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Citi Global Wealth Investments

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Infrastructure, Inflation and Interest Rates: Will Growth Prevail?

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Summary

- With many investors "at the beach" or at least in their backyards, all may appear quiet. But looking at events from Washington to Beijing, that's hardly the case. Inflation prints suggest a "hot economy", but bond markets signal slow growth ahead. Consumer sentiment data in August was surprisingly low. And two major infrastructure bills, one to literally "build bridges" and another to substantially reshape social and environmental policies passed major hurdles. And the news on COVID caseloads is troubling, especially for the unvaccinated. So, should markets expect growth through COVID and higher taxes? Or will inflation cause the Fed to tighten more quickly and curtail the delayed "Post-COVID" recovery that's yet to fully appear? Read on.

Fast and Furious: $1 Trillion plus $3.5 Trillion

After months of negotiations, a bipartisan coalition in the Senate approved a roughly $1 trillion infrastructure bill (The Infrastructure Investment and Jobs Act) on August 10. For President Biden, the measure makes good on his pledge to work across the aisle, with 19 Republicans joining 50 Democratic Senators to pass the bill with a 69-30 vote. What's more, the bill appears to have enough support to pass through the House. In parallel, the Democratic Senate took procedural steps forward with a $3.5 trillion anti-poverty and climate bill to be funded by higher taxes on the wealthy and corporations.

Winners and Losers: What Infrastructure Really Means

The Infrastructure Investment and Jobs Act calls for $550 billion in new spending on top of already approved funds, including $110 billion on roads and bridges, $73 billion on improving the electrical grid, $66 billion on passenger and freight rails (including Amtrak), $65 billion on broadband expansion, $55 billion on clean drinking water, $39 billion on improving public transit, $21 billion on environmental remediation, $11 billion in transit safety programs, $7.5 billion for electric vehicle charging stations and billions more for zero emission electric buses and other items that will create demand for batteries. The bill is paid for by redirecting unspent emergency relief funds, targeted corporate user fees and tighter tax enforcement around crypto-currency transactions.

The bill is beneficial for those industries directly and indirectly impacted such as construction & engineering, internet providers to rural and low-income areas, transportation (including EVs), and building materials firms. The bill also includes a $6 billion program to keep nuclear reactors, which provide 20% of the nation's electricity, in operation for four years as they compete with lower cost natural gas and renewable operators.

Among those industries impacted most negatively, the bill imposes fees on 42 chemicals, focusing on those that harm the environment when released, such as methane and butane. These fees are expected to cost the chemical industry $1.2 billion a year. The bill also requires the reporting of crypto currency gains and transactions of $10,000 or more to the Internal Revenue Service (IRS). As for big pharma, the bill requires drug makers to pack less into single-use containers to reduce drug waste starting in 2023. Drug companies will have to reimburse Medicare for medicine discarded by doctors.

Year-to-date, infrastructure stocks with the most US exposure (yellow line) have outperformed the market and less US-centric infrastructure indices **(see Figure 1)**.

Figure 1: US Infrastructure Stocks Have Outperformed

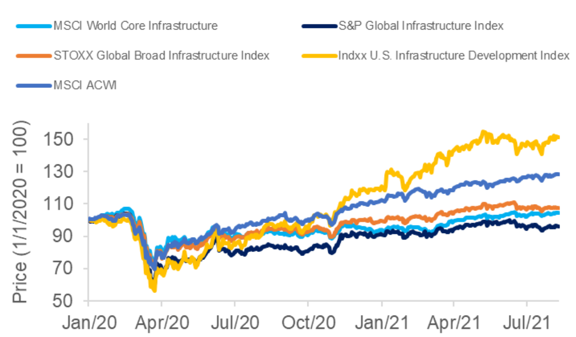
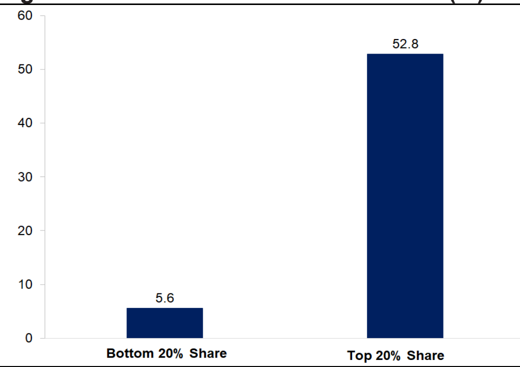


