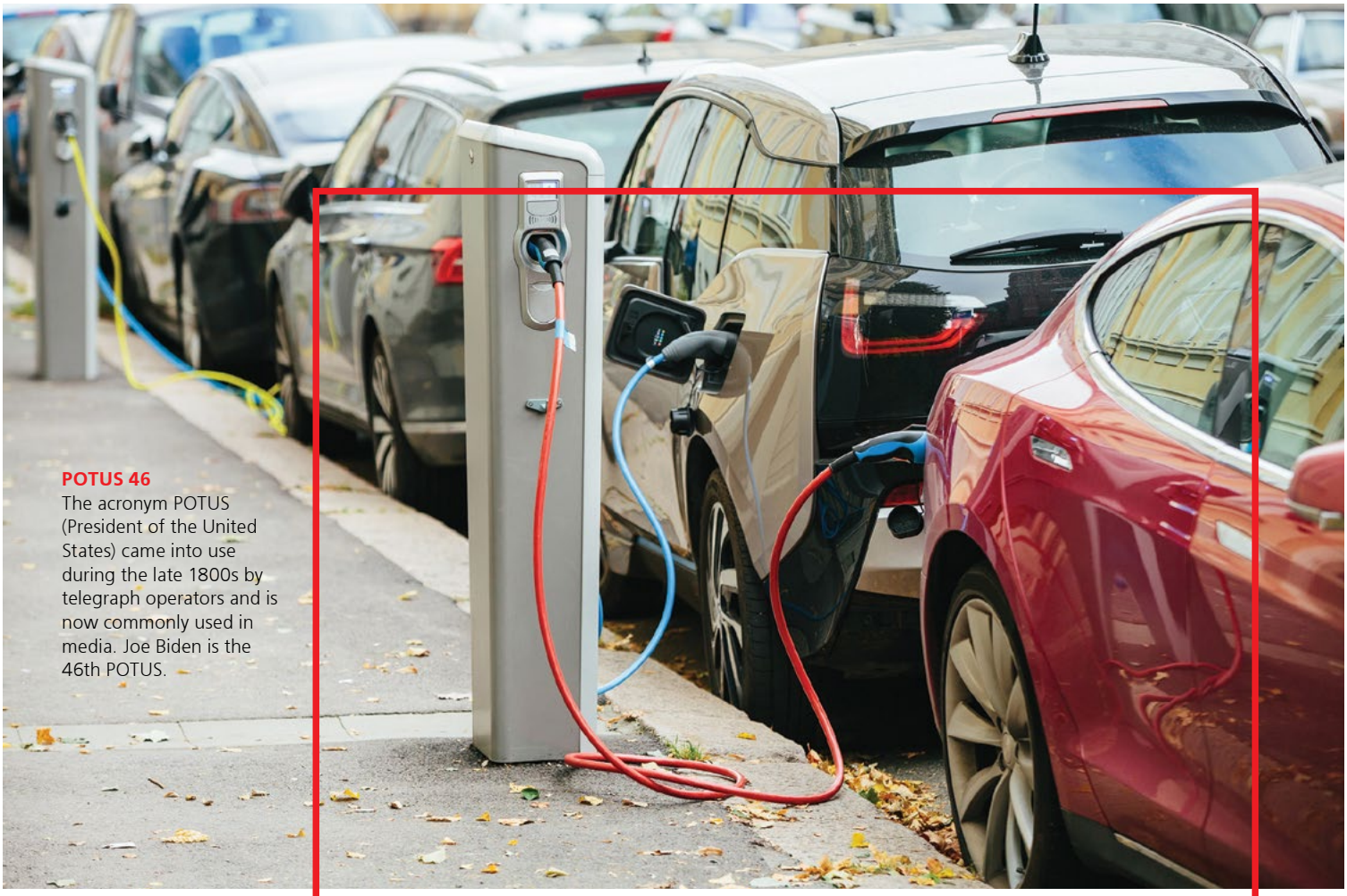
POTUS 46

Investing under a Biden administration

14 April 2021
Chief Investment Office GWM
Investment Research



POTUS 46
The acronym POTUS (President of the United States) came into use during the late 1800s by telegraph operators and is now commonly used in media. Joe Biden is the 46th POTUS.

