For professional clients only
Research & Strategy Insights

Biden's Fiscal Reflation

74 – 11 January 2021

Key points

- We finally have a clear picture of the parliamentary parameters for Biden's economic policy. The fiscal push may be a headache for the Fed, and we expect market pressure on the central bank to peak when we reach collective immunity. However, in the meantime, business conditions will first deteriorate further given the bad news on the pandemic front.

The US elections finally seem to be over, and beyond the striking pictures of the capitol under siege, the certification process has been completed, a new administration will take over on January 20th and the Democrats will command a slim majority in the Senate. This has triggered a re-appraisal of long-term interest rates in the US which have broken above 1% on the 10-year maturity, while the equity market remained buoyant. By and large we think this market's reaction is rational.

We explore here the likely shape of Biden's economic policy under the final parameters. Even if the new President will face some hurdles in pushing his agenda through – we should have in mind the difficulty Barack Obama had to get his healthcare bill in despite a much more comfortable parliamentary majority – we think that the enhanced emergency stimulus, going beyond the USD 900bn package agreed between the two parties just before the festive break, will be implemented. While some components of Biden's medium-term platform look very difficult to pass, in general we expect a further rise in public spending above and beyond the 2021 push. The medium-term spending strategy is supposed to be fully offset by higher taxes, but we think the likeliest outcome is a rise in the deficit.

The enhanced stimulus – probably ending up a c.10% of GDP – may be a headache for the Fed. Its forward guidance is consistent with more monetary easing if the macro situation deteriorates, but assuming the new package fully offsets the impact of the stubborn "winter wave" of Covid, contrary to the ECB the Fed has not explicitly pledged to fight any "unwarranted tightening in financial conditions" which the market would bring about. The rise in the supply of US treasuries will not necessarily be met by a faster pace of bond buying by the central bank.

We expect market pressure on the Fed to peak by the time "collective immunity" is finally achieved and the economy goes through another spectacular, albeit transitory, rebound. However, in the short run, business conditions are likely to deteriorate further given the latest pandemic data. The emergence of the "UK variant" is a particular concern.

Probing Biden's roadblocks

There was something possibly paradoxical in the juxtaposition of a violent mob invading the US Congress and the US equity market touching a new high, but the investors' reaction was rational in our view. Of course, the capitol hill "insurrection", to borrow a word from the President-elect, may have deep political ramifications but the fact of the matter remains that the presidential elections results were certified, as the Vice-President complied with the letter and spirit of the Constitution and objections were swiftly rejected, and Joe Biden now commands a majority in Congress, albeit slim, with the Democrats winning the two seats in Georgia. With Donald Trump greatly diminished after the Capitol incident – his capacity to influence American politics in opposition is reduced for now, and possibly indefinitely if Congress were to bar him from public office after an impeachment process - Joe Biden finds himself in a favourable position upon acceding the White House and can seize the momentum to push his agenda through.

The next President repeated in a statement issued on Saturday after a conference with the Democratic leaders in the two chambers that he considers the bi-partisan compromise over a USD900bn stimulus a mere "down payment". He hasn't released his full proposal for a bigger package yet, but he spoke of "trillions of dollars" which probably means that the initial democratic plan at USD 2.2trn should be the right point of reference

Swift implementation of this enhanced second stimulus may face some hurdles, but we think it is very likely to come through ultimately. Much has been said at the end of last week about Jo Manchin, Democratic Senator for West Virginia, "absolutely" opposing another USD2,000 "check" to individuals – an idea rejected by the Republicans in Congress but supported by Donald Trump and then the Democrats' leadership as a key plank in the next package. Manchin is the most conservative member of the Democratic caucus and is keen to foster bi-partisan deals instead of "toeing the party line". With every Democratic vote counting, he finds himself in a very strong position. He made his point more clearly subsequently though, tweeting that *"if the next round of stimulus checks goes out they should be targeted to those who need it"*, which we take it as a request for more means-testing of the support measure (it's flat up to 75K of income and is phased down to reach zero above 115k) than as a general curtailment of the stimulus. We note that in December Manchin played a key role in assembling a team of Senators from both parties to unlock the budget process and in an interview with the New York Times stated that a compromise could be found at USD1.2trn, more than the final deal, which suggests that even he felt the USD 900 bn is too small. The latest macro dataflow may also focus minds and convince moderate Republicans to support Biden's bigger push. The net loss in jobs in December suggests that even before the further deterioration in sanitary conditions observed since late December, the US economy was already softening quickly.

