Bidenonomics, Easy Monetary Policy, and Investment Returns

It is very common for armchair economists, political pundits, and "celebrity" financial media personalities to debate the economic and market impact of major tax legislation such as the 1993 budget bill which raised individual and corporate income taxes, George W. Bush's post 9/11 tax cuts, and President Obama's choice to let those George W. Bush tax cuts expire during his first term. I always find it fascinating to listen to these partisans pick and choose their data points in order to bolster the argument that they want to make, while leaving significant factors absent from their discussion because those factors do not fit so neatly into their desired conclusion.

In fairness, it would be a complex and tortured process to attempt to attribute certain economic and fiscal budget consequences to the Clinton tax increases, the George W. Bush tax cuts, and President Obama's non-renewal of some of the Bush era tax cuts. The reality is that we have a complex and global $20 trillion economy. There are too many macro factors which impact our economy from year-to-year which make it virtually impossible to clearly attribute increases and decreases in economic growth to any single set of factors. The fact remains that politicians and partisan economists will always take the opportunity to cherry pick factors which fit their view of the world in order to attribute both good economic outcomes and bad outcomes to a given monetary or fiscal policy action at any given time.

As bottom-up fundamental investors we do not have to precisely forecast the economy, fiscal budgets, corporate cash flows, and the impact of tax and investment policy proposals. However, what we must do is resist overreacting negatively or positively to various proposed fiscal and monetary policy measures when they become hotly debated. Secondly, we have to establish some base line secular assumptions. Thirdly, we have to weigh the directional impact of various policy factors on economic growth, interest rates, and corporate returns of investment.

Today, we see the following broad baseline secular assumptions:

- Average U.S. economic growth potential without additional monetary stimulus and fiscal investment: 1.75% to 2.25%.
- Long-term inflation expectations: 1.75% - 2.25% (1.90% historical 15-year average).
- U.S. average annual job creation: 2.3 million.
- Average S&P 500 constituent return on invested capital (ROIC): 7.6%
- Average non-farm U.S. business productivity growth: 1.5%

From year-to-year all of the above factors can vary widely, however we are striving to establish baselines from which to work. Significant policy actions can positively and negatively impact these baselines for a period of time and those impacts can change the expected returns of stocks and bonds.

The 15-year (4/1/06 -4/1/21) average inflation adjusted return of the S&P 500 with dividends reinvested index return was 8.133% (DQYDJ.com S&P 500 calculator). The way we think about individual company stock returns, we would expect, over the long-term, shareholder total returns to approximate a company's ROIC.

Much will be discussed in the coming months about tax increases and fiscal spending programs. Not all tax increases and government spending programs are created equal when it comes to the economy and business environment. Dr. Paul Kasriel, the retired and former Chief Economist of Northern Trust Company, did an analysis of what policy actions, between monetary policy and tax policy, had the strongest correlation to economic growth. He found that the strongest positive correlation between economic growth and various forms of stimulus was monetary policy. This analysis did not distinguish between additional government stimulus in the form of tax cuts and government spending in the form of additional transfer payments or infrastructure and R&D investments. It simply looked at additional government spending broadly coming from higher levels of deficit spending.

The Federal Reserve has been clearly telling the American people that very low short-term interest rates will be its steady state policy for at least two years even in the face of a tick up in inflation above its 2% target rate. In addition to low interest rates, the Federal Reserve continues to employ what they call quantitative easing. Quantitative easing is a fancy way to describe using the Federal Reserve's ever expanding balance sheet to buy Treasury securities and Federally insured mortgage bonds in order to provide a price agnostic bid in those securities in order to keep a lid on "market" rates of those securities. The Federal Reserve has been less transparent in regard to how long they expect to continue to employ the current level of quantitative easing if inflation rates do exceed its target 2% level in a sustained manner.

Based on our assumption that monetary stimulus is more potent than fiscal stimulus, it is important to pay close attention to the forward guidance provided by the Federal Reserve regarding how accommodative it intends to be going forward. For now, we assume that the Federal Reserve's tendencies will be to remain more patient in regard to reversing accommodative policies than we have experienced in the past.

Regarding the prospect of a modest corporate tax increase, a raising of the minimum corporate tax for repatriated global income, and a return of the highest marginal individual personal tax rate to 39.5% from the current 36%, we are not overly concerned about a materially negative impact on economic growth, as well as corporate earnings and cash flows. We do not worry because what is likely to find its way into a final bill will likely be quite modest.   Furthermore, fiscal stimulus in the form of spending should more than offset any negative macro-economic and corporate finance consequences of modest tax increases.

The most important determinant of how much of a lift we will see in some of our baseline long-term economic and corporate metrics will be driven by infrastructure and R&D investment and how much these investments will bolster productivity. Factoring in what we know about the proposed tax increases and spending proposals, we must at least make a directional assumption on productivity, as productivity increases, and decreases will directly impact return on invested capital (ROIC).

On the prospect of major productivity improving infrastructure investments, including traditional transportation infrastructure and new economy infrastructure such as 5G broadband, a modernization of the power grid, and a cross-country electronic vehicle charging network, it would be hard to argue that such investment will not positively impact overall business productivity. We concur with those who believe that higher productivity leads to overall higher ROIC, which we believe increases long-term equity market returns. As active managers we always welcome policy decisions which should produce a macro "tail wind" of higher potential equity market returns.

As we look forward from here, we continue to see some excesses in the broad equity markets, but those excesses do not appear widespread enough to derail the positives that we see from a continuation of easy monetary policies and the proposed net stimulative fiscal policies that appear likely over the next several years.

Our baseline premise as of now is that monetary and fiscal stimulus will outweigh the likely modest tax increases on the horizon. We continue to see radical innovative driven disruption ahead in almost all areas of the economy, particularly in healthcare, transportation, and the application of artificial intelligence. We are confident that to capitalize during times of radical innovative disruption, forward-looking active management is logically the best choice for investors looking to squeeze out as much risk-adjusted positive performance from their portfolios as possible.

We look forward to continuing to write about how we are positioning investors for what is likely to be a very exciting time ahead for those of us willing to embrace change and seize on resulting opportunities.

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Disclosure:

Advisory services offered through CS Planning Corp., an SEC registered investment advisor.

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