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Rethinking infrastructure

Investment implications of the American Jobs Plan

UBS

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Key takeaways

- The Biden Administration's investment program is broadly defined and will continue to encounter obstacles from members of Congress who are inclined to define infrastructure more narrowly.
- As the US economic recovery accelerates, the argument that infrastructure investment is a necessary component of fiscal stimulus will diminish in intensity. This may pose an obstacle for the enactment of some parts of the president's program.
- Enactment of legislation will have to rely on budget reconciliation, which demands an extraordinary amount of cohesion within the Democratic conference. We expect the size and scope of the program to diminish.
- The impact on the US dollar is ambiguous. Biden's proposal would increase the twin trade and budget deficits, which is a negative development for the dollar, but higher yields offer a counterbalance. In the near term, foreign exchange markets will focus on the Fed taper on one hand, and ex-US growth on the other.
- Economically sensitive value stocks should get a boost as investors reassess their future earnings potential and valuation, while higher rates would be a headwind for growth stocks.
- The drag from higher corporate taxes will not be large enough to derail the bull market.

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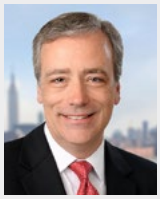

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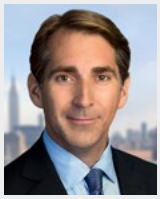

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"Politics is the art of the possible, the attainable—the art of the next best."

Otto von Bismarck, architect of German unification (1815–1898)

Bismarck's all-too-familiar appraisal of practical politics will be put to the test this year as President Joe Biden seeks Congressional approval of his widely anticipated infrastructure package. The sprawling proposal would amount to the most significant increase in federal spending on physical infrastructure since the construction of the US interstate highway system in the 1950s and 1960s. The plan encompasses a broad array of transportation expenditures, as well as investments in water treatment, clean energy, and high-speed broadband (Fig. 2).

Biden's emphasis on addressing the impacts of climate change is reflected in the details, which integrates environmental considerations to an unprecedented degree. Look no further than the provision of incentives to build 500,000 electric charging stations or the mandate to electrify the federal government's fleet of vehicles. The American Jobs Plan adds some elements that go beyond traditional definitions of physical infrastructure, provoking criticism from some Republican members of Congress. Raising the prevailing wages for healthcare workers and providing clean energy tax credits stretch the definition of traditional brick-and-mortar investments, and are likely to be a principal focus of legislative negotiations.

In the abstract, infrastructure investment enjoys bipartisan support. Unfortunately, legislation usually runs aground when discussions begin over how to pay for the improvements. Biden proposes to do so by increasing corporate income taxes. His plan includes lifting the statutory income tax rate to 28%, from 21%; raising taxes on overseas income by increasing the global intangible low tax income (GILTI) levy to 21%, from an effective rate of 10.5%, while broadening its application to more companies with foreign income; and imposing an alternative minimum tax of 15% on book income for companies with more than USD 2 billion in net income.[1] The proposed tax increases have been discussed in public for months, so their inclusion was not surprising.

Figure 2

Provisions in the American Jobs Plan

10-year estimates. See Fig. 8 on page 8 for details.

Invest in transportation infrastructure	USD 621 billion
Invest in domestic manufacturing, research & development, and job training initiatives	USD 590 billion
Expand home care services and provide additional support for care workers	USD 400 billion
Clean energy tax credits	~USD 400 billion
Improve housing stock, modernize schools and child care facilities, and upgrade VA hospitals and federal buildings	USD 328 billion
Invest in broadband, electrical grid, and clean drinking water	USD 311 billion
Total	**~USD 2.65 trillion**

Source: Committee for a Responsible Federal Budget

On the other hand, the president's decision to divide his program into two separate proposals was unexpected. A second set of proposals, dubbed the American Families Plan, is expected to be unveiled later this month with a focus on healthcare, education, and strengthening the social safety net. The revenue for this second iteration—social infrastructure—will rely on proposed increases in the rates at which individuals are taxed. We await the details but expect the Biden administration to propose an increase in the maximum marginal tax rate to 39.6%. Changes in the treatment of capital gains and changes to the federal estate tax are also likely, but will be more contentious and more challenging to implement.

