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April 26, 2021

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Main Points:

- Federal spending has increased sharply, and more huge spending proposals are being considered by the Biden administration.
- The Biden administration has also proposed raising corporate taxes, personal income taxes and capital gains taxes.
- Corporate earnings are still expected to reach record levels this year and next.
- Inflation will look quite high over the next few months due to strong consumer demand, continued supply bottlenecks and a "base effect," but inflation should moderate later in 2021.
- Stocks are short-term overbought, but a major correction is not anticipated and prices are likely to continue higher over the next year as earnings expand.
- This cyclical rebound in stock prices is expected to only end when inflation expectations gather steam and the Fed changes course and starts considering monetary tightening.

Biden Moves Aggressively

President Biden has begun his term with an ambitious agenda that is more radical than we had anticipated. Aside from a large number of executive orders and regulations affecting the oil and gas and other industries, the Biden administration moved early to pass a $1.9 trillion "stimulus" spending program which came on top of other huge programs passed during the Trump administration. At least two additional multi-trillion dollar spending programs are being planned. To help pay for the spending, Biden has plans for higher corporate, personal and capital gains taxes. Furthermore, Biden has proposed that the U.S. reduce greenhouse emissions 50% by 2030 and zero by 2050. On the whole, the Biden administration is moving aggressively in the direction of the "New Green Deal" proposed by the left wing of the Democratic party.

Federal spending programs since the Covid pandemic began have been unprecedented:

1. **March and April 2020 –** three relief packages were passed totaling nearly $2.8 trillion that included payments directly to individuals, forgivable loans to businesses and other programs to support spending and employment as the initial "lockdown" took place. This round of spending also included billions of dollars to accelerate vaccine development.
2. **December 2020 –** just after Biden was elected but before Trump left office, an additional $900 billion "stimulus" package was passed that provided additional direct payments to individuals and families. The amounts were considered insufficient by the Democrats and Biden declared the package to be a "down payment."
3. **March 2021 –** a fifth round of spending was proposed by Biden and passed by all Democrats that totaled an additional $1.9 trillion of spending, including additional direct payments to individuals, funds paid directly to the states to support their budgets, expanded unemployment benefits and spending for education and transportation projects favored by the party.

The spending programs since early 2020 caused the federal budget deficit to spike to nearly 30% of GDP in the second quarter calendar 2020, and another surge is coming. Looking back, federal tax revenues in the second quarter of 2020 fell 6.4%, year-over-year, as people stayed home and businesses closed. But the big driver in the deficit from that point was the 92% increase in spending, which brought federal government spending to an unprecedented 29% of GDP. In the second half of 2020, revenues started rebounding while spending continued at historically high levels. The result of this budget blowout can be seen in Chart 2. Federal debt held by the public has hit 100%, a level not seen since the second world war.

As extreme as these numbers are, the lasting consequences are difficult to know. But the evidence would suggest that the impact could be less than many expect. Japan, for example, has unsuccessfully attempted to stimulate growth through government "stimulus" spending and has had large deficits for decades. National debt in Japan exceeds 200% of GDP. By observing Japan's history, one might conclude that government spending does not stimulate anything, but also that large deficits do not cause any observable catastrophes. Furthermore, maybe more important than the size of the debt itself is the cost of maintaining that debt. In the case of the U.S., interest payments on federal debt hit a peak of 5.0% of GDP back in 1991, before falling to 2.5% of GDP in 2003. In the fourth quarter of 2020, interest payments were still a very manageable 2.5% of GDP. It is quite an experiment to run such large deficits during peacetime and we will closely watch the data to determine the effects.

