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# CIO Strategy Bulletin

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## Go Big or Go Home

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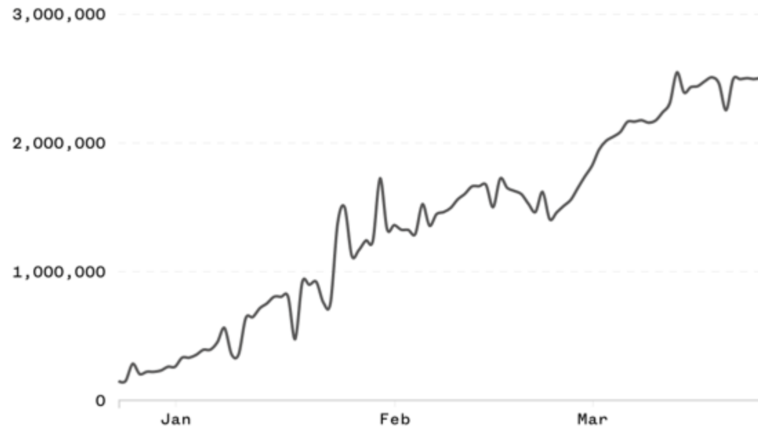
- **President Biden sees the damage from the Pandemic and America's declining global power as a crisis comparable to that faced by Roosevelt in 1933. Recently, he met with eminent historians to learn what other US Presidents did successfully to redirect America's economy toward growth and a greater sense of "possibility" in its workforce. Thus, his second transformative legislative package is set to be introduced this coming week and it is huge. This Bulletin begins to assess the scope and impacts of Biden's New Deal.**
- **Recent equity market action underscores the impact of higher rates on growth equities. The same is true in China which we also discuss herein. But even as a second stimulus bill could be a further boon for overall US employment and corporate earnings growth, we think skeptical investors underappreciate the speed with which the US, Chinese and global reopening will occur over the next six months based just on the Covid stimulus package and Chinese policy.**
- **While the recent rotation from growth and into value cyclicals has been strong, it is not nearly complete. Some investors need to "see the recovery" before they buy into the realities of the New Economic Recovery, perhaps missing out on a significant portion of this cyclical and we think, powerful, rally underway.**

## Go Big or Go Home

The $1.9 trillion COVID bill may just be the beginning. On March 2nd, President Biden met with several renowned historians at a two-hour meeting at the White House. The lengthy discussion speaks to the President's determination to be consequential or, in more common terms, to "go big or go home". US vaccine roll-outs are going extremely well **(Figure 1)** showcasing that this government can undertake and deliver upon ambitious projects. Next up is Biden's "New Deal" (a reference to FDR's transformative, Depression Era stimulus plan), an estimated $3+ trillion program that combines an infrastructure and green-energy bill with legislation that offers wide access to college education and universal kindergarten. Together, these potential programs would be much bigger than those that built the US Interstate highway system **(Figure 2)**.

**Figure 1: Average US COVID-10 vaccinations per day**




Source: US Centers for Disease Control and Prevention as of March 26, 2021.
Note: Figures are 7-day average of new daily vaccinations

**Figure 2: Possible high level details of President Biden's Infrastructure proposal**

| Reported details of Biden Infrastructure proposal (Preliminary) | | |
|---|---|---|
| | **Proposed Spending** | **Proposed Tax Changes** |
| **Bill #1: "Traditional" Infrastructure** | - $3 trillion price tag<br>- $1 trillion on roads, bridges, rail, EV charging stations, improvements to the electric grid<br>- Clean energy deployment<br>- Development of "other high-growth industries" like 5G<br>- Rural broadband<br>- Advanced training for American workers | - Increase corporate tax rate from 21% to 25%-28%<br>- Establish global minumum tax for multinationals |
| **Bill # 2: "Social" Infrastructure** | - Funds for education<br>- Funds for child care<br>- Expanded Affordable Care Act subsidies<br>- Tax credits aimed at cutting poverty, particularly for children | - Raise top marginal income tax rate back to 39.6% from 37%<br>- Tax investment income over $1 million as ordinary income<br>- Allow Medicare to negotiate prescription drug costs with pharma companies |

Source: Bloomberg as of March 26, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

In his news conference this past week, President Biden was explicit in his determination that the US close its infrastructure-spending gap with China, rebuilding "infrastructure, both physical and technological so that we can compete and create significant numbers of really good-paying jobs." Pete Buttigieg, the former presidential contender and now the US transportation secretary, said in his inaugural committee testimony that, "We face an imperative to create resilient infrastructure and confront inequities that have devastated communities", in effect combining investment in hard assets with "investment" in transformative social programs.