[1]Calculation of the GILTI levy is complex and beyond the scope of this report, but in general terms it constitutes a federal tax on earnings that exceed a 10% return on invested foreign assets. According to the Tax Foundation, the primary purpose of GILTI is a reduction in the incentive for US-based multinational corporations to shift profits overseas to low-tax jurisdictions. It operates to assess a minimum tax on foreign profits of between 10.5% and 13.125%. See Kyle Pomerlau, "What's Up with Being GILTI?" Tax Foundation, 14 March 2019.

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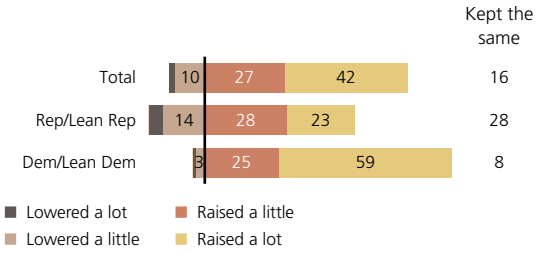
By dividing his plan into two parts, Biden has effectively allowed his physical infrastructure plan to take precedence and thereby dictate the terms of negotiations with Congress. One possible explanation for this strategy is the degree of support among registered voters for higher corporate taxes. According to a Pew Research Center survey conducted in 2019, 69% of the respondents supported the concept of higher corporate taxes. Registered Democrats and independent voters supported higher corporate taxes at a greater rate than did Republicans, but even GOP voters were evenly split on the question (Fig. 3).

Figure 3

Half of Republicans favor raising tax rates on large businesses and corporations

% who say tax rates on large businesses and corporations should be.....



Source: Pew Research Center

Looking ahead to a busy summer

Senate minority leader McConnell has already expressed his opposition to the American Jobs Plan and is likely to do so again when President Biden introduces the second half of his program. The GOP conference now appears unified in opposition to Biden's vision for a "once in a generation" investment program. Our base case therefore incorporates an assumption that Democrats will be obliged to use budget reconciliation for a single bill, rather than two separate bills, to enact any infrastructure program that remotely resembles the president's proposal.

Meanwhile, majority leader Chuck Schumer has received guidance from the Senate parliamentarian that existing budget resolutions may be amended to contain additional budget reconciliation instructions. This would allow Democrats in the current Congress to enact tax and spending bills on multiple occasions within a single fiscal year. The senator has not announced whether he will exercise the option, but the unprecedented legislative maneuver enhances his flexibility in passing legislation in the Senate along party lines. Regardless of Schumer's decision, the House is expected to pass its own budget resolution for fiscal year 2022 before the August recess.

We expect Democrats to have the votes to pass one major infrastructure bill in October, but the details will need to be ironed out over time, and substantial changes to Biden's proposals are likely. Some provisions from the American Families Plan are expected to be integrated into the final bill, but enactment of two separate bills, which together would exceed USD 4 trillion in spending, strikes us as an unlikely scenario given the complexity of the tax code and the narrow margins by which Democrats control each chamber of Congress.

Senator Joe Manchin (D-WV) has already expressed his opposition to a 28% rate, and the Senate Finance Committee chair, Ron Wyden (D-OR), conceded that the final rate would be the result of further discussions within the Democratic conference. The narrow margin of control in the Senate would suggest that moderate Democrats will dictate the terms of any tax increase. We therefore expect the corporate tax rate to rise to 25% in 2022, rather than 28% as proposed by the president. Biden's statement last week that "debate is welcome, compromise is inevitable, [and] changes are certain" is a tacit acknowledgment that some parts of his program are likely to be scaled back.

The maximum marginal individual income tax rate is expected to return to 39.6% in 2022, four years earlier than scheduled under the Tax Cuts and Jobs Act enacted in 2017. Capital gains taxes are also likely to rise, but not to the levels envisioned by the Biden administration. For the purposes of our base case, we are assuming an increase to 28% for those earning more than USD 400,000 per year. The outcome of negotiations over estate taxes is harder to foretell, but we believe a substantially higher exclusion threshold is likely.

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While the Senate receives most of the ink, it's important to remember that Democrats hold an exceedingly narrow majority in the House. Three Democratic members of the House have departed to join the Biden administration, and the untimely death of another representative has left Speaker Nancy Pelosi with a two-vote margin of error on any party-line vote until special elections are held later this year to fill empty seats. Two members of her own caucus, one from New York and another from New Jersey, have demanded relief from the limitation on deductions for state and local taxes (SALT). We expect that some incremental relief will be granted in order to move the final bill. A complete repeal is a possibility, but doubling the limitation may be enough for the speaker to hold her caucus together as the year progresses.

