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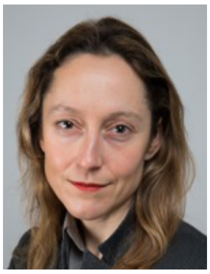
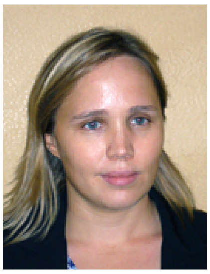
A post-Covid structural change in developed markets: the strong political will to invest in the US



Valentine AINOUZ,
Deputy Head of Developed Markets Strategy Research

Mickael BELLAICHE,
Fixed Income and Credit Research Strategist



Delphine GEORGES,
Senior Fixed Income Research Strategist

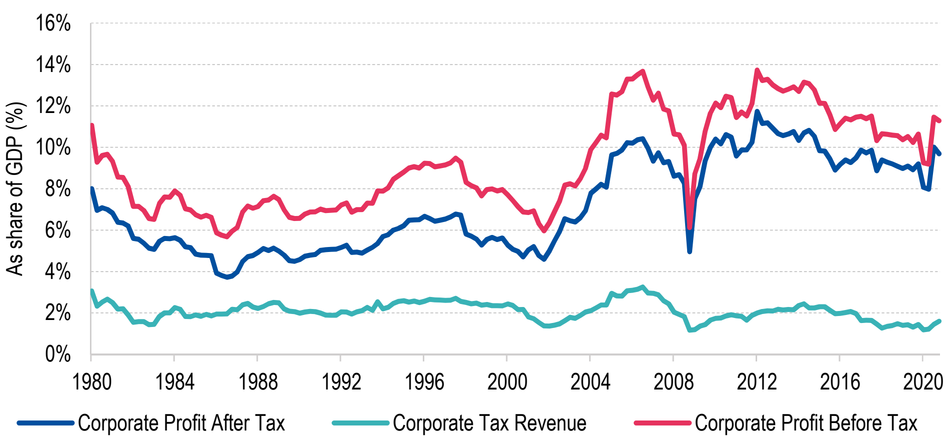
What matters to fixed income investors is the macro-financial environment that will prevail after the strong rebound in growth and inflation expected in H2. In a context where investors must question whether the change in consumer prices is transitory or a regime shift, it is important to focus on the sustainability of economic growth on the basis of capex trends. Indeed, US long-term economic growth could be boosted by a strong policy of investment (public and private). This would represent a strong contrast with Europe. What are the implications for fixed-income investors?

Biden's message is clear: investment is a top priority. The president argued that the United States' position as a preeminent global power was under threat from China if investments were not made. "Doing nothing is not an option". Biden said it would be unacceptable not to move forward: "America is no longer the leader in the world because we're not investing". China is "counting on American democracy to be too slow, too limited and too divided to keep pace" and "we can't afford to prove them right."

- **The US administration has proposed a two-part plan called Build Back Better of more than $4 trn over 10 years, after years of underinvestment in infrastructure and education.** These are the basic ingredients of long-term growth. It could have significant implications on long-term growth trends and productivity. The first part, the American Jobs Plan (AJP) amounts to more than $2tn in spending and tax incentives organised around four areas: 1) traditional infrastructure investments (roads, bridges, ports and digital infrastructure); 2) environmental infrastructure (water and energy); 3) manufacturing, supply chain and R&D initiatives (electrical vehicles and semiconductors); and 4) social welfare (investment in housing, childcare facilities, and upgrades of schools and community colleges). The second part is the American Families Plan of $1.8 trn over 10 years in new benefit spending and tax credits focused on child care and education. The new spending would raise total infrastructure investment to around 4.5% of GDP, the highest level since the 1970s. Infrastructure policies are the fiscal policies which have among the highest multipliers.
- **The tax reform proposed by the new administration aims also to improve economic efficiency via a better allocation of capital.** President Biden is in favour of raising corporate taxes to fund his infrastructure plan. However, we don't think it will penalise private investment. First, revenues from corporate taxation are beginning to look very low. The share of federal revenue raised by the corporate tax has fallen steadily for decades and is now under 10%. In contrast, the share of revenue raised by taxing labour has been growing and now exceeds 80%. Secondly, we think that aggregate demand matters more to the investment outlook than tax rate changes. Thirdly, there is no evidence that the 2017 tax law made substantial progress in long-term economic growth. The increase in corporate cash balances were mainly directed toward financing buybacks and dividend payouts for shareholders. Indeed, the recent jump in share buybacks has come almost entirely from companies with lowered tax rates.