Figure 2: US Share of Personal Income (%)



Source: Factset, Haver Analytics and MSCI as of August 11, 2021.. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Unstoppable Trends and Infrastructure

The Infrastructure Investment and Jobs Act shines a spotlight on promising growth areas directly related to our Unstoppable Trends. Enhancement to the electric grid, clean drinking water, safety and broadband are all elements of our Greening the World, Longevity and Hyper-Connectivity trends (see our Mid-Year Outlook 2021 | Traveling to a Post-COVID World). In addition, the effort to improve the nation's infrastructure is, in part, motivated by an urgency to better compete with China in a G2 World, another Unstoppable Trend. We believe the leading firms tied to these trends will out-earn the market at large.

Budgetary Impacts

For the overall economy, the annual incremental spending represents about 0.5% of the $23 trillion US economy and will be less impactful than the 2020-2021 emergency COVID relief initiatives or the $3.5 trillion in looming legislation. An August 5th analysis using the Penn Wharton Budget Model (PWBM) found no significant effect on GDP by end of the budget window (2031). An August 6 analysis by the Congressional Budget Office (CBO) showed similar results and almost no impact on interest rates by the ends of 2031. Both studies concluded that US budget deficits would be slightly higher.

Next Up: The $3.5 Trillion Antipoverty and Climate Bill

Senate Democrats also released the text of their budget resolution which outlines a $3.5 trillion agenda to offer universal pre-kindergarten, two years of free community college, expanded Medicare benefits, investments in public housing, incentives to generate 80% of US electricity using clean sources by 2030 and more. The antipoverty initiatives attempt to improve the sustainability of US economic growth through redistributive means **(Figure 2 above).**

To cover the cost, the legislation would increase taxes on the wealthy and corporations. At a high level, the impact on financial markets of changes in the US tax code may not impact markets as deeply as one might think. Historically, tax hikes have occurred most often during periods of recovery when markets can handle them. A review of the last 14 US increases to top income, corporate, or capital gains tax rates since 1950 reveals just one instance where the U.S. stock market posted a negative return in the year following the tax changes. That occurred in 1969 when the US economy experienced a recession as President Johnson tried to close a budget deficit caused by the Vietnam War while the Federal Reserve tightened its monetary policy. **(see Figures 3 and 4**).

Figure 3: Changes in the US Tax Code vs. US Stock Market Returns and Real GDP

Marginal Income Tax Rate Increase						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1968	70.0%	75.3%	LBJ	Revenue and Expenditure Control Act of 1968	11.04%	4.91%
1969	75.3%	77.0%	LBJ	Revenue and Expenditure Control Act of 1968	-8.40%	3.13%
1991	28.0%	31.0%	Bush Jr.	Revenue Reconciliation Act of 1990	30.47%	-0.11%
1993	31.0%	39.6%	Clinton	Omnibus Budget Reconciliation Act	10.08%	2.75%
2013	35.0%	39.6%	Obama	American Taxpayer Relief Act of 2012	32.39%	1.84%
				Average:	15.11%	2.51%

Marginal Income Tax Rate Decrease						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1964	91.0%	77.0%	LBJ	Revenue Act of 1964	16.43%	5.76%
1965	77.0%	70.0%	LBJ	Revenue Act of 1964	12.46%	6.50%
1970	77.0%	71.8%	Nixon	Tax Reform Act of 1969	3.89%	0.19%
1971	71.8%	70.0%	Nixon	Tax Reform Act of 1969	14.22%	3.29%
1981	70.0%	69.1%	Reagan	Economic Recovery Tax Act of 1981	-4.88%	2.54%
1982	69.1%	50.0%	Reagan	Economic Recovery Tax Act of 1981	21.50%	-1.80%
1987	50.0%	38.5%	Reagan	Tax Reform Act of 1986	5.18%	3.46%
1988	38.5%	28.0%	Reagan	Tax Reform Act of 1986	16.61%	4.18%
2001	39.6%	39.1%	Bush Jr.	Economic Growth and Tax Relief Reconciliation Act of 2001	-11.89%	1.00%
2002	39.1%	38.6%	Bush Jr.	Economic Growth and Tax Relief Reconciliation Act of 2001	-22.10%	1.74%
2003	38.6%	35.0%	Bush Jr.	Jobs and Growth Tax Relief Reconciliation Act of 2003	28.68%	2.86%
2018	39.6%	37.0%	Trump	Tax Cut and Jobs Act of 2017	-4.38%	3.00%
				Average:	6.31%	2.73%

