The Hexagon Briefing: A Global Perspective from HSBC

Episode 1: FDR's New Deal to Biden's New Deal

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I'm your host, Jose Rasco, thanks for joining us today.

Today, we're going to talk about a few key issues in the market. What's the impact of the new stimulus plan? We're going to meet today with Vince Fontana, who is our Regional Head of Fixed Income and a Product Specialist in that market.

This podcast was recorded on Wednesday, March 24, 2021.

Thanks for joining me. And let's get into it.

Issue number one, higher taxes probably coming. What does it mean for consumer spending and what does it mean for the financial markets? So, if tax rates go up on the individual side and on the corporate side, what should we do with our portfolio? That's the question, right. And clearly, this is going to be heavily dependent on who you are. And there's all kinds of questions about what kind of risk you're willing to take, etc.. But broad brush strokes, it's important to keep in mind that when individual tax rates go up, consumer spending does not fall off a cliff, okay? What we've seen historically is, yes, when tax rates go down, they go down in an effort to try to lift the economy. So consumer spending tends to pick up. Now, in the past, tax rates haven't gone up all that frequently. But when they have gone up, there's no question that there is a little bit of a downturn in other words, growth is a little slower in terms of consumer spending, but it does not fall off a cliff. It does not slow precipitously. It just slows on the margin. Consumer spending doesn't move on tax rate. Consumer spending is driven by do you have a job? What's the unemployment rate looking like? What are wages looking like? Those are the issues that move consumer spending. Right. And so tax rates, like a bevy of other issues, are really on the margin. So consumer spending historically has slowed a little. But really, it doesn't really have any meaningful effect in terms of higher taxes affecting consumer spending. That's number one.

Now, what happens with corporate taxes, right when corporate taxes go up? That's another question. And historically, it doesn't really affect the market all that much what we've seen. Yeah, no question. Capital expenditures can slow a bit. But again, it's all within the context of where we are. And what's happening is this is happening not at the end of a business cycle. It's happening at the beginning of a business cycle. So it's not optimal in the sense that people are concerned about headwinds in terms of the economy. But the bottom line is the consumer is looking pretty healthy. The economy is looking pretty healthy. The savings rate is at or near historic levels for the consumer. And more importantly, the Fed's going to keep rates low. The market rates are going to stay low because we don't see a lot of inflation. And last but not least, the government is pumping a lot of money into the economy through fiscal stimulus.

So a lot of these issues that drive the economy, drive job creation and drive wages are all pointing positive. So it suggests to us that consumer spending should remain relatively healthy, not just this year, but next year as well, as consumer spending will be affected by taxes on the margin only. So from our perspective, the effect on equities is minimal. It's on the margin. I wouldn't focus on it as a first order effect. All right. So bottom line, do higher taxes affect the economy? They do. But on the margin, people are going to make buying decisions based on other things. Do higher taxes affect equity markets? Yes and no. Again, it's on the margin. Equity markets aren't driven by consumer tax rates. Equity markets are driven by the economy. That driven by interest rates. They're driven by earnings. And all of those factors look pretty positive for this year and next. So from our perspective, higher taxes matter, but they matter on the margin. If you're going to be an equity investor, if you're going to focus on financial markets in the US, focus on the fundamentals and taxes are more peripheral than they are fundamental in terms of that equation.

After President Biden's stimulus plan passed earlier this year, I've heard a lot of speculation about what that could mean for the equity markets and for various sectors of the economy. There's a lot to unpack here, and there's no one better to explain what's going on than Vince Fontana, a product specialist and regional head of fixed income at HSBC.

So, Vince, you're an expert at fixed income and we're going to certainly touch on various aspects of fixed income today. But before we get directly to fixed income, I think what we want to talk about is where are we and where have we been? If you look at FDR's New Deal, FDR's New Deal was something that took place over basically a decade from 1933 to 1939. Some major differences between these two situations, right.

Number one was the 30s were created by the 1929 financial crisis. It was not an extemporaneous thing. It was not a thing that came out of nowhere. It was a financial crisis that caused an economic crisis. In 2020, we had a complete black swan where it was a health care crisis that thankfully has not become a financial crisis. So two very different types of environments. Right.

