GLOBAL PERSPECTIVES

Peak Stimulus, Continuing Growth

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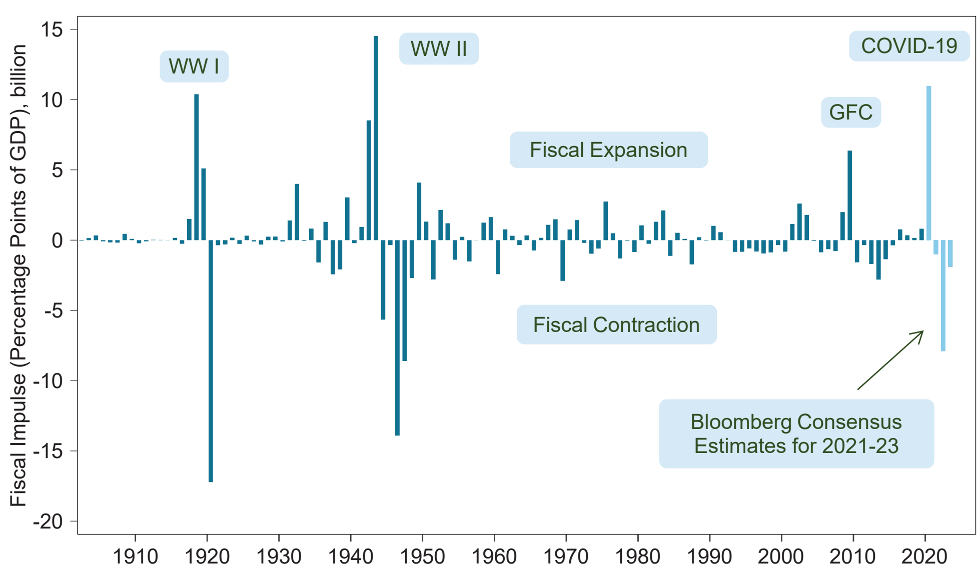
Highlights

- Even if new U.S. fiscal stimulus is passed in coming months, "peak stimulus" has probably been reached in the first half of 2021. Fiscal drag is likely to slow growth in the next few years.
- But the combination of vaccine-driven reopening, the deployment of pent-up savings, and easy financial conditions should continue to support growth in the U.S and abroad.
- A multi-year global expansion still seems likely although key foreign economies may face less fiscal drag than the U.S. The case for international diversification remains intact.

Fiscal Cliff Ahead?

As the pandemic fades, the need for emergency fiscal and monetary policies in the U.S. and elsewhere will fade as economies are taken off of life support. Accordingly, many economists have now started to warn of a "fiscal cliff" as emergency spending measures go away.[1] As we have noted before, the expansion of America's federal budget deficit in 2020 was the largest seen since World War II **(Chart 1)**.[2] As the health emergency fades, it is natural that the reduction of the budget deficit will be massive as well, comparable only to past postwar episodes.

Chart 1: Will Extraordinary Fiscal Expansion in the Pandemic be Followed by Extraordinary Fiscal Contraction in 2022?



Note: Fiscal Impulse is defined as the year-on-year change in the federal budget deficit measured in percentage points of GDP. Expanding deficits imply expansive fiscal policy and vice versa.
Source: GW&K Investment Management, U.S. Treasury, Bloomberg and Macrobond

The beginnings and ends of wars provide the only historical examples of the kind of surges and subsequent declines in government spending associated with the COVID-19 pandemic.

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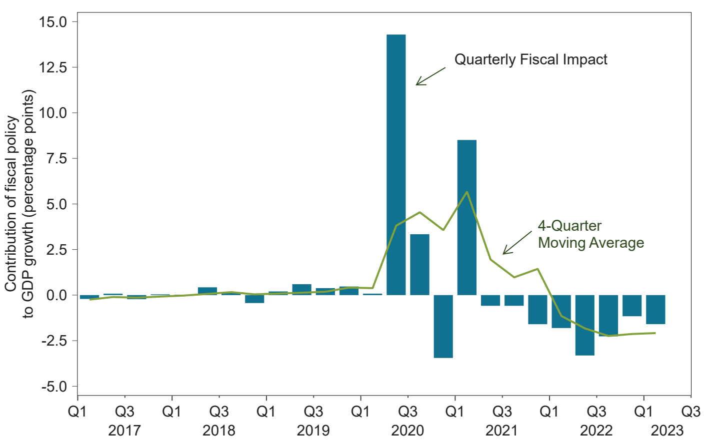
[1] For example, Ed Hyman of Evercore ISI recently noted that "Bonds are saying that a fiscal cliff is coming, growth is going to slow dramatically, and with it, inflation will slow. See Ed Hyman, Weekly Economic Report, Evercore ISI, June 13, 2021.
[2] See "The Post-Pandemic World: Fiscal Policy as the Wild Card," GW&K Global Perspectives, December 2020.