The economic impact

Taken together, Biden's American Jobs Plan and American Families Plan would bring total spending on infrastructure—broadly defined—to close to USD 4 trillion. Even within the context of a response to a global pandemic, that is a breathtaking amount of money. However, when considering the economic impact, it is important to keep in mind that the main goal of this package is not short-term stimulus. Spending will be spread out over at least eight years, and enactment will likely come too late to have much impact in 2021.

Moreover, unlike the previous packages, we expect the final version of legislation to include enough incremental tax revenue to pay for at least half of the spending costs, reducing the net stimulus. By the time spending starts to kick in, economic conditions should already be strong, with less slack in the labor market than there has been since the start of the pandemic. All of these factors suggest that the near-term boost to economic growth will be relatively limited. Our preliminary estimate is that a legislative package in line with our base case would add around 0.5 percentage points to the rate of GDP growth by the end of 2022, which doesn't sound like much given the price tag.

Both political parties have consistently supported the concept of additional infrastructure investment, while often disagreeing on the size and scope of federal programs. Indeed, it's hard to conclude that additional investment in infrastructure is a bad idea. Even a cursory review of recent research illustrates the need. According to the Brookings Institution, total spending on American infrastructure declined in real terms over the course of a decade due to the rising cost of materials. The Council on Foreign Relations reported that traffic congestion on the nation's roads cost the economy over USD 120 billion per year. Delays at the nation's airports cost another USD 35 billion.[2] Biden's proposal does include spending that should boost productivity in the longer run. Moreover, a multiyear government commitment would add impetus to private sector capital investments, which are poised to increase. Considering that the government can borrow money at historically low interest rates, we are not overly concerned about pushing debt levels up even further to finance infrastructure spending.

Our base case

On balance, legislation resembling the American Jobs Plan would be a modest tailwind for financial markets, with a lower overall impact on the economy and markets than the USD 1.9 trillion American Rescue Plan passed in March. Some sectors and companies are likely to be significant beneficiaries, while others will face some obstacles. The incremental boost to GDP growth in the near term, and the ensuing consequences for inflation and interest rates, do not significantly alter our optimistic equity market outlook for a few reasons.

First, our forecasts already call for very strong GDP growth in 2021 based on higher vaccination rates and a return to some semblance of normalcy. We expect a surge in inflation in the current quarter before moderating later in the year. Interest rates are headed higher but should rise at a gradual pace. Second, higher corporate taxes to partially fund infrastructure spending will limit the net stim-

[2]James McBride and Jessica Moss, "The State of US Infrastructure," Council on Foreign Relations, 1 September 2020. See also Joseph Kane and Adie Tomer, "Shifting into an era of repair: US infrastructure spending trends," Brookings, 10 May 2019.

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ulus to the economy, helping to avoid economic overheating. Third, the broad scope of the infrastructure proposal was widely anticipated and generally consistent with Biden's campaign platform.

Whereas a large percentage of the USD 1.9 trillion from the rescue plan will be dispersed in a matter of months, net fiscal spending from an infrastructure package is spread over years. Moreover, the COVID-19 response provided temporary support for individuals, businesses, and state and local governments during the pandemic. By contrast, infrastructure spending is intended to enhance America's long-term productivity, competitiveness, and growth potential. In short, the American Rescue Plan was about cyclical recovery; the American Jobs Plan is geared toward secular expansion.

For now, most investors remain focused on the cyclical recovery and are likely to downplay the potential for an infrastructure package to alter their outlook. That's evident in market pricing for interest rates, the federal funds rate, and inflation far into the future, which were largely unchanged in response to the jobs plan. Look no further than the tech sector's performance in the week after the president's announcement. The sector performed well despite the fact that the tech sector could face a somewhat higher tax bill than most other sectors. The subdued market reaction tells us that investors are taking a wait-and-see approach, are inclined to believe that the final bill will be different from the proposal now being floated, and are focusing primarily on the economic rebound already underway.

