Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

For the clients of Grimes Handscomb Asset Management of RBC Dominion Securities | Spring 2021

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Infrastructure, inflation, and a possible Fed policy rethink

By Atul Bhatia, CFA

With the Biden administration poised to ramp up government spending further, markets are casting a wary eye on inflation. But the infrastructure plan—if it gets through Congress—has the potential to improve existing, highly supportive policy, and we look at how a Fed framework that's already favorable to growth could get more so.

Chronicle of a spike foretold

Both the Fed and the market are estimating a sharp spike in economic activity and inflation in the coming months, driven by the $1.9 trillion fiscal stimulus, economic reopening releasing some or all of the accumulated $1.6 trillion in excess consumer savings, and year-over-year comparisons to a largely shut-down global economy. These forces are powerful but potentially ephemeral. Stimulus payments are generally one-time or short-lived in nature and the majority of economic gains during the pandemic have accrued to investing households who tend to save at a higher rate than the median. After an initial bout of spending, these households may well return to saving. For these and other reasons, the Fed has already telegraphed that it will discount near-term price spikes and instead wait for confirmation that inflation expectations are well-entrenched at or above target level. This is likely a multiyear process as the Fed evaluates business and consumer trends.

Fiscal efficiency

President Joe Biden's $2.25 trillion infrastructure plan—if enacted—could speed the Fed's decision-making. The plan has two critical attributes: first, it is a multiyear spending plan, so it has a higher chance of impacting underlying inflation expectations; second, fiscal policy gains will likely be less heavily

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skewed toward investors than monetary policy gains. Rising wages to lower-income households are typically spent immediately, potentially creating the type of self-sustaining inflation the Fed wants.

The infrastructure bill will likely be subject to considerable revision during the legislative process and may never pass into law. Whatever its final form, the key considerations for the Fed are likely to be the magnitude and duration of the spending plan and the distribution toward higher consumption, lower-income households. The more pronounced and durable the fiscal impact, the greater the Fed's flexibility to adjust monetary accommodation. We believe long-term investors will be well-served to focus on the infrastructure plan and its ramifications and de-emphasize the large, but expected, increases in near-term inflation.

Infrastructure funding and debt

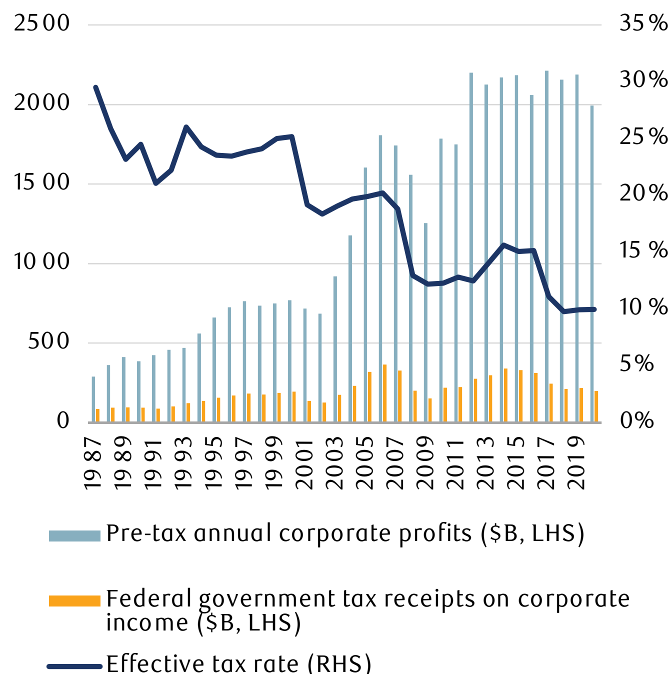
In addition to the spending aspects of the plan, there is considerable uncertainty around its funding. The plan calls for higher corporate taxes to cover the bulk of the costs. Even if Congress were to raise the statutory corporate tax rate, the effective rate for large corporations will likely remain well below that mark. According to the Treasury Department, U.S. multinationals currently pay less than eight percent of earnings to the U.S., despite the 21 percent corporate tax rate; under the prior 35 percent tax regime, actual collections amounted to only 16 percent. As a result, legislation notwithstanding, a large portion of any spending plan is likely to be funded by government borrowing.

