Fiscal Policy and Financial Markets

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If you missed our recent fiscal policy & the financial markets webinar with special guest Mary Kenney, BMO Government Affairs, please find a summary of our discussion covering everything from infrastructure to inflation.

It's been a strong year for U.S. equities. Through August, large- and mid-cap equities were up more than 20%, and U.S. markets continue to lead globally. As we head into October, however, things may start to look a little different as several policy initiatives are colliding, including an infrastructure bill, government funding and the debt ceiling.

Budget Battles and a Possible Shutdown

On Aug. 10, the Senate passed a $1 trillion bipartisan infrastructure bill, which is currently pending in the House of Representatives. At the same time, the House is working on a budget reconciliation bill to address President Joe Biden's $3.5 trillion spending plan, which includes efforts to address child care, education assistance and climate change. That bill includes tax increases to fund the package.

As Kenney explained, those two bills have become intertwined. House Speaker Nancy Pelosi had initially set an aggressive Sept. 27 deadline to bring the infrastructure bill up for a vote. *"There's lots of posturing going on both sides,"* Kenney said. *"But it seems difficult for me to see a path where Democrats would take up the reconciliation bill separate from the infrastructure bill. You're likely to see enough Democrats peel off of the reconciliation bill so that the infrastructure bill- will, in effect, be stalled while the while the broader reconciliation bill gets negotiated to a resolution in the House."*

While that battle is taking place, Kenney noted that the U.S. is also approaching a Sept. 30 deadline to fund the government as well as a deadline to suspend the federal debt limit.

"If they don't get some kind of resolution, the government will shut down," she said. *"At the same time, the suspension of the debt limit has expired. The Treasury Department has been utilizing extraordinary measures in order to fund the necessary pieces of the government, which we're told are going to expire sometime between Oct. 15 and the beginning of November. So, if we don't get some resolution to the debt limit by Oct. 15, then we will see the U.S. in a technical default. Both the funding of the government and the debt ceiling have converged into a single issue, at least as far as Democrats are concerned."*

On Sept. 23, the House passed a stopgap bill designed to fund the government through Dec. 3 and suspend the debt limit until December 2022. Senate Republicans have vowed to block it, objecting to tying government funding to the debt ceiling.

"Right now, it's very hard to see a path forward as both sides are pretty dug in," Kenney said. *"We'll see a lot of posturing by the two sides. It's a complicated mix of issues, but it's not at all clear exactly right now how all of these will wind up."*

Key Tax Proposals

The reconciliation bill includes about $2 trillion in proposed tax increases. It includes raising the corporate tax rate from 21% to 26.5%—still below the 35% rate prior to 2017, when the GOP-led Tax Cuts and Jobs Act took effect. Kenney said that's an example of the more moderate approach the House Ways and Means Committee took to its markup of the reconciliation bill.

"I do think it's going to provide a real baseline as we move through the process," she said.

From a markets perspective, Ma said the key is how the tax proposals affect corporations. About $1 trillion of the proposed new tax revenue will come from corporations, compared with about $500 billion from individuals.

"The question is really going to be about what level of spending needs to be supported," Ma said. *"We think it's possible that that proposed 26.5% corporate tax rate could come down if the local spending that needs to be supported isn't quite as high [as projected]. We do think that the market, to a degree, is bracing for an expectation that there is going to be tax*

increases at some level. It's really the question of is it at the higher end, the lower end or somewhere in between that ends up taking place. That is something that market is bracing for but is not fully priced in now, especially if the numbers come in at the high end of expectations."

We've already seen an impact in the fixed income market. Potential tax law changes have increased demand in the high-yield municipal bond market, which has led to a bit of outperformance compared with the corresponding taxable market.

According to BMO's projections, a 26.5% corporate tax rate would result in a slight downward adjustment on the market on an earnings per share basis, but not one that's catastrophic. Overall, the market impact of a tax increase is likely to be overshadowed by economic momentum, which will be the key to future performance.

"What growth looks like is going to be the dominant theme for 2022," Ma said. *"I don't want to ignore the bipartisan infrastructure package, either. Hopefully that gets passed and will provide some support to the markets, because I think there's broad agreement that infrastructure is important, and it is something that we think would provide a nice tailwind to the market."*

Markets Hold Steady, For Now

These intertwined policy issues are creating uncertainty. So far, however, markets have remained calm. But Ma said that may not last long as both side dig in their heels on these issues.

"Perhaps the market is a bit too complacent," Ma said. *"We do think there will be some resolution, but there's a heightened possibility of volatility toward the end of the month and even into October as some of these issues get discussed. Certainly, it looks like it's going to go down to the wire until some of these issues can get resolved, because it's very complicated and so many things are coming together at once in a way that this hasn't happened in in the past. That adds to that level of uncertainty, so we definitely think there's potential for volatility."*

Ma doesn't see any long-term impacts lingering from these issues, however. *"I think there some resolution will happen that does not include the U.S. government defaulting on its debt,"* he said. *"So, we don't see it as a long- or even medium-term issue, but it is something to be aware of."*

We covered a tremendous amount of ground in our conversation, including more details on the legislative battles, inflation projections through 2022, and our tactical sector recommendations. You can listen to the full discussion here.

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