A key issue for America's economy is that the combined $5.2 trillion in pandemic-related aid packages passed in the year to March were heavily front loaded.[3] As emergency measures, they were deliberately designed to pump money into the economy quickly. But the simple arithmetic consequence of that is that fiscal policy in coming quarters will subtract from growth.

According to the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution, overall government spending added 8.5 percentage points to the economy's rate of growth in the first quarter this year **(Chart 2)**. But the forecast is for that fiscal impact to turn into a very significant drag on growth by the fourth quarter of 2021 and through 2022.

Chart 2: Fiscal Drag Ahead?
Hutchins Center Fiscal Impact Measure



Source: GW&K Investment Management, Brookings Institution and Macrobond

After surging dramatically over the past year, government spending is set to fall in coming quarters and will meaningfully subtract from growth later this year and into 2022.

Essentially, fiscal policy has a "what have you done for me lately" aspect, since its contribution to growth naturally turns negative when a sudden surge in stimulus is followed by more normal levels of government spending. Consider, for example, that most Americans who were eligible to receive stimulus checks of up to $2,000 per person have already received them – and there is likely no encore.

Moreover, unemployment insurance payments are likely to shrink as people return to work, with enhanced unemployment benefits of $300 per week scheduled to end in September. On current policies, the Brookings Institution estimates that fiscal policy by the second quarter of 2022 will subtract 3.3 percentage points from growth.

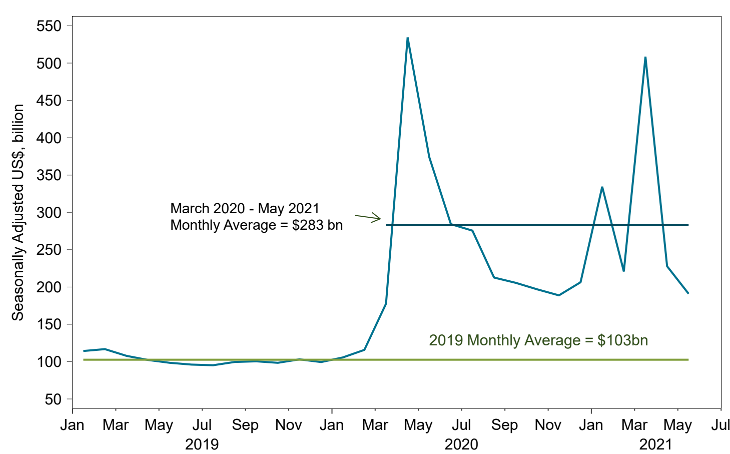
To be sure, such projections could be revised based on the outcome of current negotiations on President Biden's infrastructure and social spending plans. But those proposals call for spending and new taxes over many years and should not drastically change prospects for substantial fiscal drag over the next year or so.

Offsets to Fiscal Drag Will Be Substantial

Fortunately, America's economy should be well positioned to cope with a sharp decline in federal spending since private-sector offsets to fiscal drag should be substantial. First, economic reopening as the pandemic fades is a powerful type of stimulus. As employers add to their payrolls at a rapid pace, rising compensation will boost consumer spending even as government spending fades. Second, record-high confidence among CEOs suggests that business investment will be accelerating. Third, America's exports should pick up as overseas economies start to surge thanks to widespread vaccination rollouts.

Perhaps the largest wild card for the economy is the extent of excess savings that households have built up during the pandemic, thanks in large measure to the federal government's budgetary largesse. Since March 2020 households have saved $283 billion per month, compared to $103 billion a month in 2019 **(Chart 3)**. That works out to cumulative excess savings of $2.6 trillion, which represents 11% of GDP. It remains to be seen how much of the excess savings will boost consumer spending as opposed to being permanently saved by households.