But with nearly $22 trillion—or just over 100 percent of U.S. GDP—in existing federal debt, some in Congress have questioned the sustainability of additional borrowing. In testimony to the Senate, Treasury Secretary Janet Yellen addressed those concerns in part by highlighting that low interest rates keep debt servicing costs down and allow the U.S. to comfortably manage higher debt-to-GDP levels. This position has also found support from former Treasury Secretary Lawrence Summers, an outspoken critic of current policy. In a paper written late last year, he suggested that debt-to-GDP was an inappropriate measure and that keeping inflation-adjusted debt service costs—currently near 0.5 percent in the U.S.—below two percent of GDP was a better target.

To some degree, this choice between debt-to-GDP and debt service is a false dichotomy. The larger the debt-to-GDP ratio, the greater the impact of a rise in borrowing costs and the more likely and quickly debt service costs

Effective corporate tax rate well below statute

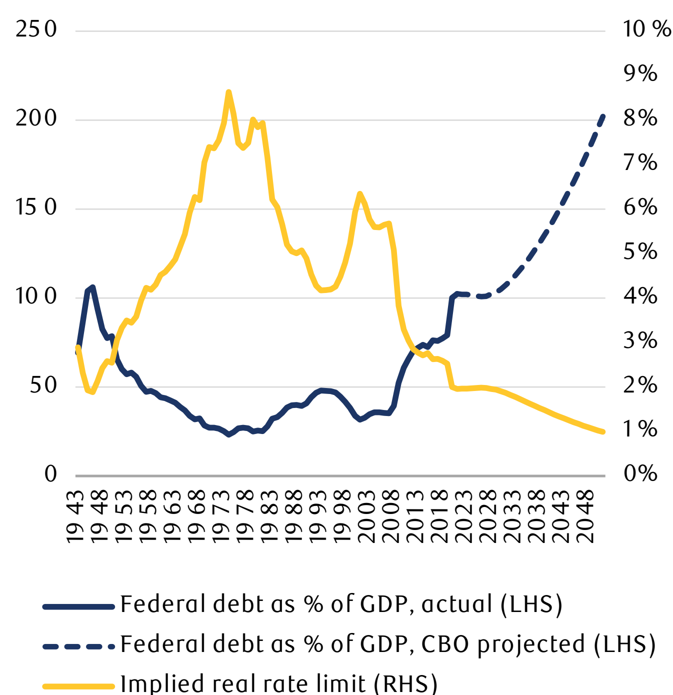
1987 – 2020



Source - RBC Wealth Management, St. Louis Federal Reserve

Higher debt tolerable with lower real rates

1943 – 2050E



Source - RBC Wealth Management, Congressional Budget Office (CBO)

rise above the two percent level. For the U.S., with debt-to-GDP near 100 percent, the Summers' analysis would imply the need for Fed policy to keep inflation-adjusted government borrowing costs below two percent and potentially lower as debt-to-GDP increases.

Fed policy constrained in a different direction

A focus on federal debt service costs would imply the need for a different type of monetary accommodation. Rather than attempt to stimulate demand by pushing bond yields and credit spreads down across the board, the Fed would be able to more narrowly focus on Treasury funding rates and inflation. It could likely accomplish a two percent real rate with a more normalized interest rate policy, although potentially with added emphasis on asset purchases and with a consistent tolerance for higher inflation.

A rejuvenated fiscal policy has the potential to achieve the Fed's employment and price goals more quickly than monetary policy can accomplish, theoretically freeing the Fed to reduce accommodation. At the same time, based on how fiscal policy is funded, the Fed may face a new set of limited constraints against rates rising, this time in the form of federal budgetary pressures. As a result, the Biden infrastructure plan has the potential to improve the existing, highly supportive policy framework, by allowing for monetary policy normalization with potentially limited impact to asset prices.

Fairway of upside

By Jim Allworth

Most developed-country stock markets moved higher through Q1. A notable exception, the Nasdaq stepped away from the party for a while, gaining almost no ground over three months and at one point retreating 12% from its most recent high. That move lower by the tech-heavy index should have dampened the anxiety level of the many commentators who spent much of the last half of 2020 and into 2021 arguing the whole market was threatened by what appeared to be a nonstop advance of a relative handful of large-cap tech or tech-related stocks.