> *"Doing nothing is not an option"*
> *(Joe Biden)*

1/ **Corporate profit and taxes as a share of GDP**



Source: Datastream, Amundi Research - Data as of 31 December 2020

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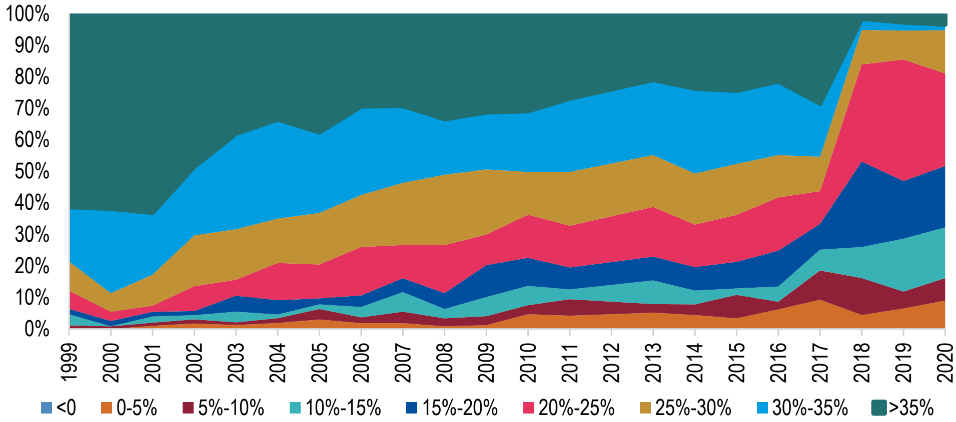
2/ **Distribution of effective tax rates among US IG**



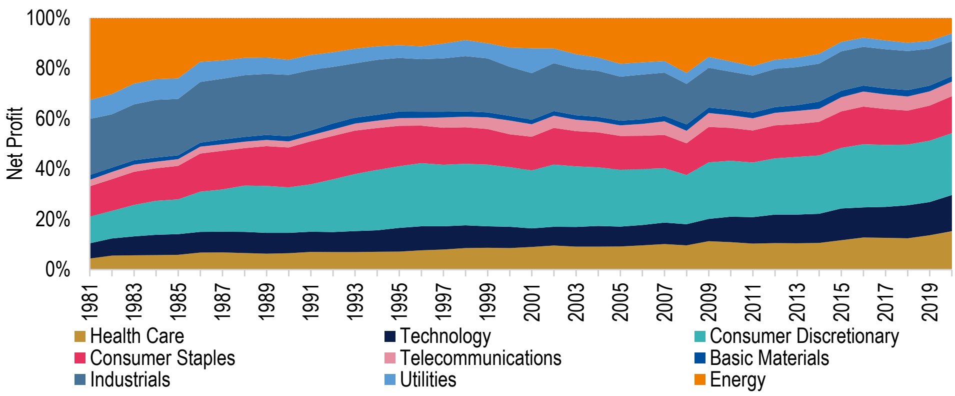
Source: Bloomberg , Amundi Research - Data as of 31 December 2021

The Fed is willing to let the economy run hot

In addition, we see a pick-up in private investment in the technology and consumer non-cyclical sectors. The change in the Fed's policy framework is providing strong support to the US economy. Indeed, we have observed a strong rebound in investment by American companies sustained by the very low interest rate environment.