President Biden is trying to avoid the mistake many believe Obama made, allowing fiscal policy to be tight in the early stages of the last recovery. Remember that Obama lost control of a unified government in late 2010 and US fiscal policy tightened well before the economy was fully healed. While no one knows if additional government spending would have accelerated re-employment, the US unemployment rate didn't return to the pre-2008 level until 2015. During those years and after, many people suffered long-term unemployment that had lasting negative impact on their skills and 'lifetime income'. This period argues for *less* bi-partisanship now on the assumption that Republicans will simply not cooperate with macroeconomic policy support, particularly one that redistributes the tax burden or raises the future tax burden. Thus, inclusion of spending well beyond infrastructure is notable precisely because Republicans are unlikely to engage in any bipartisan legislation that is not narrowly focused on bridges, highways and transportation infrastructure.

## Irreconcilable Reconciliation: Republican Bridge or a Democratic Pothole?

In the event that the Democrats are truly determined to pass broad, transformative legislation, they may have to go it alone if they cannot secure 10 Republican Senate votes. This leaves them two pathways. The first is known as "Reconciliation", a process contained in the Congressional Budget Act of 1974 that reconciles law-making with budget resolutions passed by Congress. In other words, if the Democrats can find the taxes to pay for the spending over a ten-year period, they can expedite Biden's New Deal with just 50 votes. The other option is to remove the Senate filibuster, a procedure which requires a super-majority to pass most legislation. Elimination of the filibuster would be a controversial, more "nuclear" option that could change the functioning of the Senate permanently.

## First, New Taxes

Given that the President sees the damage from the Pandemic and America's declining global power as a crisis comparable to that faced by Roosevelt in 1933, taxation is one obvious means to pay for Biden's New Deal. On the table are new tax ideas, including a "mileage tax" where "how we pay for roads is you pay based on how much you drive" and a carbon tax to raise new revenue and reduce greenhouse gas emissions. In addition, there would have to be increases in existing tax rates. To pay for infrastructure, increases could include raising the corporate tax rate. It is unlikely that corporate rates would be hiked back to pre-2017 levels, though an increase from 21% to 25% or even 28% seems to be on the table **(Figures 3-4)**. Moreover, Biden's plan may also include increasing the global minimum tax paid, ending federal subsidies for fossil fuel industries and making multinational corporations pay the U.S. tax rates on all operations, US and domestic. To pay for "social infrastructure", taxes on those making more than $400K could rise, including increasing the highest income tax rate to 39.6 percent, reducing deductions that rich taxpayers can claim, taxing dividends as normal income for those earning more than $1 million and changes in estate taxation.

**Figure 3: Change in effective tax rate by sector following Tax Cuts and Jobs Act in 2017**

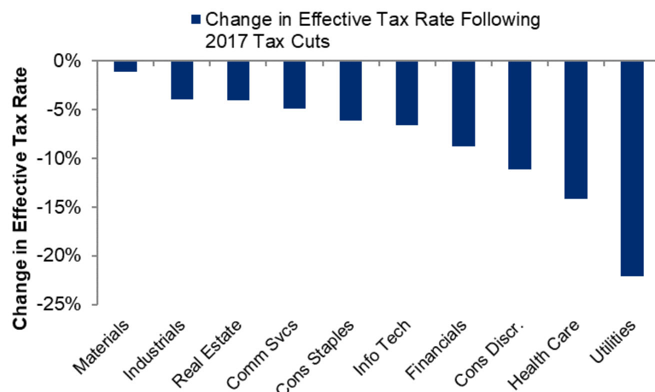
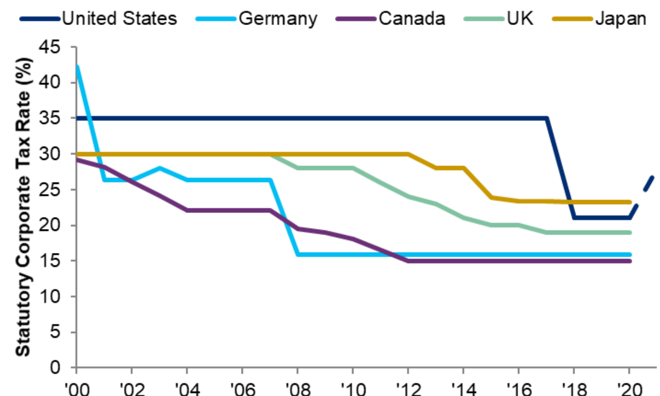