Number two, we had two recessions in the 30s. And what we're seeing here is actually a very rapid economic expansion. So we're in a very different place. Now where we see parallels is in the 1930s, FDR realized that demand was not picking up. So he spent a great deal of money trying to create jobs and trying to create demand. And what he did was he spent so much money that it led to spending at about 40% of GDP in those days. So 40%, that was a huge number.

If you look at where we've been from last year to now, the Cares Act, the Trump spending plan in December and the 1.9 trillion we saw from President Biden most recently, that totals the ARP, that totals about 5.3 Trillion, which is about 26% of GDP in 2021. Now, if we add another trillion or two and the talk out of Washington, Vince, is we're going to add about another two trillion to spending, not all of it's going to be debt. We know that there will be some tax increases as well to help pay for these programs. But if we add another two trillion to spending, it gets us to about seven point three trillion, which is roughly 35% of GDP today.

So, Vince, even though we know it's not going to be all debt related, how do you think the government debt market looks today relative to where it was a couple of years ago? And can the debt markets absorb this increase in debt and not have indigestion?

Vince Fontana: Absolutely. Thanks so much, Jose. It's an interesting question, and I feel like you and I have been discussing this point sequentially over the last few years as government debt has been growing and growing. You know we kicked off in the global financial crisis area of 08, 09, and now it clearly has skyrocketed over this now covid year. And it's not just US, right? We see that very much across the globe. The indigestion, I think there's two key points to look at when we think about how well markets can handle things.

One, I think you have to look at first the demand for government bonds. A lot of it has come to market. A lot of it, as you said, Jose, they will continue to come to market. But the global demand for government securities, particularly in this medium term, you know, call a five to seven belly of the curve, which will likely be or you'll see a lot of issuance, there's still quite a healthy bit of demand for it, because if you look across the US, across the pond, I should say, most of the world still in negative territory. You got 10 year bonds on the German side, you're still in negative territory. So that demand for positive yielding paper, however low we think yields generally are from historical perspective, is still there. So I think that demand should take on a lot of this new supply and there shouldn't be too much indigestion.

Second point, if we take a look at history and not just in the US, but other countries that have issued quite a bit of debt, getting to some of those GDP figures that you mentioned, Jose, as a percentage, Japan, of course, comes to mind and a couple others. In quarters where you have these large portions of new issuance, you typically don't see the yield curve or the yields a general move all that much, which is kind of counterintuitive, right? When we look back at the textbooks of econ that we studied back in college and high school. Yeah. You think more supply price goes down, yield goes up, but that doesn't happen in reality, at least not not over the last 10 to 12 years of time. So markets should be OK in terms of the indigestion. You have that demand and again, that historic relationship. You typically don't see rates skyrocket when you do have these record issuances coming into the fold.

Jose Rasco: And one key thing that you and I talked about several times is the fact that due to the zero interest rate policy from the Fed, we're basically looking at debt service, which is going down, so the interest payments on the debt as people are refinancing and don't forget, the government borrows long and they spend in short term, refinancing and the debt service is going down in the household sector, the corporate sector, even on the government side. So we're seeing interest payments as a percent of GDP are actually going down, which is important. It puts less pressure on the budget.

Now, one of the big things we see, Vince, is this long term trend in tech and convergence. And it's going to play into this whole Biden's Green New Deal thing, because what we're seeing is technology and 5G. Beginning this year, the rollout of 5G is beginning in earnest in 2021 as the economy recovers and the seven point three trillion, we're looking to spend this incremental two trillion he's looking to spend. A good portion of it is being put not just to roads, highways, tunnels and bridges, but to that digital footprint. And we're going to be building out the digital infrastructure of the US for the next generation of technology.

And one of the key things, Vince, is in the ESG space, in particular environmental, we're going to see what we call convergence. Technology one plus technology two, one plus one is not going to equal two. It's going to equal five because you're going to get productivity and a return on invested capital that's going to be exponential. And that's where we're going to see the rise in productivity. That's we're going to see the rise in profitability. Now, it's also going to play a role in the social side of ESG and sustainability, because we're going to see that digital divide.