- **Companies are benefiting from historically attractive financing conditions**. In 2008, the recession was triggered by an endogenous financial shock, which led to a prolonged period of tight financing conditions and private sector deleveraging. This time is different from 2008: the Fed's monetary policy has pushed the cost of debt to historically low levels, and activity on the corporate debt primary market remains very solid. On the one hand, the record low cost of funding has led to reduced interest payments on debt and improved corporate creditworthiness. The weakest companies (with the lowest ratings, affected by the Covid crisis) are taking advantage of low rates to refinance their debt and lower their average cost of debt. On the other hand, solid and well-capitalised companies are using the very low cost of debt to accelerate their development.
- **Cash on the balance sheets of S&P 500 companies is at an all-time high of $2.7 trillion.** Cash holdings along with improving cash flow could spark more capital spending, dividends and buybacks but also investment. The cash is concentrated in the technology, heath care and consumer sectors.
- **M&A activity remains on track in the United States and Asia despite the crisis.** M&A activity accelerated sharply during the second half of 2020; during this period volumes were the highest of all 2H periods since 2015. This rebound in M&A activity was driven by technology, consumer non-cyclical and communication sectors. These companies have outperformed in recent years and were the big winners of the crisis. Most of them are well-rated and well-capitalised. They have an offensive strategy and pursue external growth to gain in scale and diversity (by product, region, and customer). By contrast, M&A activity remains modest in Europe.
- **US capex was one of the surprising areas of resilience in the last quarter of 2020.** While capex is growing in most

3/ **S&P500: U.S. net profit by sector (% total)**



Source: Datastream, Amundi Research - Universe: S&P500 ex. Financials and Real Estate
Data as of 31 December 2020

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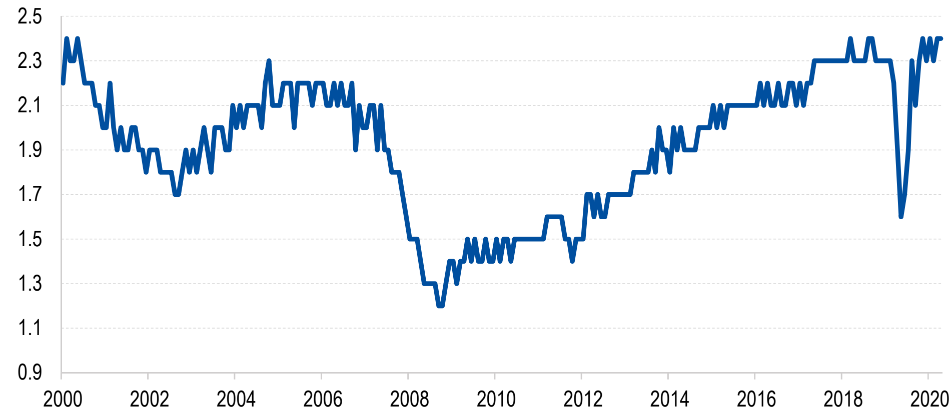
4/ **Rate of job quitting (in %, SA)**



Source: Datastream, Amundi Research - Data as of 31 March 2021

areas of the economy, two areas stand out: technology and renewable energy.

Overall, the technology, health care and consumer discretionary sectors continue to show strong development. These sectors, which had already been driving the US economy over the past decade, are the big winners of the crisis. Interestingly, the situation on the labour market is completely different from that of 2008. Despite the high unemployment rate, we are already seeing tensions in the labour market. In the April NFIB Small Business Optimism Index report, a record 44% of surveyed businesses noted they had one or more jobs that could not be filled. People who have voluntarily quit their jobs have already returned to the pre-Covid level.