**Figure 4: US corporate tax rates relative to trade partners**




Source: Haver Analytics as of March 26, 2021

## Better and More Municipals?

Alternative funding proposals could include the issuance of "Build American Bonds". These bonds are unusual as they allow states and counties, which manage most of the infrastructure, to issue municipal debt with interest rate costs subsidized by the federal government. These forms of financing were last used during the Obama Administration following the Great Financial Crisis. Total issuance then was $181 Billion and would have to be far greater this time around given the scope of the proposed plans. Notably, the value of municipal bonds to wealthy investors rises as tax rates rise.

## The "Super Bowl of Tax Reform"

With the pending announcement of Biden's plan on March 31st in Pittsburgh, Pennsylvania, the "Super Bowl of Tax Reform" will be underway as advocacy groups from across the full political spectrum begin to lobby lawmakers intensely. Like we saw during the 2017 tax reform, it is quite difficult to predict what the tax code will ultimately look like at the end of this process, as countless interest groups will be fighting for influence in crafting the legislation. Importantly, the President has the support of Senator Joe Manchin, a key centrist Democrat from West Virginia who said that he supports a multi-trillion-dollar infrastructure package that would be paid for in part by raising taxes.

## Winners and Losers

From an investor's standpoint, the second huge stimulus has two major and offsetting consequences: What would such spending and taxation do to economic growth and markets?

At this time, it is impossible to determine the net impact of the legislation until the spending and funding are defined. However, there are important differences between the COVID and Infrastructure legislation that suggest the general effects will be different this time around. The former was funded mostly by new debt issuance. The latter may be funded by tax increases over a range of sources with less reliance on new debt issuance. Thus, some economists note that if the tax increases are broad and do not reverse previous legislation completely, the impact on corporate earnings may be modest. During a New Economic Recovery, the drag on corporate earnings growth and buybacks would be taking place as overall growth is accelerating. Looking back to the 1987 and 1993 capital gains taxes increases, we see a modest drawdown of less than 5% after the passage of the changes. That said, the combined impact of two major bills on business growth is not certain. Even as the stimulus could be a boon for overall employment and corporate earnings growth, it could lead to more sustained inflation and higher interest rates.

Looking at sectors, however, the passage of Biden's New Deal is likely to create bigger winners and losers. Fossil fuel producers, refiners and distributors could be hurt as the government puts its finger on the scale in favor of clean energy and transportation electrification. Companies building next generation, climate sensitive industrial equipment and other transformative technologies would be clear winners. Thus, we see the opportunity in our "Unstoppable Trends" as accelerating, too. Further, to the extent that the passage of this second "New Deal" coincides with the Biden Administration's willingness to assemble a Western coalition to address competitive issues with China, our "G2" thesis about further and intensified competition between two distinct economic spheres will become more relevant for investors.

One thing is for certain, Joe Biden is looking at history and his legacy as a guide for the size and scope of the actions his administration is willing to take. At the March 2nd meeting, the conversation included the limits that a President has on going bigger and faster than the public might accept or understand. According to Axios, Biden told an aide afterwards: "I could have gone another two hours." You can be certain that we will issue more advice over the coming weeks.