Corporate Tax Rate Increase						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1950	38.0	42.0	Truman	Revenue Act of 1950	31.45%	8.68%
1951	42.0	50.8	Truman	Revenue Act of 1951	23.97%	8.05%
1952	50.8	52.0	Eisenhower	Revenue Act of 1951	18.16%	4.09%
1968	48.0	52.8	LBJ	Revenue and Expenditure Act of 1968	11.04%	4.91%
1993	34.0	35.0	Clinton	Omnibus Budget Reconciliation Act	10.08%	2.75%
				Average:	18.94%	5.70%

Corporate Tax Rate Decrease						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1964	52.0	50.0	LBJ	Revenue Act of 1964	16.43%	5.76%
1965	50.0	48.0	LBJ	Revenue Act of 1964	12.46%	6.50%
1970	52.8	49.2	Nixon	Tax Reform Act of 1969	3.89%	0.19%
1971	49.2	48.0	Nixon	Tax Reform Act of 1969	14.22%	3.29%
1979	48.0	46.0	Carter	Revenue Act of 1978	18.45%	3.17%
1987	46.0	40.0	Reagan	Tax Reform Act of 1986	5.18%	3.46%
1988	40.0	34.0	Reagan	Tax Reform Act of 1986	16.61%	4.18%
2018	35.0	21.0	Trump	Tax Cut and Jobs Act of 2017	-4.38%	3.00%
				Average:	10.36%	3.69%

Source: Bloomberg as of August 12, 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 returns. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 4: Summary of US Stock Market Reaction During Tax Increases Since 1950

US personal income tax	US corporate income tax	US capital gains tax
Only 1 of 5 cases coincided with a yearly decline in US share prices	0 of 5 cases coincided with a yearly decline in US share prices	0 of 4 cases coincided with a yearly decline in US share prices

Average annual gain in US shares when	Tax increases %	Tax cuts %
Personal income tax rates change	15.1	6.3
Corporate tax rates change	18.9	10.4
Capital gains tax rates change	16.3	18.9

Source: Citi Global Wealth Investments Office of the Chief Investment Strategist as of August 12, 2021.

To pay for the proposed "democratic" legislation, discussions are centered on the corporate tax rates. There is a debate about the rate moving from 21% to between 25% and 28%, instituting a global minimum tax of 15%, taxing capital gains and carried interest as income, and returning the top personal tax rate to 39.6% from 37.0% **(Figures 5-6)**.

While we do not know the outcome of the tax increase discussion precisely, we believe this a good time to engage in wealth and estate planning conversations.

Figure 5: Distribution of Worldwide Corporate Tax Rates, 2020

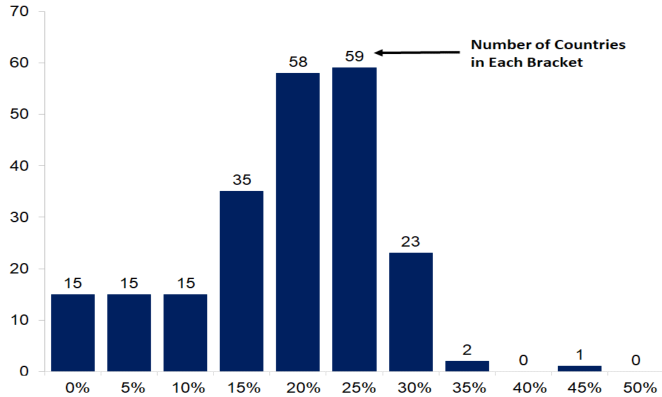
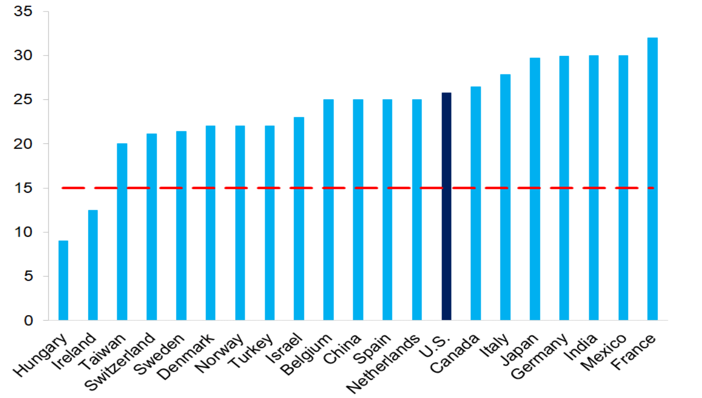


Figure 6: Corporate Tax Rates in Select Countries vs. Global Minimum Tax Rate of 15%



Source: Bloomberg and Haver Analytics as of August 12, 2021.