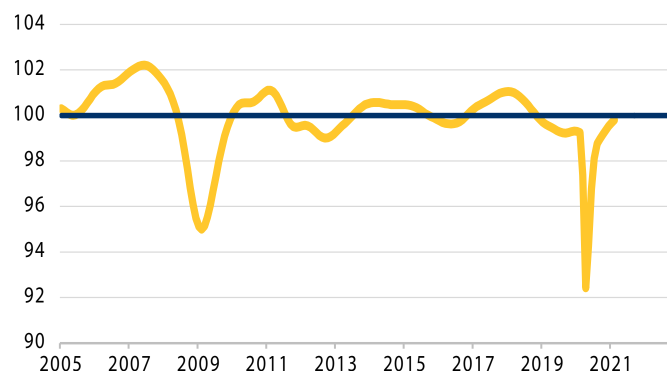
Most of the stocks in question—Amazon, Apple, Microsoft, Facebook, Netflix—gained little to no ground in Q1, consolidating within a range after setting all-time highs back last summer. Comparative newcomers, Tesla and Shopify, corrected mightily (both down about 30% from their peaks) without affecting the rest of the market. Alphabet (Google) was the only one to make an appreciable new high in the quarter.

Valuation is not a reliable timing tool—the perceived over- or undervaluation of a particular group or relative handful of stocks even less so. What can change the outlook for the direction of the stock market for the worse is a downturn in the economic cycle: every bear market for equities has been associated with a recession, in particular a U.S. recession.

In our view, no recession is in sight. Recessions have almost always arrived on the heels of a pronounced tightening in credit conditions—i.e., a combination of prohibitively high interest rates and banks becoming unwilling to lend. Such tightening looks to lie a long way down the road, probably years. That reality won't stop intense discussion about when and how the Fed and other central banks will change course. That in turn may produce bouts of market volatility or corrections. Corrections can be bruising while they last, but what triggers them and what ends them, in our view, remains mostly unknowable, despite rearview mirror judgements that "anyone could have seen that coming." It's instructive to recall that throughout the entirety of the longest uninterrupted bull market in U.S. history from 2009 to 2019, the stock market was constantly being referred to as "expensive" or "dangerously overvalued." Whether such characterizations were valid—we did not think they were—at the end of the day it was a collapsing economy which produced last

It's not just the U.S. global rebound underway

OECD Global Leading Indicator (Jan. 2005 – Feb. 2021)



Source - RBC Wealth Management, Organisation for Economic Co-Operation and Development

year's big retrenchment in share prices, not some intense aversion to "overvaluation."

There are powerful tailwinds moving the economy forward:

- The continuing impact of fiscal stimulus, much of which sits unspent in bank accounts
- The ongoing effort by businesses to replenish severely depleted inventories
- The potential for large infrastructure spending starting in 2022
- The coming reopening of sectors largely shut down by social distancing and travel bans with positive knock-on effects for other sectors, employment, and confidence
- The very strong growth of corporate earnings, which are already rising faster than expected while also driving a capital spending rebound that is likely to improve productivity and help keep inflation in check

In our view, the equity market has a long fairway of upside ahead, with occasional visits to the rough an unavoidable accompaniment.

Administrative corner

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Inflation, valuation, and the market outlook

Jim Allworth and Mark Bayko, members of the Global Portfolio Advisory Committee, discuss the emergence of new concerns such as inflation, rising bond yields, and stock valuations.

Click on the image below to listen to the podcast or read the transcript.

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Audio commentary: Inflation, valuation, and the market outlook

Related Information

- Transcription

Wealth Management

Benchmarks

Equity market 12-month trailing return (for month ending March 31, 2021)	
S&P/TSX composite total return index	44.2%
S&P 500 total return (C$)	39.7%
S&P 500 total return (U$)	56.4%
DJIA total return (C$)	37.4%
DJIA total return (U$)	53.8%
Nasdaq composite price return (C$)	53.7%
Nasdaq composite price return (U$)	72.0%

RBC CM Canadian bond market indices 12-month trailing return (for month ending March 31, 2021)	
Short-term index	2.8%
Intermediate-term	1.7%
Three-month T-Bill (C$)	0.2%
Three-month T-Bill (U$)	0.1%

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