the Treasury department might go looking for coins in the couch. Treasury owns marketable assets like gold and oil. While the Federal government has other assets and of course taxing power, it's disturbing that the Treasury Department account at the Federal Reserve was $2 trillion at the start of this year and might be down to $0 in the coming weeks without lifting the debt ceiling limit.

At what rate will inflation normalize? Eventually, probably where the Fed wants it

Without political interference, we believe the Fed will stick to its long-term inflation target of 2% (with tolerance for above that near-term) and has the tools to achieve that target. Some believe that inflation is likely to significantly and persistently overshoot the Fed's target owing to supply side challenges. We recognize supply side challenges, but see these as risking slower real growth more so than accelerating inflation. This is because if commodity, labor, import, etc. costs rise and are passed on to consumers on essentials it results in consumers having less money to spend elsewhere. Consumers will need to tap into savings or borrowings to keep real spending unchanged if prices rise. A wage-price spiral also requires growth in money supply to sustain. This would cause excess reserves held at the Fed by the banks to start dropping and a further climb in cash in circulation. If this occurs, the Fed should raise overnight rates or sell assets. That said, we acknowledge the political risks facing the Fed in achieving its mandate, as well as the Fed's own concerns about risking recession by fighting inflation too

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aggressively. We believe inflation will slowly trend toward the Fed's target, but we seek inflation protection. We expect 10yr Treasury yields to reach 2.0% in a year and core personal consumption expenditures (PCE) inflation to average 2.5% in 2022.

S&P 3Q EPS season ahead: Physical economy remains supply side constrained

Many companies that move or make things have been warning of profit pressures owing to rising input costs and supply chain related production shortfalls. This is reflected in prudent analyst consensus earnings per share (EPS) estimates for 3Q. They only raised 3Q consensus by 3.0% during July-September, despite huge 2Q beats and strong economic momentum since. S&P 3Q bottom-up EPS is $49.10 now, down 6.5% vs. $52.55 in 2Q. We expect S&P companies to deliver a 5-10% aggregate beat, putting 3Q S&P EPS at $53-55. By sector, EPS was cut in September, led by Industrials (-2.5%), Consumer Discretionary (-1.0%), Financials (-0.5%) and Communication Services (-0.4%); sectors raised most are Energy (+1.9%), Utilities (+0.3%) and Consumer Staples (+0.2%); other unchanged. Energy's 4Q EPS outlook is improving. Our 2021E S&P EPS of $215 might be a tad too high, probably $212-215, but we aren't changing our estimates before 3Q results given the reoccurring pattern of strong beats from Tech, Communications and Health Care. Our 2022E S&P EPS of $215 still seems reasonable inclusive of an about 7% hit from higher corporate taxes.

Our base case remains fair S&P PE at 20+ and 4400 yearend price target

Unless Treasury Inflation-Protected Securities (TIPS) yields shoot well above 0%, we see a 20+ price-to-earnings ratio (PE) as fair for the digitally dominated S&P 500. We think the current dip is unlikely to go much deeper, as we don't see a US default and while much of the proposed tax hikes are still coming there is likely to be some tempering of the spending plans, should slow the Treasury yield ascent. At 20x 2021 or 2022 S&P EPS likely over $210, 4200 should be support and fair to raise S&P allocation.

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GLOSSARY

Consumer discretionary is a sector of the economy that consists of businesses selling nonessential goods and services.

Consumer staples is a sector of the economy selling essential products.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The personal consumption expenditure (PCE) measure is the component statistic for consumption in gross domestic product (GDP) collected by the United States Bureau of Economic Analysis (BEA).

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.
A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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