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BUDGET RECONCILIATION IS A KEY FOR FINANCIAL MARKETS

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The last significant infrastructure policy came from Obama's post-financial crisis American Recovery and Reinvestment Act in 2009. Then the focus was on shovel-ready projects that could be completed in three years. The projects fell short of strengthening U.S. economic competitiveness. Now, it's President Biden's turn. On the campaign trail, he pledged to revitalize the nation's infrastructure and invest in clean energy; this big feat would have major implications for markets and investors.

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Bipartisan awareness of the pandemic's damaging effects on worsening income inequality is keeping the minimum-wage issue alive. The issue goes beyond the wage increase itself to one of fairness for both employees and employers, particularly those in the private sector.

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We believe that budget reconciliation is unlikely to provide a solution to contentious legislative issues. Budget reconciliation seems unlikely to provide a backdoor for more extreme or fringe issues.

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Infrastructure spending under Biden

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Can President Biden build it back better?

Infrastructure is vital to the health and well-being of the country. The U.S. economy could not function properly without its vast networks of roads, bridges, and airports or its water and sewer systems. Yet, delivering world-class infrastructure requires adequate funding to bankroll projects coupled with productive partnerships between the federal government and state and local municipalities.

Infrastructure is a priority for Biden, but Presidents Obama and Trump offered similar promises with few tangible results. As the Biden administration formulates its infrastructure policy, it is unclear whether it will resume a similar course set by the Obama administration or take a more assertive approach.

In 2018, China spent 5.57% of GDP on infrastructure spending versus 0.52% for the U.S.

Source: www.statista.com and OECD, based on 2018 data

A widening gap

Aging and obsolete infrastructure has been a persistent issue for the U.S. In August 2007, a bridge collapse near downtown Minneapolis during rush hour exposed the risks of infrastructure erosion and political indecisiveness. Obama's post-financial crisis American Recovery and Reinvestment Act in 2009 included significant infrastructure spending to create jobs. The stimulus package gave priority to shovel-ready projects that could be completed in three years. The projects helped clear out maintenance backlogs but did not expand capital stock or strengthen U.S. economic competitiveness.[1]

In 2015, the Congressional Budget Office estimated that $1 spent on infrastructure brought an economic benefit of $2.20.

Source: "Reimagining Infrastructure in the United States: How to Build Better," McKinsey & Company, July 6, 2020, and www.cbo.gov

During the 2016 campaign, candidates Trump and Clinton touted plans to overhaul the nation's highways and power grid. Rebuilding infrastructure was part of Trump's America First agenda, but proposed legislation failed to gain bipartisan support and narrow the sector's funding gap. In 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act last year included support for transit agencies but no funding for capital projects. Last summer, House democrats passed a $1.5 trillion infrastructure bill, but Republicans rejected it due to the large number of climate-change provisions.

The American Society of Civil Engineers estimates a total loss of more than $10.3 trillion in U.S. GDP by 2039 if the infrastructure investment gap is not addressed.

Source: "Failure to Act: Economic Impacts of Status Quo Investment Across Infrastructure Systems," American Society of Civil Engineers, 2021

Biden's turn

During his campaign, Biden pledged to revitalize the nation's infrastructure and invest in clean energy and domestic manufacturing. Last month, Biden remarked that U.S. infrastructure spending per GDP (gross domestic product) ranks 38th globally. He contends that rebuilding infrastructure will increase U.S. 21st century competitiveness. Biden's American Rescue Plan Act of 2021 earmarked about $24.5 billion for infrastructure ($17 billion) and broadband ($7.5 billion) projects, far short of the projected funding needs for infrastructure systems as estimated by the American Society of Civil Engineers (see chart 1).