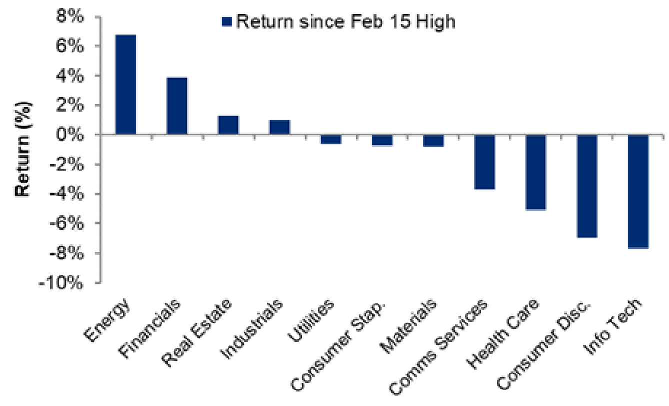
## The Ides of March

We believe equity markets are in the midst of a significant turning point. From November 2020 until about mid-February 2021, investors largely enjoyed a "goldilocks" scenario for equity markets. Optimism on the vaccine front generated confidence about an economic reopening while rates remained extremely low, enabling both growth and value to rally sharply together. That situation – material economic growth without higher rates – was "too good to be true" or at least unsustainable. With the "wake up" of the bond market, equity valuations became the central focus for investors. And with that came the great rotation and higher volatility. This has deeply impacted the best performing "Stay at Home" technology shares. Meanwhile, the need to fund large US deficits became a bit easier as divergent Central Bank interest rate policies between Europe and Japan, versus the US, have made US bonds more attractive.

Looking more deeply at markets, there are entire sectors of equities that have seen double digit declines since mid-February. Yet, broad index levels have barely budged. As we have said before, focusing on indices and index performance misses the market action. Sectors we have focused on like Financials, Industrials and REITs – those most likely to benefit from reopening – have continued to move higher along with interest rates **(Figures 5-6)**. In fact, the S&P 500 and Dow Jones Industrial Average both closed Friday at new all-time highs, while the Nasdaq remains 7% below February's record.

**Figure 5: Leave Your Home vs Stay at Home baskets**

**Figure 6: Global sector returns since February 15, 2021**




Source: Bloomberg as of March 26, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. "Stay at Home" basket includes names identified to benefit from COVID-related disruptions and a shift to working from home "Leave Your Home" basket includes Buy and Neutral Rated US names in the following sub-industries: Banks, Industrial Conglomerate, Machinery, Oil Gas & Consumable Fuel, Textiles Apparel & Luxury Goods, Energy Equipment & Services, Hotels Restaurants & Leisure, Building Products, Retail REITs, Construction & Engineering, Leisure Products, Airlines, Multiline Retail.

## The Value of Diversification and Where to Find it Now

Perhaps the most notable characteristic of markets recently has been the *negative* correlation between different sectors within equity markets **(Figure 7)**. These disparate outcomes can largely be tied to movements in interest rates, with the more tech-heavy Nasdaq falling on average on days when rates are rising, while the more diversified S&P 500 and cyclically-oriented Dow Jones Industrial Average have rallied on days when interest rates move higher **(Figure 8)**. As we wrote in the March Quadrant, we expect the 10-Year Treasury to average 2.5% during the next several years of economic expansion. Once valuations among secular growth sectors adjust for higher discount rates, we expect those with superior earnings power to move ahead. That said, there will need to be more discernment among "high growth" companies as those that can sustain growth and drive higher cash flow will ultimately gain even in a higher rate environment.