Inflation Appears to be Peaking

Inflation remained elevated in July with consumer prices (CPI) 5.4% higher than a year prior. June's readings were tied with the highest increases since 2008. Core CPI was up 4.3%, which excludes food and energy. This is after the initial Spring inflation caused by people leaving home after receiving COVID vaccinations, record cumulative fiscal emergency relief and a surge in business re-openings.

While overall inflation has yet to recede, there are numerous signs that it will. After lumber and copper prices peaked on May 7 and May 11, respectively, expectations of inflation embedded in 10-year Treasury Inflation Protected Securities (TIPS) peaked on May 12 **(see the next section on Interest Rates)**. Brent crude oil futures peaked on July 5 and WTI crude futures peaked on July 13. After used vehicle prices rose sharpy in April, May, and June due to a shortage in semiconductors impacting the supply chain of new vehicles, they rose just 0.2% in July. In addition, we see a slowdown in the fiscal impulse following the infrastructure and reconciliation bills currently underway. These factors should prove more meaningful than a potential rise in rents on the heels of higher property prices.

It is understandable that people and investors worry about inflation due to its varied sources – it appears to be everywhere. But in our view, these are major distortions largely associated with the impact of COVID itself. In all, we expect inflation to average around 3.0% in 2022 and somewhere between 2.0% and 2.5% in the years that follow. Once the pandemic-related effects on supply and demand fade, the main driver of inflation should be monetary policy, led by a central bank targeting higher personal consumption expenditure (PCE) inflation between 2.0% and 2.5% over time.

Tracking Interest Rates

The benchmark U.S. Treasury yield (UST) started the year at about 1%. The COVID-19 vaccine roll-out was still ahead. A very accommodative Federal Reserve was keeping short term rates at 0% and providing $120 billion in new monthly Treasury and MBS purchases.

In early spring, the market began to see how COVID-19 risks were receding, and how the economy was quickly re-opening. Yet, the re-opening was accompanied by supply shortages in almost every good and service. Additionally, raw material prices such as lumber, oil, and copper were spiking higher on this sudden surge in demand.

The combination of these supply shortages and higher commodity prices quickly led to a market expectation of growing inflation pressures, which in turn pushed the 10yr UST yield higher to almost 1.75% at the end of March. Indeed, inflation expectations remain anchored in the mid 2% range irrespective of duration, as evidenced by inflation breakeven rate curves for Treasury Inflation Protected Securities or TIPS **(see Figure 7)**.

Then, suddenly, there was a rate reversal. Rates hit 1.12% in early August before settling in around 1.35% by mid-month. Something beyond inflation was driving yields down **(see Figure 8)**.

Figure 7: US inflation breakeven rate curve

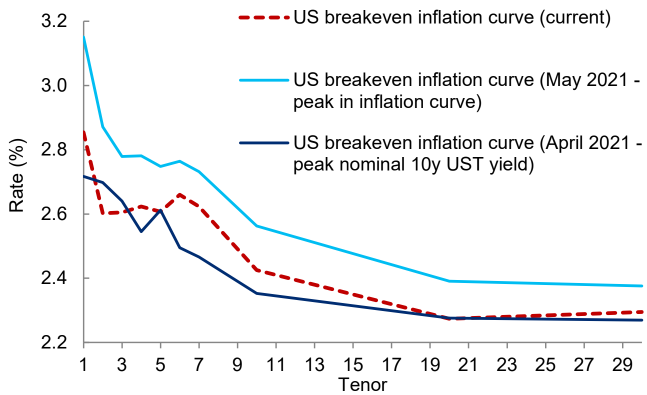
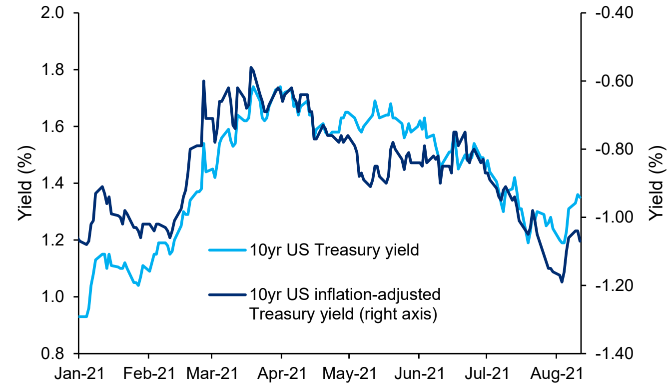