Still, the role of someone like Senator Manchin in the context of a slim majority is going to be crucial beyond the 2021 fiscal stimulus. Indeed, he has expressed his opposition to two institutional changes which could deeply alter policy-making in the US: first, ending "filibustering", under which many decisions in the Senate require a majority threshold of 60; second, "packing" the Supreme Court with new appointees, raising the total number of Justices, to dilute the current conservative bend of the Court which could throw a spanner in the wheels of the Democratic platform. **This probably means Joe Biden will have to choose his battles carefully.** We note that right after his election, President Obama could count on a much larger majority in the Senate (57 seats) and in the House (257, 39 above the majority threshold) than Joe Biden, but passing his flagship "Affordable Care Act" still proved to be an ordeal and took most of the legislative bandwidth of his first mandate left by the need to deal with the aftermath of the financial crisis of 2009.

Ultimately, the reason "Obamacare" made it to the statute book was "reconciliation", a filibuster-proof legislative process which allows budget bills to pass with a simple majority in the Senate. In principle, Congress can pass one reconciliation bill every year on three separate issues: revenue, spending and the federal debt limit. However, in practice, only one reconciliation bill is passed every year. This suggests that if Biden is forced to use this process to pass his short-term stimulus now, his medium-term platform will wait until 2022.

The medium-term package is going to be more difficult to deliver, at least as it is structured today. It is organised around three main spending components. An infrastructure plan of USD 1.3trn over 10 years (i.e. 0.7% of GDP each year assuming a linear time distribution), USD 0.75trn over 10 year on an extension in Obamacare (0.4% of GDP p.a) and finally measures supporting the green transition, with an emphasis on renewable energy. The latter – which comes with the biggest price tag, USD 1.7trn – will be difficult to push through. Here we find Joe Manchin again. Representing West Virginia, a coalmining state, he has systematically taken a negative stance on environmental bills. Biden will have difficulty by-passing him by calling upon moderate Republicans, since they are often sympathetic to the fossil fuel industry (e.g. Lisa Murkowski, Alaska Senator).

Still, we would expect significant parts of the medium-term platform to go through, at the risk of raising the deficit further. While the green agenda may be problematic, there is a fairly high level of consensus in US policy circles around the poor state of infrastructure and its cost for productivity and growth. Moreover, the old political economy wisdom suggests it is always easier to find parliamentary support for more spending, irrespective of nominal ideological commitment to fiscal prudence, than for more austerity. Biden's platform is fully costed – the spending spree being offset by a hike in corporate tax and income tax for the wealthiest. We suggested before in Macrocast that given the macro situation he may want to spend first and tax later. **The risk obviously to the US public debt trajectory is that the tax component never materialises, especially if the Democrats were to lose their majority in the House in the mid-term elections in 2022.**

In the 21 mid-term elections held since 1934, the President's political party has lost on average 30 seats in the House and the Senate. The Democrats already lost seats in 2020 and their majority in the House is very thin (4 seats). Although they have the advantage of having less competitive seats to defend than the Republicans in two years, odds are not in their favour.

These political considerations may explain why the equity market has continued to be buoyant. A fiscal push without the prospect of ensuing tax hikes, combined with a fair probability that the Democrats, upon losing their majority in 2022, would be unable to structurally change the macroeconomic set-up of the US, on tax or on environmental and labour regulations.

This may be a bit short-sighted though. Indeed, **achieving a majority in the Senate will give Joe Biden a lot of leeway in choosing his appointees to key positions in the US administration, and this alone would trigger a significant break from the Trump era.** In our last Macrocast before the Christmas break ("Pressure Points") we mentioned the capacity of agencies to mould the policy stance on labour relations or environmental issues. With a swift confirmation of Biden's choices for the key federal agencies, merely implementing existing bills will trigger a swift change of direction relative to the current stance. The choice of the next Labour Secretary is a case in point. Joe Biden is appointing Boston Mayor Marty Walsh. Walsh's entire career before becoming mayor has been in organised labour – he was the leader of the Boston Building and Construction Trades Council, an umbrella group for unions. It may well be that the Biden administration will try to offset the legislative difficulties in passing bills through congress by more "agency activism", if only to appease the most radical wing of his party.