Chart 1

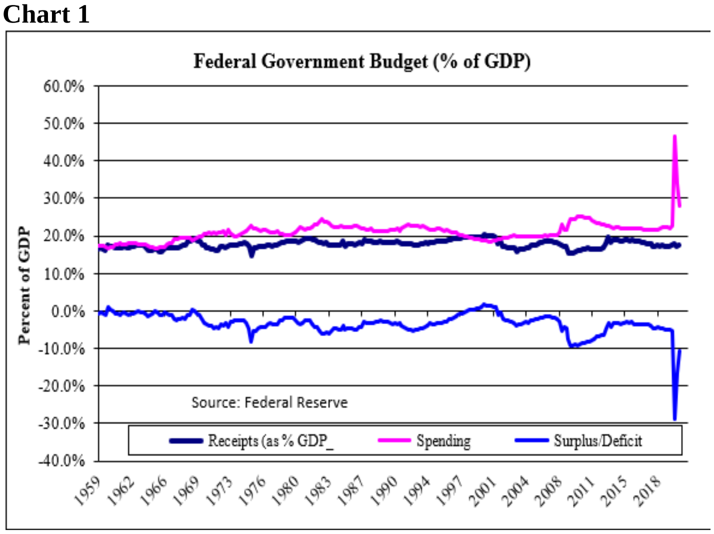
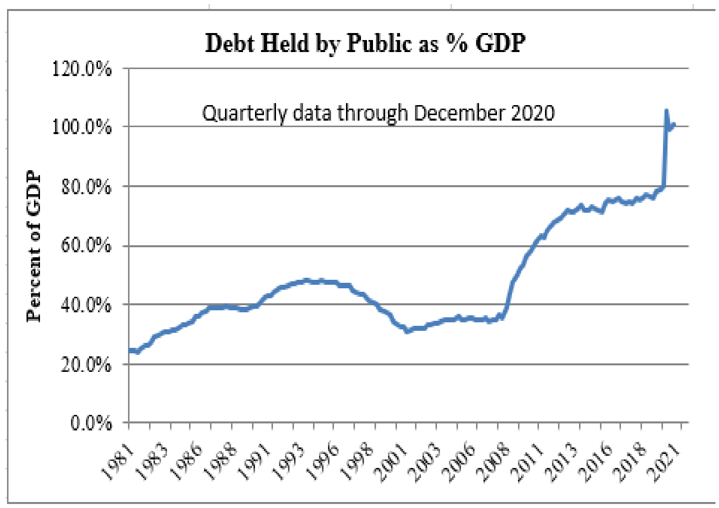


Chart 2



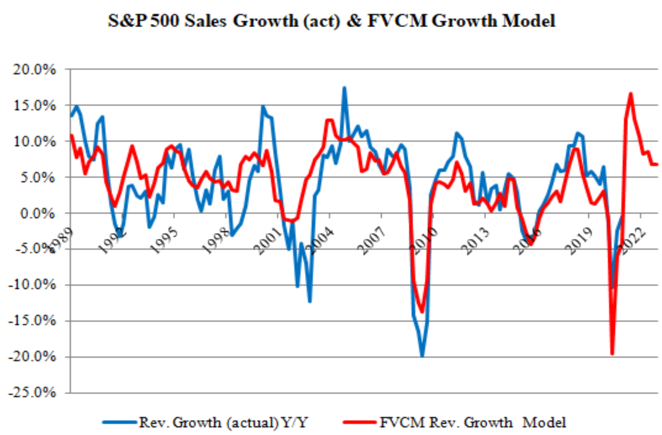
Biden's tax proposals will likely have a depressive effect on business over time, but the positive cyclical effects of the ending pandemic will dominate activity over the next year. The most significant parts of the Biden tax plan are as follows:

1. Increase the top Federal tax rates on individuals from 37% to 39.6% and expand social security payroll taxes to incomes above $400,000 (currently, social security taxes only apply to incomes below $142,800).
2. The corporate tax rate would be increased from 21% to 28% and a 15% minimum tax would apply to corporate book income.
3. The tax rate on capital gains would rise from 20% (23.8% including a 3.8% surtax that funds Obamacare) to 39.6% (43.4% including the surtax).

The Tax Foundation, an independent organization dedicated to analyzing tax policy, looked at Biden's proposals, excluding the effects of changes in capital gains since that proposal just came out. As for the other proposed changes, the tax increases are expected to raise $3.3 trillion in tax revenues over the next decade on a conventional basis. When accounting for macroeconomic feedback effects, the changes are expected to raise $2.8 trillion. The difference between the two numbers reflects a 1.62% decrease in GDP over the long-term. Make no mistake, the U.S. is now entering a strong cyclical expansion as the economy rebounds from the Covid recession. GDP growth and corporate earnings growth will be very strong this year and next. The negative effects from higher taxes will become more apparent in 2023.