There will be an attempt in this Biden plan to help provide technology, wifi, computers, et cetera, for those who don't have access now, which will help level the playing field for Americans in general. So that's really important. And if you go back to that concept of lower debt service, that's what defines it all together. Now, this is something we've talked about in the corporate sector. And Vince, if you could go over that, what has happened in the corporate sector with the refinancing? Correct me if I'm wrong, we had an annual record issuance of corporate debt in the first six months of the year last year, is that right?

Vince Fontana: That's right. I mean, it was a record year across the board, no question. Right. In 2020 and you definitely had that come to bear on the corporate debt side as well. Really historic numbers and the first half and the second half of the year is something that I like to focus on. The first half, it was very much defense: building up that shoreline because we knew there was a big tidal wave coming our way from a covid perspective. Right. So you saw a lot of companies saying, OK, well, let's make sure we have cash on the balance sheets. Let's issue, right, the the rates are still quite low, getting lower at that time. And let's make sure we have cash to fortify ourselves and defensify ourselves, if you will, for this upcoming storm.

The second half of the year, it was more about pushing out the maturity schedule. So saying, OK, well, let's continue to take advantage of these lower rates in fact, they're even lower now than they were at the start of 2020. Let's push out this yield curve as much as we can, and we saw a lot of that. So if you take a look at the maturity schedules for corporates at the start of 2021, very, very healthy, you're seeing, you know, maybe within 1 to 5 years 31% of all corporates, that's much higher than it used to be in the past. So all of this stuff has been pushed out the curve, extending the duration quite a bit and really setting ourselves up for a healthy perspective in terms of fundamentals, particularly on US investment grade side.

Now, turning the table a little bit as we look ahead, there are some changes at the forefront here? You're starting to see companies make more equity friendly issuances. So you had this pent up demand for M&A mergers and acquisitions, you know, share holder purchases or buybacks. That's another aspect that corporate are looking to do because rates are so low. But you're right, Jose, 2020 very much a historic time period, record issuance, first half of the year, a lot of clean up, second half of the year, setting themselves up for prosperity, if you will, in the years to come as we recover from this very shorter duration and very longer on the extended duration, extending out that the duration quite a bit.

Jose Rasco: So companies very intelligently looking at their cash position saying we're doing well in terms of cash, for the most part, there are sectors that are still hurting in a big way. But for the most part, the S&P, if you look at the broader markets, companies looking a lot healthier because they have a lot of cash on hand. But what they've done is they've done a lot of balance sheet repair and now they've extended duration so they are locked in for longer periods of time with these very low rates. So that's very important. So it means as market rates go up, it doesn't mean it's going to affect the ability to invest going forward. Now, one thing that may affect investing is the other side of this, which is we're going to see more government debt hit the market with this new plan. But there's also talk of higher taxes.

Now, the rumor is that President Biden understands he doesn't want to derail the economy, he's going to wait either to the beginning of the new fiscal year, which is October for the government, or he's going to wait for the new calendar year, which is January of 2022 to bring about these higher taxes now we all like to be forward thinking, we're not talking about corporations, we're talking to our individual investors who are our clients. So on the tax side, what are we expecting to see? Clearly, he's talked about higher income taxes for individuals, higher corporate taxes. He's talking about a minimum tax of, I believe, 10% for the corporate sector so that the corporate sector contributes more to government receipts and puts less pressure on the individual taxpayer. And then on the individual taxpayer side, he's talking, as I mentioned, higher income taxes, but also higher capital gains. Capital gains would go to the marginal tax rate, which would be more than a doubling of the capital gains tax. That's the rumor.

So, if that happens, it's sort of like a double whammy twice on an investments, at least on the individual side, as well as on the corporate side. Right? So you're going to get hit a couple of different ways. Now, the good news is there will be many offsets is what we're hearing in terms of the plan. So in other words, yeah, you may cash in terms of higher taxes, but there will be offsets to minimize what that increase is and there will be incentives provided to help increase investment spending. Now, for the individual investor, there will be offset as well. And he's talking about a great deal of offsets for different things. And we don't want to speculate on what those will be. But bottom line, Vince, is clearly taxes are going up and that's across the board. It seems like at first he said it's only people who make 400,000 or more. We're not sure how that's going to play out, but for our investors, they will be probably disproportionately affected by this tax increase. Let's talk about some of these mitigation strategies. There will be offsets for people. That's one thing.