Although Biden won the Democratic primary as a moderate, we continue to think he represents a sweeping change from the Clinton era, and is likely to deliver a more traditional democratic policy stance. The Clinton democrats could be broadly summarized as very progressive on social issues, building on a "coalition of minorities" to secure elections, while espousing a very market-friendly stance on economic issues (free trade, fiscal prudence, financial deregulation), leaving a gaping hole in their electoral equation: the white working class, which increasingly turned to the Republicans, especially under Trump. Biden will maintain the appeal to minorities but will also endeavour to restore the Democratic party as the "natural habitat" of the white blue-collar voters.

This "Biden shift" may ultimately help normalise the US political landscape by re-creating space for "non-populist" Republicans. Over the last twenty years, the US political debate has focused on cultural issues, hiding a fairly high level of consensus on economic issues across the two parties. A shift of the pendulum back to discussing public deficits and markets regulation could "de-hysterise" the American political discourse. It's the beginning of a new year, we want to be optimistic.

A challenge for central banks

The perspective of another fiscal stimulus of 10% of GDP in the US in 2021 is a mixed blessing for the Federal Reserve. Jay Powell had made it plain that central banks alone would not be able to mount a strong enough defence against the pandemic crisis and explicitly called on the US government to prolong its support to the economy, even at the risk of engaging in "overkill". In October 2020 in a speech to the National Association for Business Economics he strikingly stated that *"the risks of overdoing it seem, for now, smaller"* than opting for a too-small stimulus. Since the winter wave of the pandemic is proving more stubborn and devastating than expected, it is unlikely the Fed chairman has changed his mind. While Republican lawmakers – and some Democrats – may balk at Biden's full-fat fiscal push, the Fed should welcome it. **An issue though is how far the US central bank will be ready to go with its own stimulus to accommodate the ensuing further increase in the supply of US treasuries**. Two possibilities there:

If an even bigger stimulus does not offset the impact of the winter wave, then a lower than expected aggregate demand would in theory pave the way for more action from the Fed. This would be the mechanical consequence of what Jay Powell reiterated on December 16th: "our guidance is outcome-based and is tied to progress toward reaching our employment and inflation goals. Thus, if progress toward our goals were to slow, the guidance would convey our intention to increase policy accommodation through a lower expected path of the federal funds rate, and a higher expected path of the balance sheet". The US central bank would purchase a higher proportion of the additional treasury supply.

However, if the bigger stimulus fully offsets the growing damage from the pandemic, especially since it is likely to be in full swing once the economy if in normalisation mode post collective immunity, it is hard to see how the Fed could justify scaling up its own accommodative stance. The market would be right in pushing its re-appraisal of market interest rates further. Following on this logic, the Fed would not be in position to react to a steepening of the curve which would merely reflect a rise in inflation expectations amid a generally better macro outlook. The pace of bond buying would be unchanged, which in the context of a bigger supply of treasuries would be akin to allowing the steepening to continue.

This gets us back to a point we have made before in Macrocast when discussing the Fed's new strategy and Average Inflation Targeting. AIT is a promise NOT to do something in the future, to wait longer than usual to normalise monetary policy for any given level of inflation. The Fed's forward guidance is a promise to do more IF the macro environment deteriorates. **"Something in between" is missing and that's the European Central Bank's pledge to keep financial conditions unchanged.** The flexibility of its Pandemic Emergency Purchase Programme would allow the ECB to nip in the bud any exogenous rise in market interest rates. No such pledge has been made by the Fed so far.

Now, arguably this is only a semantic distinction: the ECB may be clearer about this, but for sure the Fed would also react to an "*unwarranted tightening in financial conditions"* if only because it would slow down progress towards restoring full employment and thus bringing inflation back to target. That is indeed highly plausible, but the art of monetary policy often consists in making what is implicit explicit. Making such pledge could get the market to pause and re-think before pushing long term interest rates further.

The Fed could settle for an intermediate position and rather than raising again the pace of its balance sheet extension engage in "operation twist", capping the long end of the curve, but reading carefully the latest minutes of the FOMC, there does not seem to be a consensus around this. Indeed, while "*some participants"* were considering this approach*, "a few participants underlined the importance of continuing to evaluate the balance of costs and risks as- sociated with asset purchases against the benefits arising from purchases".* This is where financial stability considerations may get in the way. Indeed, flattening the curve is rarely positive for financial intermediaries.