Chart 3: $2.6 Trillion of Excess Saving:
Personal Savings per Month



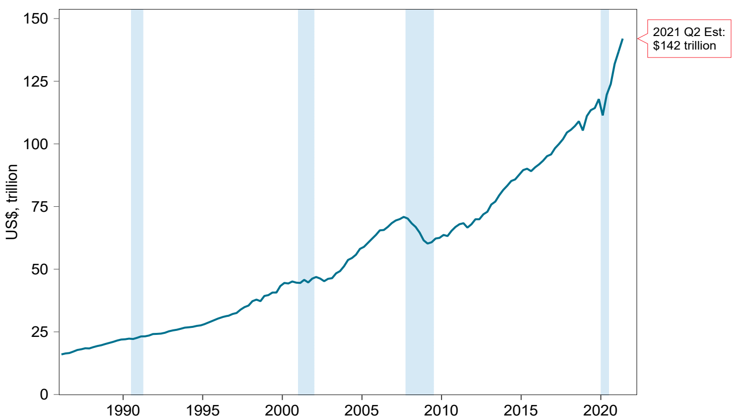
Source: GW&K Investment Management, BEA and Macrobond

A powerful offset to the coming decline in government spending could come from a surge in consumer spending, supported by $2.6 trillion in "excess" household savings that have built up since March 2020.

[3] This framing of the fiscal drop-off issue is based on Neil Irwin, "The Pandemic Stimulus Was Front Loaded. That Could Mean a Bumpy Year," New York Times, June 21, 2021.

One reason to be optimistic about the consumer spending is because increases in consumer net worth have been remarkable. Economist Ed Hyman of Evercore ISI estimates that consumer net worth has risen by $32 trillion over the past five quarters to a current level of $142 trillion **(Chart 4)**[4]. The $32 trillion increase is almost 50% bigger than U.S. GDP and reflects robust gains in both stock market and real estate markets. This creates ample balance-sheet strength for households, tilting the odds for a large boost to spending as consumers tap into their excess savings.

Chart 4: Record High: U.S. Consumer Net Worth



Note: Shaded areas denote U.S. recession periods
Source: GW&K Investment Management, Evercore ISI, Federal Reserve and Macrobond

Another reason to expect consumer spending to offset the coming decline in government spending is because of the huge surge in household wealth of $32 trillion over the past five quarters.

The mainstream view is that the baton will be passed smoothly from government to household spending over the next year. For example, Bloomberg's current survey of economists projects overall economic growth of 6.6%, 4.1%, and 2.3% respectively for 2021, 2022, and 2023. Those robust growth rates are expected despite the survey's forecast for negative fiscal impulses of 7.9% of GDP for 2022 and 1.9% for 2023.

As shown in Chart 1, the drop in government budget stimulus projected for 2022 would be the largest on record since the post-World War II demobilization year of 1947. Moreover, relative to the size of the economy, it would be more than twice as large as any negative fiscal impulse experienced since then. In addition, it is expected to be followed by a negative fiscal impulse of nearly 2% of GDP in 2023 as well, which itself would be the second largest negative fiscal shock in the last fifty years.

Such daunting figures not implausibly could lead to a sub-par recovery. However, there is a great deal of confidence among economists that a surge in private sector spending will readily offset the huge decline in government support. We share that optimism based on the $2.6 trillion of excess household savings noted above. But as Fed Chair Jerome Powell recently noted: "We really don't have a template or any experience of a situation like this. And so, I think we need to be humble about our ability to understand the data."

How Will Fiscal Drag Shape the Investment Environment?

Prospects for large fiscal drag raise numerous issues for investors. First, a basic national income accounting identity is that the federal government's budget deficit is equal to the private sector's surplus. That identity means there was a very direct channel during the pandemic between the expansion of the federal government budget deficit and the rapid recovery in corporate profits and stock markets.[5] Will that channel work in the opposite direction as the pandemic fades and the deficit shrinks? Fortunately, a decline in household savings can boost profits even if a decline in government spending is working in the opposite direction.

Second, if we have already passed through peak stimulus, then peak growth rates cannot be far behind. Will that lead quickly to a reduction in inflation pressures? Will it justify the Fed's confidence that the recent unwelcome rise in U.S. inflation is indeed transitory? The degree to which inflation and growth are curbed by fiscal drag could also have a significant impact on prospects for growth stocks versus value stocks. That's because investors tend to pay a premium for growth stocks when their strong earnings stand out because overall macroeconomic growth is subdued.