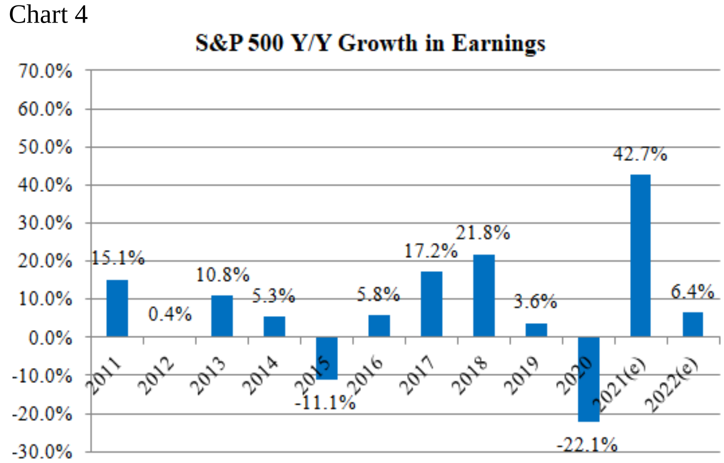
We are estimating record earnings of 175 for the S&P 500 for 2021, a tremendous 43% increase on top of the 2020 earnings of 122, which was down 22% because of the pandemic. Sales were down 4% in 2020 because of the pandemic-caused recession, and operating profit margins were squeezed down to 9.0% from 11.1% in 2019. With the vaccine being rolled out and business returning to normal, sales this year are estimated to increase nearly 15% and margins are expected to expand to 11.3%. Our models suggest further increases in sales and earnings of 7.6% and 6.4%, respectively, in 2022. As strong as these gains might seem, there are higher estimates on the street and we may actually be conservative.

Chart 3



Source: Federal Reserve, FVCM

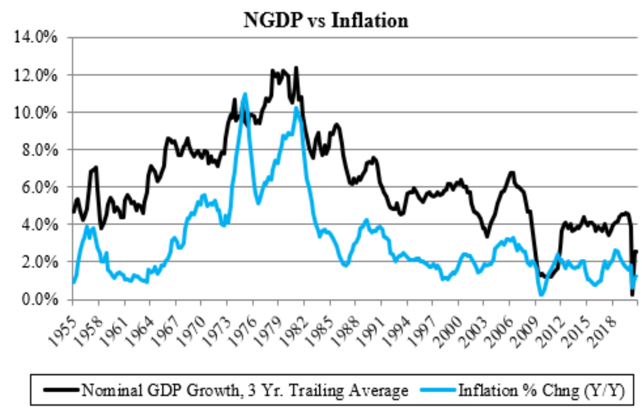
Chart 4



Source: Federal Reserve, FVCM

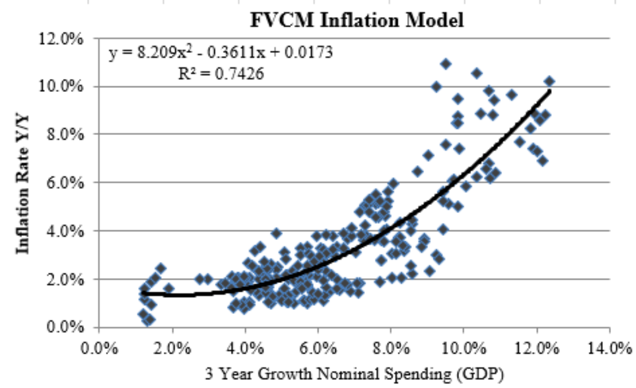
Aside from earnings growth, inflation is the most important factor for the markets because it is the prime determinant of long-term bond yields as well as the discount rate on stocks, i.e., P/E ratios. The good news is that underlying inflation pressure remains well anchored. Inflation is hard to stop once it takes off, and it is hard to start when it is low. It is true that increases in the money supply provide fuel for inflation, but for money to be inflationary it has to be spent. If money sits under people's mattresses, it cannot cause inflation. Hence, in Chart 5 we see the relationship between nominal spending and three year trailing inflation. Our model, in Chart 6, shows the good fit between past spending and current inflation. With nominal spending having grown a paltry 2.5% over the past three years, underlying inflation pressure is only about a 1.3% rate. Even if we model a super strong 8% growth rate in spending every quarter through 2022, we still only get back to a 2.0% inflation rate. This favorable outlook for inflation over the next two years is positive for stock valuations. The rise in stock prices we have seen reflect this goldilocks condition of strong earnings and high valuations, thanks to subdued inflationary pressure.