Market pressure may get to a peak once the Covid pandemic wave starts to recede and the economy rebounds. In all likelihood, the Fed would choose to "lean against the wind" if long term interest rates were to rise too fast and too high, and start with a rhetorical warning to investors that it stands ready to act, ultimately boosting the pace of purchases or launching operation twist in last resort. If the Fed's communication works well, what we may get is a mere "hump" in long-term interest rates. Still, there is now a clear upside risk to our forecast for the 10-year **treasury yield at the end of 2021 (1.2%).**

Contagion to non-US markets from such a "hump" is likely to be a key theme of 2021. We think the ECB has to a large extent insured itself against the usual traction effect the US bond market has on its European counterpart, thanks to the PEPP flexibility we mentioned above. A key difference between the ECB and the Fed is that the former needs to keep financial conditions accommodative across various national markets. Its tolerance for higher yields on the reference asset (Bunds) is thus limited. We would make two points though on the potential limits to this insurance.

First, the Governing Council's resolve will be tested. We described the outcome of the December meeting as a "dovish compromise" but the hawks have not given up. Communication may be difficult if the "hump" we describe on US yields comes along a similar pattern for inflation. We discussed this at the end of last year. A lot of the extreme weakness in consumer prices observed these last few months can be attributed to temporary exogenous factors (drop in oil prices, cut in VAT rate in Germany). We believe – and judging by their forecasts the ECB staff does too – that the mechanical rebound we will see next year will not sow the seeds of a proper, endogenous rebound in inflation given the underlying situation of the labour market, but the coincidence of stronger inflation and a mechanically spectacular, if transitory, rebound in Euro area GDP growth upon reaching collective immunity, could get the hawks to talk more. We think it is more likely than not that the ECB will ultimately have to spend the entirety of its PEPP top up to keep financial conditions anchored.

Second, even PEPP has its limits. We have already discussed it in Macrocast. The EUR 500bn top-up allows for some further increase if need be, but beyond another EUR150bn the central bank could be close to holding more than 50% of the eligible public debt of a member state, leaving no space for its ordinary QE programme subsequently.

All in all, the US elections' impact on the bond market could be significant. Beyond directionality (towards higher yields in almost all scenarios now) we would insist on the risk heightened volatility. Micro movements in the US Congress could trigger significant valuation re-appraisals, and although the broad policy stance of the Fed and the ECB are well-known and unlikely to change much, the market will be monitoring very closely even tiny inflexions in their communication on the calibration of their quantitative easing programme. Volatility could also plague emerging markets. The perspective of a generic rebound in global trade in the second half of his year will help them of course, but they recently have been among the main beneficiaries of ultra-low interest rates in the developed world. If perceptions were to change, the most fragile of them (e.g. the most dependent on foreign capital) will suffer.

Beware the British variant

While US yields have already jumped in reaction to the latest political developments, most of these considerations won't probably reach "peak relevance" before collective immunity is achieved. In our year-end forecasts we wanted to remain prudent on the timing for this – we are not expecting it before the middle of the year – and for now the slow-start of the vaccination programmes in most countries seem to justify our caution (see Exhibit 1). In some cases – e.g. in France – the slow take off was at least initially attributable to the very prudent approach of health authorities faced with particularly high levels of public distrust towards the vaccines, but more fundamentally, production bottlenecks and distribution issues continue to be spotted.

Beyond the timing of collective immunity, a key issue for this year is the depth of the cyclical trough. Unfortunately, from this point of view, bad news is accumulating. As usual we focus on positivity rates (see Exhibit 2) and even in the countries which had recently managed to get the pandemic back under control – Spain for instance – there has been a rebound, while an initially strong performer such as Germany continues to face a relentless deterioration. Just before Christmas we made the point that the exit from the current level of mobility restriction would have to be delayed. Our concern now is that the lockdowns will have to be made more stringent, not merely prolonged, and not just in the UK.