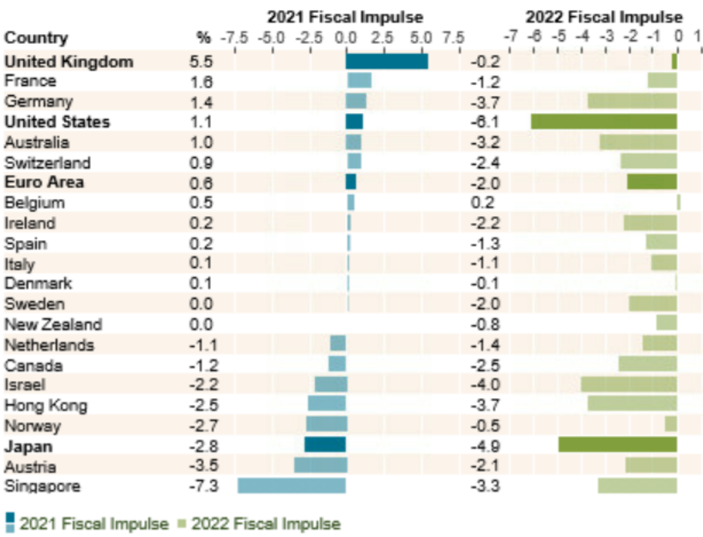
Third, America's fiscal expansion has been exceptionally aggressive compared to other major nations. That implies that the payback in America could be more pronounced as well. As a matter of simple arithmetic, the impact of the fiscal impulse on profit growth will tend to be most negative for nations that have to wean themselves off the largest government budget deficits. Accordingly, this drag on profit growth in the next few years is likely to be much lower in places like Europe, China, and other Emerging Market (EM) nations that did not use fiscal policy so aggressively **(Charts 5 and 6)**.

[4] See Ed Hyman, Weekly Economic Report, Evercore ISI, June 13, 2021.
[5] For a discussion of this identity see "Thank You, Uncle Sam: Understanding the Amazing Resilience of U.S. Profits," GW&K Global Perspectives, January 2021. The identity defines corporate profits as follows:

Corporate profits = Investment + Dividends/buybacks - Household savings - Government savings - Rest of world (ROW) savings.

A rise in government savings (declining budget deficit) implies lower corporate profits, but a decline in household savings implies higher profits. Optimistic profit forecasts rely on the latter effect dominating.

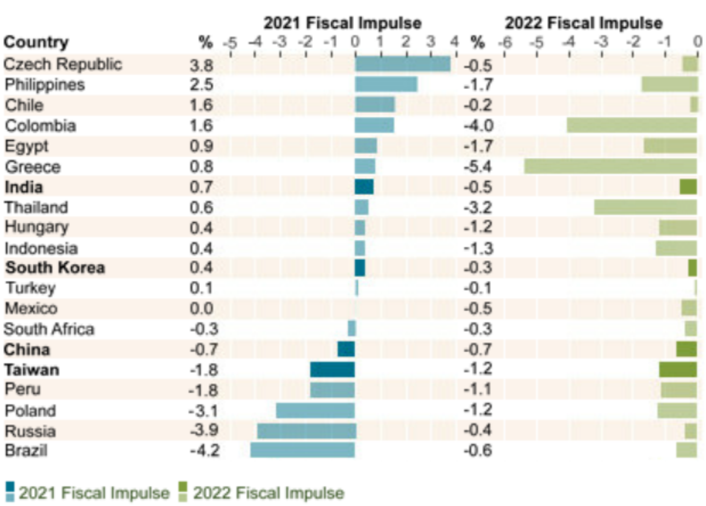
Chart 5: The DM Hangover: IMF Projected Fiscal Impulses for 2021 and 2022



Source: GW&K Investment Management, IMF and Macrobond

Among developed market (DM) nations, the U.S. is forecasted by the International Monetary Fund (IMF) to have the largest fiscal drag in 2022.

Chart 6: The EM Hangover: IMF Projected Fiscal Impulses for 2021 and 2022



Source: GW&K Investment Management, IMF and Macrobond

With just a few exceptions, the IMF forecasts that most EM nations will have very modest fiscal drag in 2022, including key Asian nations like China, India, South Korea, and Taiwan.

In short, the odds are high that we have passed through the period of peak fiscal stimulus for the U.S. and many overseas economies as well. Whether the withdrawal of this stimulus will bring a more challenging period for economies and markets remains to be seen. We still believe that the most likely scenario for the global economy is for a multi-year recovery from last year's Great Lockdown recession.

That said, today's fiscal tailwinds are clearly set to shift to headwinds later this year, which raises more questions than can be met with firm answers. At a minimum, these questions underscore the value of portfolio diversification. This includes diversification across broad asset classes like equities, bonds, and real assets. Moreover, within equities, the case for international diversification remains intact since America's fiscal exceptionalism means that it may have borrowed more heavily against its future growth than many other nations.

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