

Market Update

Implications of Biden's fiscal policy for US growth

12 March 2021



The US economic growth outlook continues to improve. After the passage of the Biden stimulus plan, growth is forecast to be even stronger. The US economy is poised for a strong cyclical rebound and is also at the beginning of a secular technology revolution that should lift productivity and corporate profitability.

- The Biden administration has passed a \$1.9 trillion COVID-19 relief package called the American Rescue Plan (ARP). This new initiative has increased the total fiscal spending package for COVID relief to approximately \$5.3 trillion in less than one calendar year. The size of the fiscal injection brought forward by the US government is far in excess of the injection of capital in 2009 after the Great Recession. It is notable that the total amount spent on the combined stimulus plans is rapidly approaching the amount spent by President Franklin D Roosevelt (FDR) on a 'New Deal' that helped get the economy out of the Great Depression in the 1930s.
- A part of the stimulus plan goes beyond targeted COVID-19 relief measures and is more focused on the longer-term recovery of the US economy including infrastructure, green energy, healthcare, and education initiatives. This very large fiscal stimulus, combined with low interest rates, the beginning of a technology revolution that should be productivity enhancing, and the Biden administration's desire to begin a green or sustainable revolution, could all combine to create a 'Green New Deal' that President Biden has so often talked about.
- The combined effect on the economy and financial markets could be quite positive as it could create better than expected economic growth, productivity and profitability in the US for years to come.

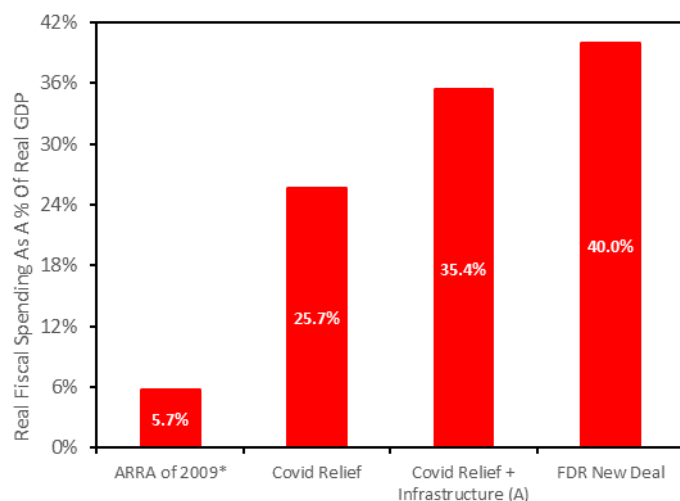
How the pandemic impacted the US policy

At the beginning of the COVID-19 pandemic we expressed our views on how the financial market performance would be heavily dependent on two factors in the wake of the pandemic. First, the response in terms of healthcare options and the availability of vaccines, therapeutic drugs, and anti-microbial products. Second, was the response from governments around the world in terms of their fiscal and monetary policy response.

In the US, the Fed was quick to act in lowering policy rates dramatically as well as increasing their quantitative easing programs to keep the yield curve flatter and lower than usual. Moreover, the Fed served as a backstop to provide the necessary liquidity and stability so financial markets could function normally. Fiscal policy took a bit longer to get going

but the response has been quite impressive. The Trump administration came forward with two bills providing about \$3.4 trillion in relief for consumers and small and medium size business owners.

COVID-19 fiscal relief spending approaching the size of President Roosevelt's 'New Deal' of 1930s



Source: American Recovery and Reinvestment Act of 2009. (A) Infrastructure plan expected to total as much as \$2 trillion and could be included in the next fiscal year budget proposed by the Biden administration. Federal Reserve Bank of St. Louis, HSBC Private Banking as of 3/11/2021.

The Biden Stimulus

The US Congress has put together a package of \$1.9 trillion in COVID-19 relief. With this package, the fiscal stimulus response from the US federal government is approaching \$5.3 trillion over the last 12 months. This package includes:

- ◆ **Direct payments to households:** The plan would pay \$1,400 per tax filer (or \$2,800 for couples) an \$1,400 per eligible dependent. The payments would start passing out at an individual income of \$75,000 and capped at those who earn \$80,000, based on most recent year's tax returns.
- ◆ **Pandemic-related unemployment benefits:** The bill extends \$300 per week in jobless aid supplements and programs. This makes millions more people eligible for unemployment insurance until September 6th. The plan also makes individuals first \$10,200 in jobless benefits tax free.
- ◆ Appropriates an additional \$7.25 billion to the US small business administration for the PPP loan programme, including 'Cobra Health Insurance' assistance.
- ◆ Significantly, ARP offers \$350 billion in relief to state, local, and tribal governments. About 57% is allocated to states and 35% to local governments.

