Fiscal and Monetary Policy Considerations Under the Biden Administration

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Joe Biden won what may arguably have been the most contentious presidential race in modern history. Though victorious, President Biden will need support from both sides of the political aisle to advance his agenda and pass legislation. At present, Democrats hold a very narrow majority in the House of Representatives. In the Senate, the split is 50/50, with Vice President Kamala Harris poised to break any tie votes.

This new political reality may significantly impact future stimulus efforts as well as fiscal and monetary policy.

Fiscal/Monetary Policy and Stimulus Considerations

In early 2020, as COVID-19 spread, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which provided approximately $2 trillion of support to the U.S. economy. Moreover, in December, $900 billion in fiscal stimulus support was passed by Congress. In terms of monetary policy efforts, the Federal Reserve (Fed) did its part, working to mitigate economic damage by:

- Cutting short-term interest rates near zero and stating that rates are likely to remain at low levels for an extended period
- Purchasing trillions of dollars of treasury and mortgage-backed securities
- Introducing new facilities to help support financial markets

We observe a growing consensus among Fed officials, economists and politicians that more stimulus is needed as the nation continues to grapple with the coronavirus pandemic and its lingering impact on the economy. Economists are presently expecting additional stimulus measures to be passed by Congress and signed by the President, who has proposed $1.9 trillion of new fiscal spending. His proposal includes direct payments to taxpayers of $1,400, as well as funds dedicated to the distribution of vaccines, an extension of unemployment benefits and direct support for state/local governments.

There is considerable debate regarding using political capital to pass such a large package and the ability of such a plan to pass. And while there may not be a broad appetite to pass some of the more progressive policies that were debated during the party primaries or the general election, increased infrastructure spending (with perhaps a tilt toward green building) is expected. Other possibilities include legislation or executive action on clean energy and immigration. Some of these efforts may prove stimulative when it comes to job creation. Though the question remains, "When will these efforts make it onto the House and Senate floors for a vote?" Infrastructure has been a topic of interest for the past four years, but there has been minimal progress.

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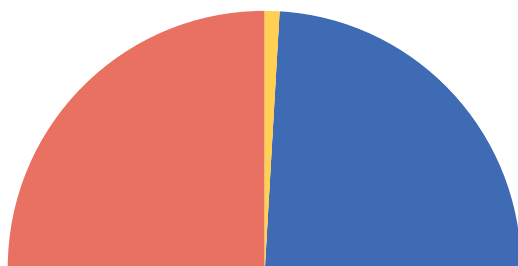
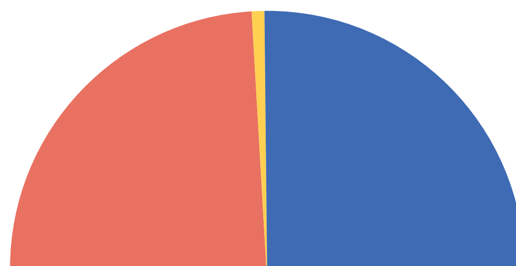
SENATE



HOUSE



With all of this in mind, we remain hopeful, as there are a handful of moderate Democrats in the Senate, such as Joe Manchin of West Virginia, who may be able to both advance the administration's agenda and work with Republicans to pass legislation. Manchin is also a counterbalance to a more progressive agenda and has pushed back against (or has been noncommittal on) $2,000 stimulus checks for all, preferring a more targeted approach. That said, he has supported trillions in spending on infrastructure.

Personnel Changes Worth a Mention

One cabinet position of particular interest to the capital markets is that of the Treasury Secretary. Former Federal Reserve Chair Janet Yellen has been confirmed for that position and is the first woman to hold that title. At the Fed, she was known as a fiscal "dove," and the expectation is that she would support policies that would lead to increased employment.

It is also worth noting that Jerome Powell's term as Fed Chair expires in February 2022. If President Biden chooses to replace Powell, the current expectation is that any candidate he selects would not initiate major/meaningful changes to monetary policy. In our view, a steady hand is indeed what we need during these trying times.

Possible Impact on the Economy, Federal Reserve Policy and Capital Markets

Given the Democrat Party election wins and assuming additional stimulus of ~$800 billion (which some expect on the low end) to the $1.9 trillion proposed by President Biden, consensus gross domestic product (GDP) estimates have begun to increase. Currently, the consensus GDP forecast stands at 4.1% (per Bloomberg), which is highly uncertain due to the continued coronavirus cases and the final amount of fiscal package that is actually passed. However, some economists at prominent firms have begun to increase their 2021 GDP estimates to over 6%, an increase of 1.25% from their previous forecasts. (For reference: The U.S. economy is believed to have contracted by approximately 3.5% in 2020).