Chart 5



Source: Federal Reserve, FVCM

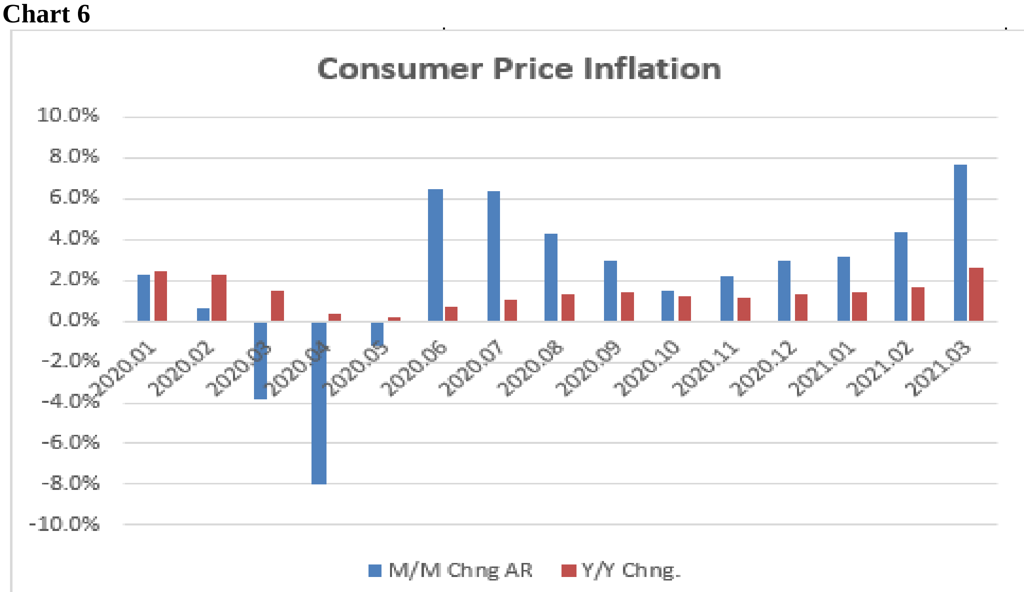
Chart 6



Source: Federal Reserve, FVCM

While underlying inflation pressure remains muted, near-term inflation data will look rocky due to pandemic related supply disruptions and because of the mechanics of inflation accounting. When the economy went into lockdown in March 2020, consumer prices contracted at a 3.8% annualized rate (ar) that month as spending fell (see Chart 6 below). That decline in prices was followed by an even steeper decline in consumer prices of 8.0% (ar) in April 2020 and a 1.2% (ar) decline in May. On a year-over-year basis, consumer inflation fell to a 0.2% rate. Now, we are seeing the flipside of that coin. In March 2021, the CPI was up 0.7% (ar) and the year-over-year rate has jumped to 2.6%. The year-to-year figures will continue to look bad through May since the numbers are being compared to depressed figures from the year before. This is referred to a "base effect." Because the bottlenecks in the supply chain and the base effect are both considered to be temporary, we are not seeing any significant impact on the markets.

Chart 6



Source: Federal Reserve

While the so-called easy money has been made over the past 12 months as the markets rebounded from the shock-lows of the pandemic, we suggest that investors stay long with equities. The major elements of the bull case remain in place: Vaccine rollout and business normalization; easy monetary and fiscal policy; and a rapid rebound in economic growth and earnings. Of course, with all of those positives, there is now some attention being paid to a more cautious narrative involving peak growth, margin headwinds, tax risk, stretched sentiment, and high valuations. This caution is normal after the gains of the past year and these issues are important factors. However, markets tend to rise most of the time because earnings rise most of the time. Bears are rarely happy investors. We will become concerned when core inflation becomes a persistent problem and the Federal Reserve's discussions shift toward tightening monetary policy. That will be the time when markets seriously start focusing on the next downturn in the business cycle. Ironically, when the Fed starts raising short-term interest rates may also be the right time to shift from stocks back into long-term U.S. Treasury securities. We are not there yet and patience should pay in the meantime.