**Figure 7: Rolling Correlation between Leave your Home and Stay at Home baskets**

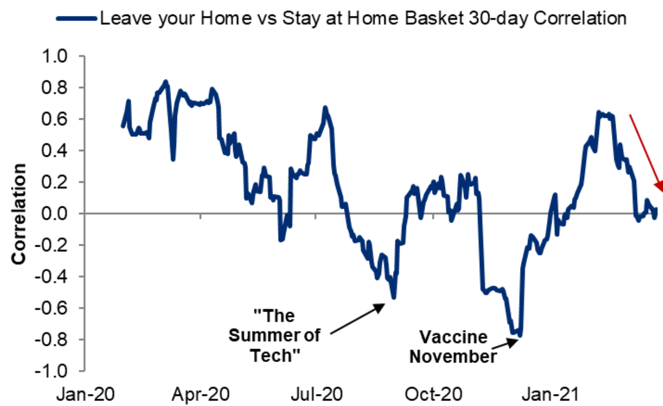



**Figure 8: Average US equity Index Returns on Days When Rates are Rising or Falling**

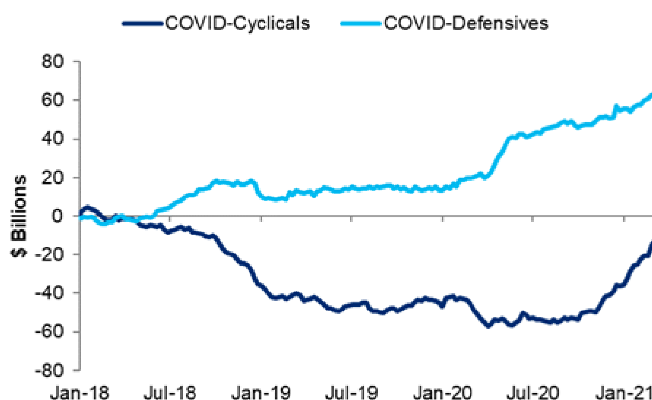
| | Avg return this year when rates are… | |
|---|---|---|
| | **Rising** | **Falling** |
| **S& 500** | 0.25% | -0.12% |
| **Dow Jones** | 0.09% | 0.00% |
| **Nasdaq** | -0.11% | 0.15% |

Source: Haver Analytics as of March 26, 2021. Note: Leave your Home and Stay at Home Basket definitions are referenced above in Figure 5. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

The rotation into value cyclicals is supported by increasing flows into "reopening" sectors, as investors buy into the idea that consumers are highly likely to spend more on "socially close" services than household goods in the year ahead. With that said, recent inflows have only brought net AUMs in cyclical funds back to pre-COVID levels, while inflows remain steady into defensive sectors like technology despite higher recent volatility **(Figure 9)**. While recent vaccine data has been extremely encouraging, some investors remain quite wary of the recovery. As such, we would expect inflows into these COVID-cyclical names to continue to "catch up" to COVID-defensives as the economic recovery actually transpires. In other words, while the recent rotation from growth and into value cyclicals has been strong, it is not nearly

complete. Some investors need to "see the recovery" before they buy into the realities of the New Economic Recovery, perhaps missing out on a significant portion of this cyclical and we think, powerful, rally.

**Figure 9: Inflows into COVID-Cyclical sectors have picked up since late 2020**




Source: EPFR as of March 26, 2021. COVID cyclicals are Energy, Materials, Industrials, Financials, Consumer Discretionary (ex-ecommerce), and Real Estate. COVID defensives are Technology, e-commerce, Telecom Services, Healthcare, Staples and Utilities.

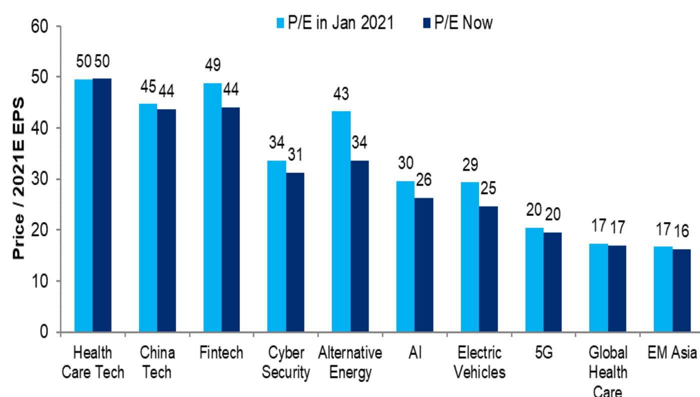
## Thinking Beyond the Immediate Reopening

While we retain a tactical cyclical bias in our recommended equity allocations, the selloff in secular growers and recovery in reopening stocks will ultimately present opportunities to re-orient exposure back towards areas that are likely to see the strongest upside in the post-COVID economic cycle.