While unemployment came down from its peak of nearly 15% to 6.7%, there is slack in the labor market because the coronavirus pandemic upended the workforce. Market-based measures of inflation expectations have picked up considerably over the last several months, but inflation is still below the Fed's target of 2%. The Fed has also moved to a framework of Flexible Average Inflation Targeting (FAIT) that some believe might reduce the need to adjust the Federal Funds Target Rate further. That said, the Treasury market's front end is expected to be anchored to the current near historic low yield levels.

As a result of expected increased fiscal stimulus, we have seen longer maturing Treasury yields. For example, we saw the 10-year Treasury note increase by nearly 25 basis points (bps) between January 4 and January 11 (2021). While the Fed is currently buying ~$80 billion of Treasury securities each month, there is potential for the monetary body to ratchet up purchases. It could also ultimately shift the maturity parameters of future purchases and begin to focus more on longer maturing securities, though, to be clear, we do not perceive that as being imminent and it is becoming increasingly unlikely. As long as financial conditions are not being materially negatively impacted, we believe that the Fed may allow rates to move higher gradually. Based on comments by several Fed officials, some market participants are factoring in the possibility of tapering of purchases in the second half of 2021. With these bond purchases, the equity market continues to be the recipient of flows based on an expected recovery in profits, which should translate into better returns for stocks. The broadening of the recovery rally during the fourth quarter of 2020 would only cement views on equity expectations for this year.

The path of interest rates in longer maturities is highly uncertain. A number of interest rate strategists and economists have revised their yield forecasts higher based on the outcome of the Georgia election. Some changes were minor in the 10-15 bps range, while others substantially increased their expectations by approximately 50 bps.

While we expect some upward pressure throughout 2021, the magnitude will depend on several factors:

- Of the proposed $1.9 trillion, what dollar amount is actually passed? How much treasury issuance will be needed to fund the deficit?
- Is there an additional appetite for infrastructure spending?
- How do economic activity, employment and inflation/inflation expectations evolve throughout the year?
- What is the possibility of financial market conditions tightening (increased volatility, wider spreads on debt instruments and lower equity prices)?
- What is the feedback loop between financial conditions and the Fed's reaction function?
- Is there an ability for our economy to get back to normal operations?

So, while we expect interest rates to remain low and stable in shorter maturities, and longer maturities to move higher (the yield curve to steepen), the magnitude is uncertain. Spreads (the additional income earned over treasury securities) in high-quality sectors remain on the historically tight side. A strengthening economy could provide continued support to the tight valuations (low spreads). Still, a large move in interest rates could tighten financial conditions and become a catalyst for spreads to move higher. Looking out further on the risk spectrum, high yield should continue to do well as names tied to the energy sector, which have suffered due to slackening in demand and low oil prices, should start to rebound.

Looking at equities more broadly, we believe that 2021 will see positive returns. Domestic equities have bounced back from their pandemic lows, and our expectation is that we could continue to see a widening of returns if the new administration can achieve its vaccination goals. Internationally, improved government relations could mend frayed partnerships, but it doesn't seem as if trade agreements are on the front burner of the Biden agenda. Emerging markets could continue to do well if we see currency depreciation as the result of an increase in demand for foreign goods.

It is also worth mentioning that lower interest rates have led some investors to consider adding alternatives to their portfolios. Our view is that Private Equity and Debt could continue to see increased interest and that Real Estate may be overall mixed depending upon the region/area of focus. Private Equity remains a hot topic as

both IPOs and Special Purpose Acquisition Companies (SPACs) continue to receive a lot of attention within the marketplace. But the popularity of these along with the significant amount of unused funds on the sidelines could drive up deal multiples, hence providing lower return opportunities in the future. Private Debt should continue to outperform as continuing difficulties in the broader economy increase the need for non-traditional funding, and banks could become more reluctant to lend at lower rates.

Meanwhile, Real Estate has been mixed, but lower interest rates bode well for areas such as residential-single family homes. However, the current demographic trend is a headwind for multi-family units. Finally, we believe that Commercial Real Estate (e.g., office buildings) could struggle with more headwinds and uncertainty within this space exist.

Final Thoughts

Despite significant progress toward a comprehensive economic recovery, headwinds persist, and the virus continues to spread. These challenges are likely to linger throughout the first half of 2021. Again, further fiscal and monetary stimulus should help mitigate conditions caused by the ongoing public health crisis. PFM will continue to closely monitor any policy changes and we stand ready, as always, to serve our clients' best interests during these trying and turbulent times.

For more information, please contact your PFM representative.

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