Figure 8: 10yr US Treasury yield vs "real" yield



Source: Bloomberg, Haver Analytics as of August, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Though there are many factors for this counter-trend move in rates, three are predominant in our view. An imbalance in the demand and supply of USTs was a major factor as rates in the US were higher than elsewhere and capturing them through hedging became feasible. A second was the resurgence of the virus and the Delta variant. And a third was the fact that the global economy was "post" peak growth rates and was normalizing toward a sustainable 2022 growth rate of 3.5%.

In short, the bond market is telling us that growth will fall materially and that investors will be willing to accept negative real returns in excess of 1% for years to come. We are not sure that this is likely.

We think that the Fed is willing to see higher inflation to maintain above trend growth right through the pandemic. We see the present slowdown in China as temporary and the market imbalance in US Treasuries as transitory. China is currently easing its monetary policy in order to restart growth. The Federal Reserve is likely to announce a gradual tapering of its monthly securities purchases, leading to higher short-term rates by the end of 2022.

Accordingly, we are maintaining our expectation that the 10y UST rate will likely trade in a 1.5-2% in 2021, with some possibility of rates moving higher over time depending on the path of long-term inflation.

Our Economic Outlook: Putting This All Together

Overall, the economic outlook for the year ahead remains positive with Citi Global Wealth Investments expecting solid US and global GDP growth through 2021 and 2022. US and global leading economic indicators (LEI) remain elevated after peaking a few months ago, consistent with our view that growth will be slower in 2022 than in 2021 **(Figure 9)**.

We also believe that productivity is trending higher and this may help protect corporate profit margins in the wake of higher wages and other costs, while also keeping runaway inflation at bay **(Figure 10)**.

Even if the Fed starts to taper its asset purchases in late 2021, it will still be buying bonds into 2022 and rates will still be low on an historical basis for the remainder of this recovery. Monetary policy will remain generally accommodative.

All of this suggests that remaining overweight equities is wise and that focusing on dividend income (relative to bond income) makes sense. Earnings growth will slow but remain above-trend and those companies focused on higher payouts will achieve them.

Figure 9: Leading economic indicators (LEI): US vs. OECD

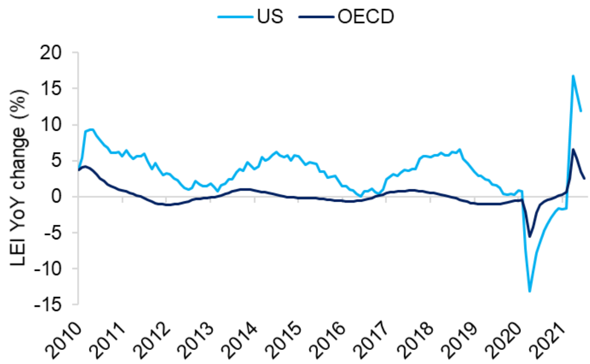
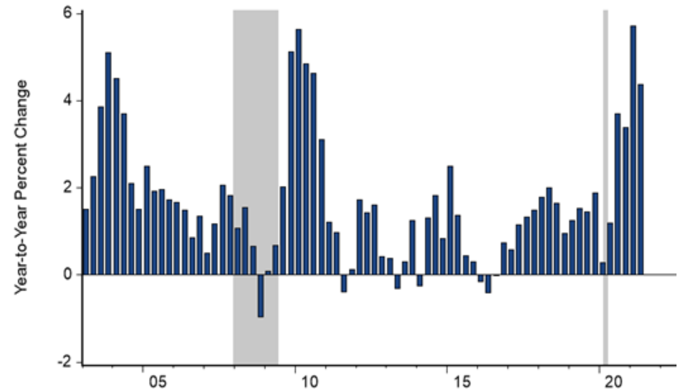


Figure 10: US Productivity Growth, Output per person (YoY)



Source: Bloomberg and Haver Analytics as of August 12, 2021. Note: Grey shaded bars indicate US recession. 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 returns. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

There are risks to this view, of course. With the Delta variant surging even in highly vaccinated countries and concentrated pockets of unvaccinated people experiencing the worst outbreaks of the pandemic in their communities, there are threats for 2022. In fact, the surprise drop in consumer confidence for the first half of August (the lowest level since 2011) shows that fear and risk remain strong impediments to full normalization (see our latest Data Watch publication) and **Figures 11 and 12**.