Number two, in the investment environment, one of the things people look at all the time to offset taxes or to mitigate taxes or to delay taxes is the municipal bond market. So can you talk to us about what are the fundamentals look like and what do you see as being some of the positives for munis as we go forward? And we're going to probably do a whole other piece on this at some point as we get, you know, further clarity from the government. But what are you seeing, Vince, as our fixed income man, what's going on in the muni world?

Vince Fontana: Discussions are already well underway, Jose, in regards to the tax picture, we're having them daily now with clients. The wealth planners are already very much plugged into this. So, yes, that's a conversation that's only starting, but already is quite on the way in earnest, no question with our clients. And munis are a great place to start. And clearly the advantage of having muni, a tax advantage portfolio only goes up when taxes go higher. And that's, as you mentioned, likely to occur over the next, let's say, a couple of years or so. Some great fundamental positives for the sector overall. The receipts that came in last year actually better than anticipated. You saw no surprise, a lot of doom and gloom forecasting at the start of 2020. But if you take a look at the mobility graph and how the reopening has occurred or even had occurred at 2020 now, better than anticipated and it's certainly better than the rest of the world with our lockdown's being more at ease more rolling, it had some openings here and there and generally just more movement by the US population relative to other parts of the globe. And that means more receipts more spending more sales.

Jose Rasco: Hey Vince?

Vince Fontana: Yes.

Jose Rasco: Let me be rude and interrupt before you move on. You touched on the key point, mobility. Many people moved from large cities to second and third tier cities. Many people moved in search of jobs to avoid covid, social unrest. Many people moved from the large megacities to second, third tier cities and suburban and rural areas. What kind of effect did that have? So therefore, the myth and this is maybe one of the myth busters out there, that local governments are really hurting. So, yes, large cities have issues, but a lot of cities saw influx of people and capital and receipts. Right? Is that true?

Vince Fontana: That's right. You have these small towns calling themselves Zoom Towns, you know, where you can sort of have a couple offices in your home and you don't have to go into the city or be as close to the city as you used to. So that migration has definitely been under way and it likely will continue for quite some time as these small towns you hear in Nashville, you hear in Memphis, towns that maybe they didn't have as much in Tampa Bay, down in Florida, of course, having additional raises, going back to our tax discussion right earlier, there's a lot of these cities that didn't have as much of a shine as they used to, but now have a lot more going for them. So that's helped, no question the larger cities. Yeah, that's going to be a little of a tug of war, potentially around tax time, which is a bit pushed out this year, as you know in May, were you in New York City for work or were you actually somewhere else? And who was in charge or who gets claim over those tax receipts? You know, that kept that going another 30 minutes just discussing on that. But, yes, that mobility, whether it's going on holiday or seeing friends more so than in the rest of the world or true mobility, as you mentioned, Jose, and full movement.

And then, of course, buying more furniture. Maybe working on the new home a bit more, heading out to the various home improvement stores, that's also generated some nice sales receipts and is a good buttress of support for the muni market. The stimulus payments also a great fundamental buttress of support here. And finally, when you look at the investor base for munis, we speak about the retail client, they're going to be even more interested in munis going forward. But also the institutional client, the taxable muni side has also been quite attractive relative to some of the other sub asset classes within fixed income. So you've had another large buyer enter the market for munis that likely isn't moving around any time soon. So more demand, more demand and more demand for munis as we look ahead to 2021.

Jose Rasco: All right. Thanks, Vince. Great insight in terms of the government market, in terms of the corporate market and certainly in terms of munis. And we will go back to this as we go forward and we get more details out of Washington and what the green New Deal is going to look like and what it's going to be comprised of and how does it affect individual investors and how we can help them in terms of their individual portfolio allocations. Thanks again, Vince, for your time.

Vince Fontana: Thank you for having me.

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