- ◆ Expands the child tax credit for one year. It will increase \$3,600 for children under six years of age and to \$3000 for children between 6 and 17.
- ◆ The bill increases the earned income tax credit for 2021 only. The ARP would raise the maximum credit for adults without children from \$530 to nearly \$1500 and raise the income limit for the credit from \$16,000 to about \$21,000. Workers over the age of 65 could claim the credit.
- ◆ Adds \$25 billion in rental and utility assistance programmes and about \$10 billion for mortgage aid.
- ◆ Offers nearly \$30 billion in aid to restaurants.
- ◆ Legislation expands an employee retention tax credit designed to allow companies to keep workers on payroll.
- ◆ The Biden tax credits are fully refundable which means that if tax credits exceed tax liabilities the difference would be reimbursed to individuals which could boost personal after-tax incomes next year.

Improved demand leads to higher prices, which leads to increased supply and eventually lower prices



Source: Bloomberg, HSBC Private Banking as at 3 March 2021. Past performance is not a reliable indicator of future performance.

Improving US Cyclical Growth outlook

The US economic growth outlook continues to improve. After the passage of the Biden stimulus, it seems clear that first quarter growth could actually be much stronger than many forecasters had been thinking. In fact, through March 11, the Atlanta Fed GDP model predicts that first quarter GDP could rise 8.4% on annualised basis from the prior quarter. In addition to the record levels of fiscal stimulus, continued accommodative monetary policy from the Federal Reserve has kept policy rates and the yield curve flatter than usual. This has enabled households to refinance mortgages and corporations to issue record numbers of lower interest-bearing corporate debt. The result has been improved in balance sheets in both the corporate and household sectors in the US, which is freeing up incremental cash flow that can be invested or spent.

Corporate cash levels are high and the consumer savings rate is at historic levels. This suggests that consumer pent-up demand could lift the economy as the cash is there to be spent. After all, through January, 2021 the consumer savings rate sits at 20.5%. On the corporate side it is also clear that a stronger economy could unleash investment spending as cash levels are also high. Last but not least, expectations for corporate profits continue to rise in 2021. Through the end of last week the consensus expectation for corporate profits growth for the S&P 500 in 2021 was 40% according to Bloomberg. This suggests that any turn around in demand should be quite profitable and could be met by increases in employment and spending by the corporate sector.

The US economy is poised for a strong cyclical rebound and is also at the beginning of a secular technology revolution that should lift productivity and corporate profitability growth rates over the next few years. While the risk of much faster growth does increase the odds of a pickup in inflation in the short term, increased supply of goods as the economy re-opens should help normalize inflationary growth rates in the not too distant future.

Investment Summary

The prospects for better economic growth, contained inflation, low interest rates, and higher corporate profits continue to suggest that an overweight position in US equities is appropriate. While we are mindful of the risks of higher interest rates, greater government borrowing, and higher inflation in the short term, the reopening of America remains firmly in place. As a result we maintain our overweight position in the interest rate related cyclical sectors such as housing, autos, and technology. Moreover, the inventory build already underway, combined with the prospects for infrastructure spending should continue to lift performance in the materials and industrial sectors as well. For Fixed Income investors, we continue to look for volatility in fixed income markets but believe there is a limit to the upside for treasury yields. We focus on carry opportunities in Fixed Income and look to select opportunities in Investment Grade and High-Yield credit markets.



Risk Disclosures

Risks of investment in fixed income

There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk

Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments

High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

Changes in legislation and/or regulation

Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalization risk

The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk

A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.

Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.

There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.

Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Alternative Investments

Investors in Hedge Funds and Private Equity should bear in mind that these products can be highly speculative and may not be suitable for all clients. Investors should ensure they understand the features of the products and fund strategies and the risks involved before deciding whether or not to invest in such products. Such investments are generally intended for experienced and financially sophisticated investors who are willing to bear the risks associated with such investments, which can include: loss of all or a substantial portion of the investment, increased risk of loss due to leveraging, short-selling, or other speculative investment practices; lack of liquidity in that there may be no secondary market for the fund and none expected to develop; volatility of returns; prohibitions and/or material restrictions on transferring interests in the fund; absence of information regarding valuations and pricing; delays in tax reporting; - key man and adviser risk; limited or no transparency to underlying investments; limited or no regulatory oversight and less regulation and higher fees than mutual funds.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (e) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products

In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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