Exhibit 1 – Slow start on vaccination

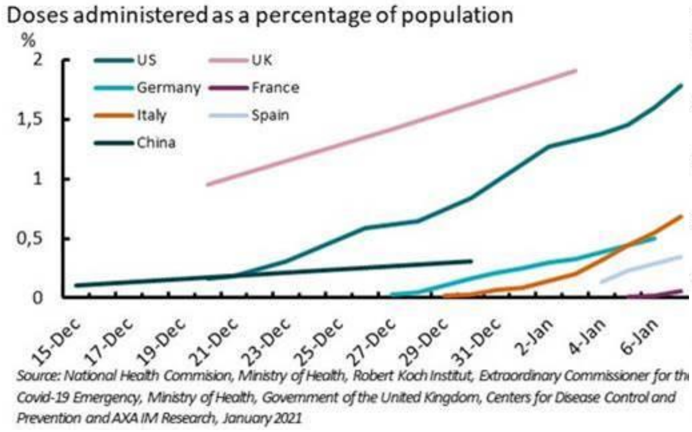
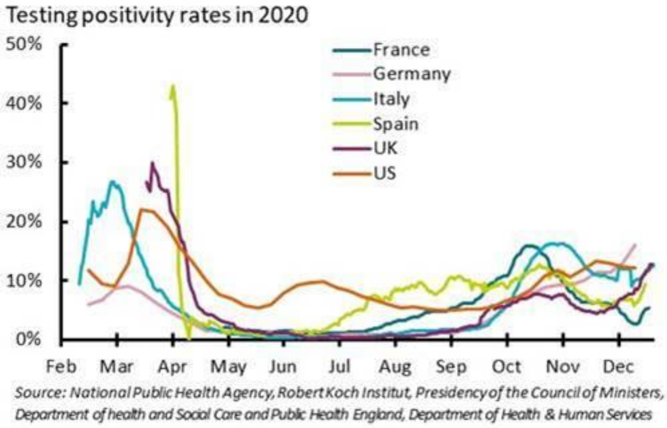


Exhibit 2 – Still going in the wrong direction



The "variant" of the Covid virus detected in the UK has been spotted on the European continent, in several US States as well as in some EMs. The characteristic of this variant is a stronger reproduction rate (the "R" coefficient). According to the British public health authorities it has the potential to lift R by 0.4-0.7 points. We provide in Exhibits 3 and 4 a simple arithmetic illustration of such a change in "R", here taking 0.92 as a starting point for the pandemic expansion under the "old" form of the virus (it currently is the value of "R" calculated for Germany by the Koch Institute), bringing it to 1.42. After 10 "rounds" of propagation (which takes roughly 1.5/2 months), the explosive nature of the trajectory, if no additional measures are taken, is obvious (we started from a level of 25,000 cases in these scenarios). The variant does not seem to be more lethal, but the simple fact that the number of cases would rise faster would mechanically trigger more casualties. An illustrative heuristic is that for such a rise in R by 0.5, the number of casualties would be multiplied by 15.

Exhibit 3 – The impact of a higher "R" on cases…

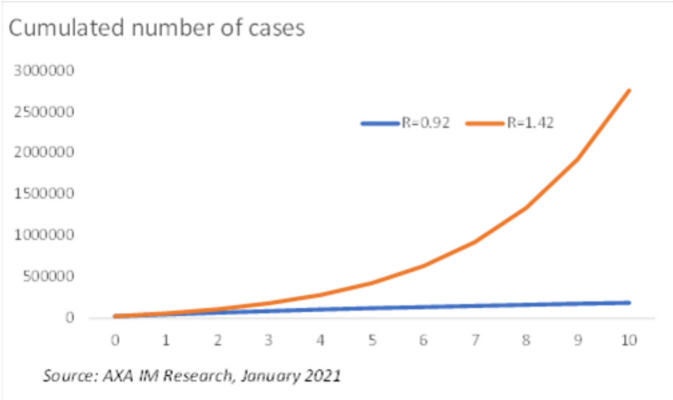
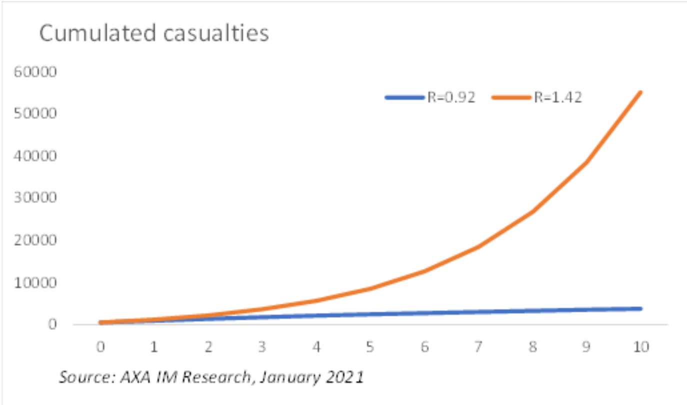
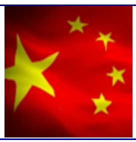


Exhibit 4 – …would mechanically be replicated on mortality



We insist on the fact that this is purely an illustrative trajectory which does not take into account the "feedback loop" of the more stringent measures taken to curb such a higher "R", neither the impact of the vaccinations nor the fact that the virus infection potential diminishes faster (higher number of people having gained immunity after being infected). It is also possible that continental authorities will be able to "nip in the bud" the new variant before it becomes dominant as it is now in the UK where "R" is now estimated to stand between 1.0 and 1.4. Still, the balance of risk on the beginning of 2021 has deteriorated.