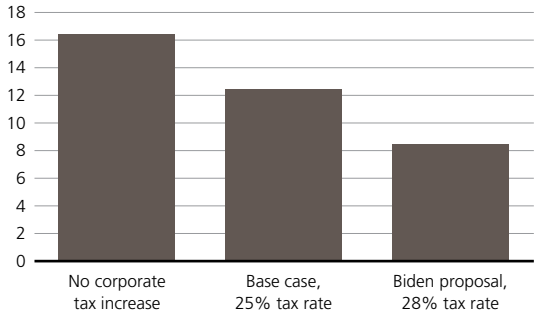
Overall, we believe the potential drag from higher corporate taxes will not be large enough to derail the bull market. In our base case, higher taxes will trim S&P 500 profits by about 4% in 2022. Even with this drag, S&P 500 companies should still be able to produce healthy profit growth of 13% thanks to continued, above-trend GDP growth. The impact across sectors should be fairly uniform, but tech and communications services could face a modestly larger headwind. On the flip side, utilities would be largely unscathed.

In addition, a potential hike in the capital gains tax rate shouldn't have much of an impact on the equity market. Historically, there has been no correlation between equity market returns and changes in capital gains tax rates. This perhaps surprising result is due to the fact that taxable domestic investors only own 25% of the US equity market. In addition, for those investors with a longer time horizon, it usually makes more sense to defer recognition of a taxable gain and hold on to a (therefore larger) position, even if the gains will ultimately be taxed at a higher rate in the future.

Figure 4

Profit growth should be healthy, even with tax increases

2022 S&P 500 EPS growth, UBS CIO estimates, in %

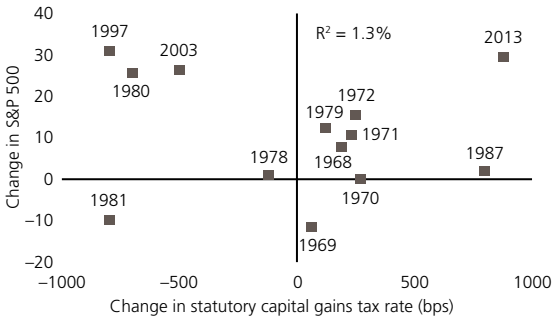


Source: UBS, as of 13 April 2021

Figure 5

No relationship between capital gains taxes and market returns

Change in the capital gains tax rate (in basis points) and S&P 500 returns, in %



Source: FactSet, UBS, as of 24 March 2021

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Investment opportunities

While some areas of the market have rallied in anticipation of the American Jobs Plan, there remains some uncertainty about the package's prospects in Congress. Therefore, we don't think the plan's impact is fully priced in and see room for further upside for certain market segments.

Infrastructure
Companies leveraged to traditional infrastructure spending, such as steel and aggregate companies, stand to benefit. However, we trim our steel exposure after the sector's strong outperformance—partially due to limited supply—on concerns related to potentially increased capacity later this year that could pressure metal prices. A number of industrial companies still look well positioned.

Greentech
A meaningful portion of the proposal is devoted to decarbonization initiatives. Incentives for electric vehicles, renewable power, clean energy (such as hydrogen), energy efficiency, and water and electric grid upgrades should boost the earnings outlook for a range of companies and their suppliers. Many stocks leveraged to these themes have seen significant gains over the last year, but have pulled back over the last few months. Therefore, we are avoiding companies with loftier valuations.

Semiconductors
The semiconductor industry lies at the heart of the tech race between the US and China. Biden has earmarked USD 50 billion to subsidize domestic semiconductor manufacturing and research. So far this year, a few semiconductor companies have already announced plans to expand their manufacturing footprint in the US.

Beneficiaries of higher interest rates
As we explained earlier, the Biden administration's infrastructure proposal has the potential to increase the long-term growth rate for the US economy, driving an increase in long-term interest rates. As a result, we recommend stocks that are poised to benefit from rising interest rates, such as financials. We think the positive impact of higher rates will offset any modest drags from potentially tighter regulation.

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Figure 8

Provisions in the American Jobs Plan

10-year estimates. Climate initiatives highlighted in green.