Consumer confidence and similar real time sentiment indicators are likely to play a larger role in Fed decision making as they monitor the vibrancy of the economy in the face of COVID. In our view, the global economy is likely to demonstrate resilience as distribution networks, e-commerce and adaptive technologies will support "work from home" But the headwinds from the Delta variants surge are real and distortive. They are likely to keep the Fed accommodative for longer than may have been obvious even a few months ago.

Figure 11: US New Cases of Covid-19

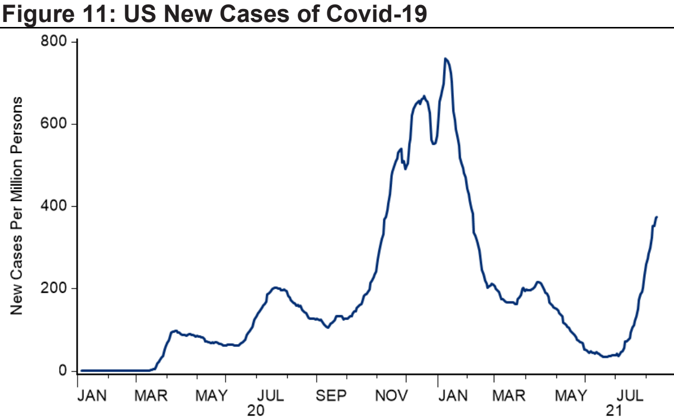
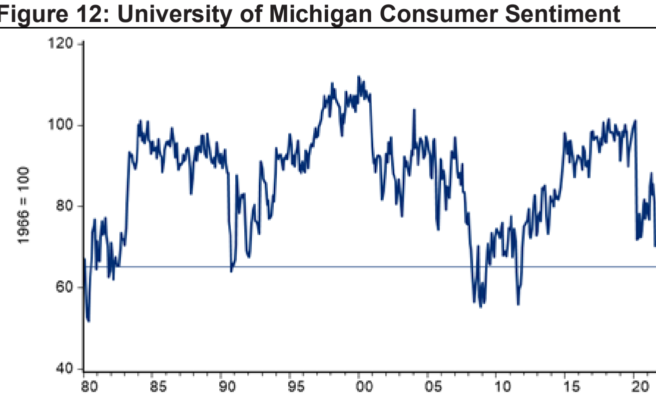
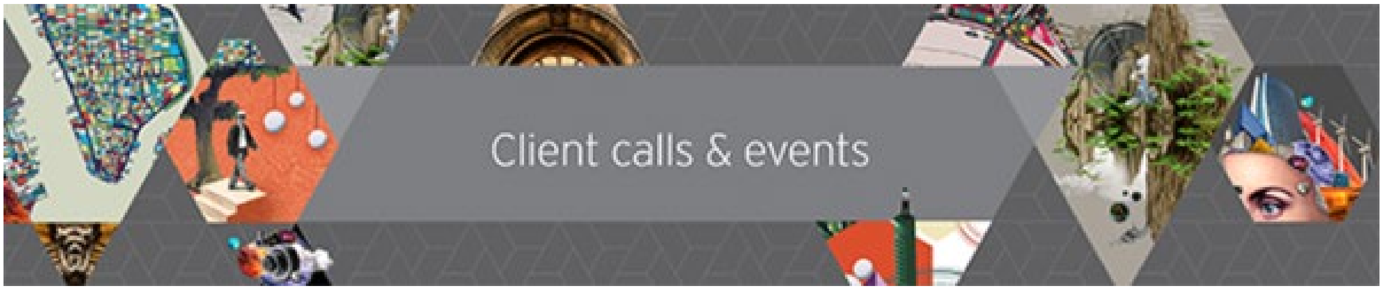


Figure 12: University of Michigan Consumer Sentiment



Source: Haver Analytics as of August 14, 2021.



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