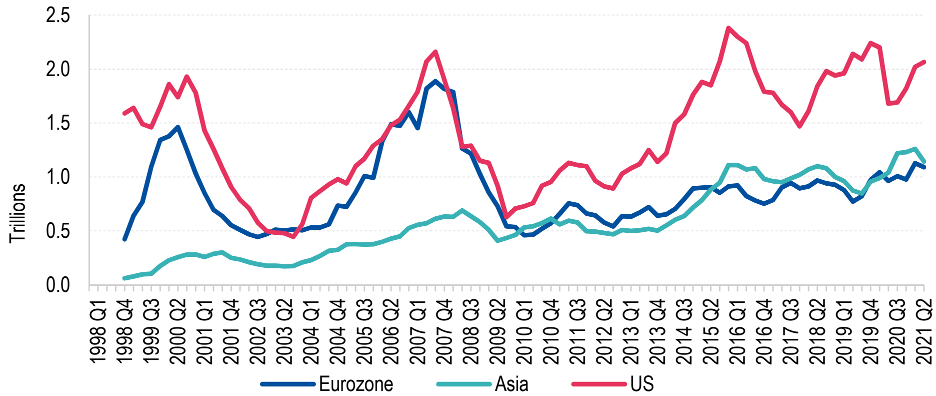
Over the long run, the US current expansionary fiscal policy has the potential to raise the equilibrium real interest rate

In the short term, strong growth and buoyant inflation will drive sovereign core bond yields higher. The coordinated response of monetary and fiscal policies to the Covid shock has been of unprecedented magnitude in peacetime, particularly in the United States. With the economic recovery accelerating, the case for shorter duration remain (in particular in the US).

Over the long run:

- **In the US, the current expansionary fiscal policy (BBB) and investment growth have the potential to raise the equilibrium real interest rate.** After decades of decline, the US real equilibrium interest rate is now estimated at around 0% to 0.5%. It could rise in the next few years as greater tolerance for budget deficits, unconventional monetary policy and structural measures to promote investment should lead to a new macroeconomic regime and a receding of the risk of secular stagnation.
- **The upside in euro core rates will be limited by the economic fragmentation between Eurozone countries.** The EU recovery fund (€750bn) and expansionary fiscal policy has allowed countries like Italy and Spain to have strong investment plans. However, public stimulus measures are not as ambitious as those planned in the US, and private investment has so far remained muted. The size of the EU recovery fund is not sufficient to compensate for years of underinvestment. Indeed, the last decade has been marked by a strong divergence in R&D expenditure among developed countries. The overall R&D-to-GDP ratio in Europe has been around 2%, i.e., significantly lower than in the United States, Japan, South Korea and

5/ **M&A volumes (trailing 4 quarters in USD)**



Source: Bloomberg, Amundi Research - Data as of 30 April 2021

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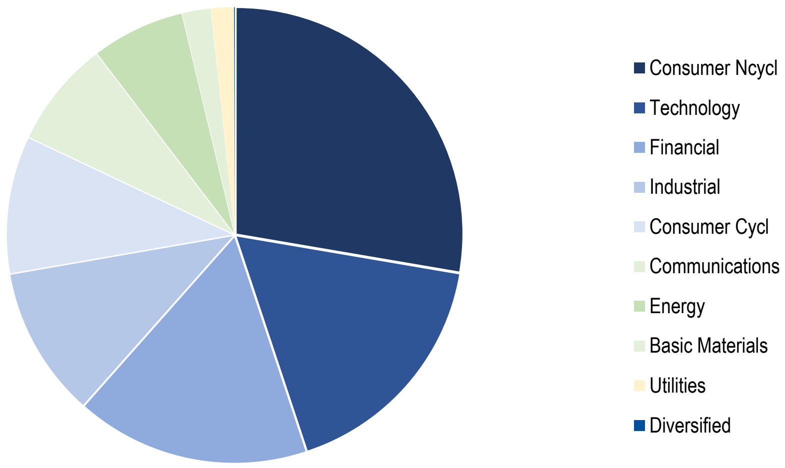
6/ **M&A activity in North America (last 12 months)**



Source: Bloomberg, Amundi Research - Data as of 30 April 2021

Singapore. R&D spending has been particularly low in peripheral countries. Barring a significant rise in growth expectations, the ECB stands alone in trying to avoid financial fragmentation. The ECB's ability to stabilise the markets is thus essential. Fiscal policy can only be effective if sovereign yields remain low and stable even in the face of growing deficits. Otherwise, divergences on the ECB board are likely to increase as the economic recovery starts, as the debate on the assessment of "favourable financing conditions" is still open within the ECB.

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Conception & production
BERGER Pia, *Research*
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