Country/Region	What we focused on last week	What we will focus on this week
	• Congress certifies election results; Trump supporters storm Capitol building, 5 dead • New virus cases accelerate again, evidence of new variant in several states • FOMC minutes for December showed little appetite for QE maturity extension for now • Non-farm payrolls dropped by 140k in Dec, but unemployment stayed at 6.7%	• Signs of post-Xmas rise in new cases and vaccine roll-out • US retail sales for December, last major contribution to Q4 GDP estimate • Empire State survey (Jan), manufacturing holding up better than wider economy • Fed's latest Beige Book released to give anecdotal evidence on economy
	• IP remained strong in France and Germany • EU approval of Moderna vaccine (160 mln doses) and 300mln top up of Pfizer/BioNTech • Germany extended lockdown measures until end January, with school and non-essential retail closures. • EA retail sales declined by 6.1% mom in November, reflecting restrictions	• German CDU will hold its party leadership contest, with 1001 delegates voting for either Merz, Laschet or Roettgen- the winner could be the next CDU/CSU lead candidate for Chancellor (elections on September 26) • Keep an eye on Italian politics: our baseline is for a minor government reshuffle
	• Covid cases reach new highs, daily cases exceeding 60k – UK in full lockdown again • Vaccine shots exceed 1.5m • Light port traffic averted Brexit disruption so far, but major retailers cancelled EU exports • Chx Sunak announces a further £4.6bn business support package	• Signs of virus cases levelling off, vaccine numbers increasing to 2m/week target • Monthly GDP for November, we expect a sharp fall of 4% m/m • Broader output and trade data for November, manufacturing expected to rise. • RICS housing survey
	• The gov unveiled a 3rd supp budget with fiscal spending reaching ¥32tn-5%of GDP • State of emergency in Greater Tokyo • Unemployment rate down by 0.2ppts at 2.9% • Manufacturing PMI up to 50 from 49.7 while services PMI slightly down to 47.7 (-0.1point)	• Monitoring any extension of the state of emergency on nationwide level • December bank lending should remain very high as banks continue to provide sustained support • December Economy Watchers poll
	• PMI moderates but continues to suggest decent growth momentum	• Export growth may have decelerated in December, while import growth strengthened
	• CRBT raised its one-week repo auction rate by 200bps to 17 percent as domestic demand conditions, FX and deterioration in inflation expectations continue to affect the pricing behaviour and inflation outlook adversely • Mexico headline inflation declined to 3.15% (Dec) from 3.33% (Nov) mainly explained by fruits and vegetables slowing -5.5%MoM	• Central bank meetings: Poland, Peru, South Korea • Brazil CPI inflation expected high as BRL depreciated due to domestic risks

Upcoming events	**US:**	Wed: CPI (Dec), Fed budget balance (Dec; Fri: Retail sales (Dec), PPI (Dec), Empire State mfg survey (Jan), IP (Dec), Busi inventories (Nov), Michigan cons sentiment (Jan)
	Euro Area:	Mon: Sp IP (Nov); Wed: EA Lagarde speaks, IP (Nov), It IP (Nov); Thu: Ge GDP (2020); Fri: EA TB (Nov), Fr, Sp HICP (final, Dec)
	UK:	Mon: BoE speech on negative interest rates; Tue: BRC Retail Sales Monitor (Dec); Thu: RICS Housing Survey (Dec); Fri: Monthly GDP (Nov)
	China:	Mon: CA balance (Nov), TB (Nov); Tue: Economy Watchers Survey (Dec), Broad money (Dec); Wed: Private 'core' machinery orders (Nov)
	Japan:	Mon: CPI (Dec), PPI (Dec); Thu: Exports (Dec), Imports (Dec), Trade balance (Dec)

Our Research is available on line: http://www.axa-im.com/en/insights

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826