While it is often simple to view the world through the prism of growth OR value, we see that framework as unnecessarily limiting. In an environment where it feels like all secular growth opportunities are fully priced or even over-priced for their expected growth, we can still find areas of the market that exhibit interesting value and solid growth prospects, but would not fall into the traditional definition of deep value or cyclical shares. So far this year, strategies focused on identifying cheap growth, known as "growth at a reasonable price", have outperformed both growth AND value (**Figure 10**). Indeed, our upgrade to Health Care in January was squarely in line with this kind of investing realism: identifying an area likely to deliver strong earnings for years to come, but one which is not yet fully priced for that growth. The ongoing selloff in many of our favorite secular growth stories, like cyber security, fintech, and renewable energy will also ultimately present an opportunity to add to these long-term "Unstoppable Trends" at better valuation entry points than were available just a few weeks ago. This is why we must keep looking at the "rotation" taking place closely and maintain our stance on areas where our confidence is squarely based on what is most likely to happen in 2021 and 2022.

**Figure 10: Growth at a Reasonable Price has outperformed both Value and Growth YTD**

**Figure 11: Secular growth valuations re-rating lower**

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## An Inauspicious Start to the New Year in China

Investors in Chinese equities had a difficult week:

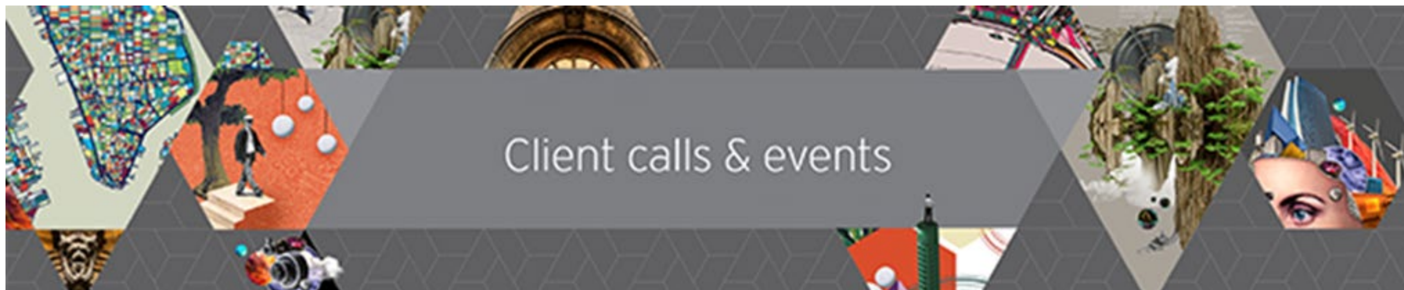
- The US, EU, UK and Canada announced sanctions on Monday against China over human rights abuses in Xinjiang. China responded to the EU quickly with similar measures, targeting sharp critics in the European Parliament, a German think tank, a Danish foundation and two scholars who have published work on Xinjiang.
- On Tuesday, the US Securities and Exchange Commission said that it is taking initial steps to enforce stricter accounting rules for ADR issuers (American Depositary Receipts are securities that represent a foreign company and allows that company's shares to trade in the US financial markets). If this accounting rule were to be enforced, Chinese companies who have not allowed US regulators to independently audit accounts would be at risk of being forced to delist if they do not comply for 3 years.
- Separately, on Thursday, Bloomberg carried a story that Chinese regulators are considering a proposal to create a “government controlled company” to oversee data from internet platforms.

The MSCI China index fell nearly 5% this week, and is now 17% weaker since mid-February. China’s tech names are even more beaten up, down 27% in just 6 weeks. Some of this parallels the revaluation in technology stocks globally, particularly in US markets. Though Nasdaq’s decline is driven by the ongoing normalization in US interest rates, in China’s case valuations and sector rotation are not the full story. Our expectation that Chinese authorities would tighten credit growth led us to reduce our tactical allocations to neutral in January, ahead of much of this volatility **(Figure 12)**. The speed and magnitude of the selloff is notable, as the underlying fundamentals underpinning China’s “new economy” sectors are largely unchanged despite the barrage of policy headlines. Looking ahead, we are keenly watching secular growth markets, including Chinese equities, as we will eventually want to reallocate back into an area which we continue to view as a long-term core growth opportunity. Again, this an example of discerning the facts from the emotions of markets.

**Figure 12: MSCI China valuations and domestic credit**

**Figure 13: China earnings growth expected to be robust in 2021**

Source: Bloomberg as of March 26, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

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