Invest in transportation infrastructure	USD 621 billion
Invest in Electric Vehicles (EV), including consumer rebates to purchase EVs, grants and incentives to build 500,000 new charging stations, and replacing and electrifying federal vehicle fleet	USD 174 billion
Modernize bridges, highways, roads, and main streets in critical need of repair	USD 115 billion
Modernize public transit	USD 85 billion
Improve passenger and freight rail service	USD 80 billion
Improve infrastructure resilience by safeguarding critical infrastructure and services, defending vulnerable communities, and maximizing resilience of land and water resources	USD 50 billion
Improve airports	USD 25 billion
Establish dedicated fund for beneficial projects to regional or national economy	USD 25 billion
Improve road safety and establish Safe Streets for All program	USD 20 billion
Establish program to reconnect neighborhoods and ensure new projects increase opportunity	USD 20 billion
Improve ports and waterways	USD 17 billion
Other spending	USD 10 billion
Invest in domestic manufacturing, research & development, and job training initiatives	**USD 590 billion**
Provide additional funding for domestic manufacturing, investing in capital access programs, supporting modernizing supply chains, and creating a new financing program to support debt and equity investments	USD 52 billion
Provide additional funding to the National Science Foundation	USD 50 billion
Establish Department of Commerce office to monitor domestic industrial capacity and to fund investments in the production of critical goods	USD 50 billion
Provide funding for semiconductor manufacturing and research	USD 50 billion
Provide funding for workforce development infrastructure and worker protection	USD 48 billion
Support clean energy manufacturing with federal procurement	USD 46 billion
Provide funding to upgrade research infrastructure in laboratories	USD 40 billion
Establish Dislocated Workers Program and invest in sector-based training	USD 40 billion
Provide additional funding for climate change research and development	USD 35 billion
Provide funding for community-based small business incubators and innovation hubs	USD 31 billion
Provide additional funding for research and development to spur innovation and job creation	USD 30 billion
Protect against future pandemics through medical countermeasures	USD 30 billion
Establish regional innovation hubs and Community Revitalization Fund	USD 20 billion
Create centers of excellence that serve as research incubators for HBCUs and MSIs	USD 15 billion
Provide additional funding to National Institute of Standards and Technology (NIST)	USD 14 billion
Provide funding for workforce development in underserved communities	USD 12 billion
Provide funding for research and development at HBCUs and other MSIs	USD 10 billion
Provide funding for enforcement of workforce protections	USD 10 billion
Establish Rural Partnership Program	USD 5 billion
Other manufacturing investments	USD 2 billion
Expand home care services and provide additional support for care workers	**USD 400 billion**
Expand access to long-term, home and community-based care services under Medicaid and extend the Money Follows the Person program	USD 400 billion
Clean energy tax credits	**~USD 400 billion**
Clean energy tax credits	~USD 400 billion

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Improve housing stock, modernize schools and child care facilities, and upgrade VA hospitals and federal buildings	USD 328 billion
Build over a million energy efficient housing units and eliminate certain zoning & land use policies	USD 126 billion
Provide direct grants to upgrade and build new public schools, with an additional $50 billion leveraged through bonds	USD 50 billion
Provide funding to improve public housing system	USD 40 billion
Establish Clean Energy & Sustainability Accelerator	USD 27 billion
Establish Child Care Growth and Innovation Fund and provide tax credits to encourage businesses to build child care facilities	USD 25 billion
Incentivize the building or rehabilitation of over 500,000 homes for low- and middle-income homebuyers with a Neighborhood Homes Investment Act (NHIA) tax credit	USD 20 billion
Modernize VA hospitals and clinics	USD 18 billion
Improve community college facilities and technology	USD 12 billion
Modernize federal buildings through bipartisan Federal Capital Revolving Fund	USD 10 billion
Invest in broadband, electrical grid, and clean drinking water	**USD 311 billion**
Provide funding to build high-speed broadband, reduce the cost of broadband internet service, and promote transparency and competition	USD 100 billion
Invest in power infrastructure	USD 100 billion
Upgrade and modernize drinking water supplies through grants and low-cost flexible loans to states, Tribes, territories, and disadvantaged communities	USD 56 billion
Replace all lead pipes and service lines	USD 45 billion
Provide funding to monitor PFAS substances in drinking water and invest in rural small water systems & household well & wastewater systems	USD 10 billion
Total	**~USD 2.65 trillion**

Source: Committee for a Responsible Federal Budget

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