1. "Remarks by President Biden Before Meeting With Labor Leaders to Discuss the American Rescue Plan and Infrastructure," **www.whitehouse.gov**, 2/17/21

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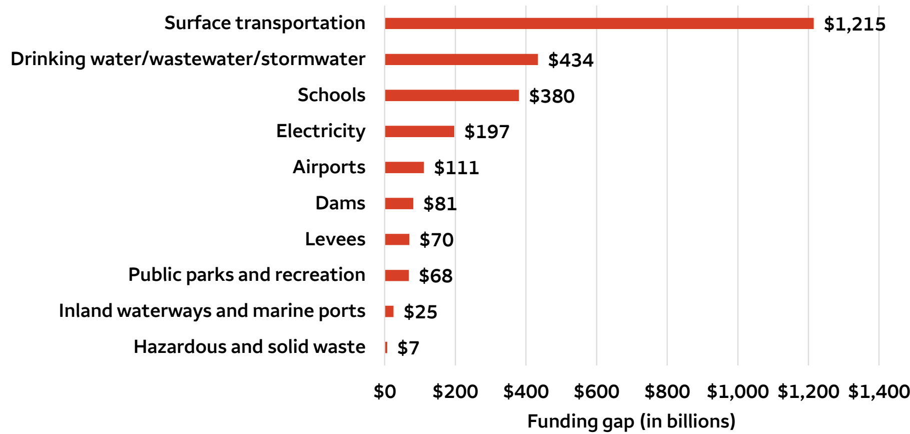
Chart 1. Funding gap for U.S. infrastructure systems (in billions)



Sources: Wells Fargo Investment Institute and American Society of Civil Engineers, 2021

Key takeaways

- Infrastructure is vital to the country's standard of living and is a priority for President Biden.
- The American Rescue Plan Act of 2021 earmarked $24.5 billion for infrastructure, far short of the sector's funding gap.[2]
- We currently favor Materials and Industrials, sectors which will likely benefit from infrastructure spending.

Now that the American Rescue Plan Act has passed, Speaker Pelosi has pledged swift work by Congress on an infrastructure package. With Republican support, a proposal could advance through the protracted budget process and pass this year. If Republicans cannot support the bill, the Democrats could use the budget reconciliation process to pass it with a simple majority in the Senate. (See "A primer on the budget reconciliation process" section of this report.) If the bill is passed, it is important to understand that most infrastructure project and procurement decisions are made at the state and local levels. The federal government is primarily a grant-maker and regulator of the nation's infrastructure.

As the Biden administration moves forward, questions to consider about infrastructure legislation include the following: Can it include climate-change provisions and still garner support from moderate Senate Democrats and any Republicans? Will tax hikes be required to fund it? Might there be more than one infrastructure bill? We expect more clarity in the coming months.

Implications for the markets

Capital projects supported by infrastructure legislation would likely target transportation, clean energy (with broad bipartisan support), and 5G broadband networks. In the near term, we expect that successful infrastructure legislation would benefit the Industrials and Materials sectors (we are favorable on both) and likely boost metals usage (we are favorable on commodities) for industrial projects.

Looking ahead, one key challenge with rebuilding outdated infrastructure, particularly in urban centers, is that retrofitting antiquated systems can be cost prohibitive. State-of-the-art technologies make refurbishing more feasible through reduced costs and increased capacity for projects.[3] This trend could be beneficial for the Information Technology sector.

2. "Senate Passes $1.9 Trillion Stimulus Package," Strategas, March 6, 2021
3. "Infrastructure Options for the Future of Cities," McKinsey & Company, January 2021

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The stakes in a minimum-wage increase

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Still going

There's ongoing interest in a minimum-wage increase despite its failure to make it into the $1.9 trillion pandemic-relief package. First, there's a greater awareness by the public of income inequality and the pandemic's role in aggravating it. Second, moderate Democrats and Republicans favor something less than the phased-in minimum-wage increase to $15 per hour that they oppose. The federally mandated $7.25 minimum hasn't been increased since 2009. A phased increase to $13 to $14 per hour from a $7.25 minimum would bring the inflation-adjusted minimum back to its 1968 peak of $9.19 an hour in today's prices[4] and align it with the norm in other advanced economies.[5]

The Congressional Budget Office estimates that a $15 per hour minimum wage would boost incomes for 27 million workers and lift 900,000 out of poverty, but at a cost of 1.4 million jobs.

Any future debate over the minimum wage likely will take a more bipartisan turn, either favoring something closer to the $11 per hour suggested by Democratic Senator Manchin of West Virginia or, at best, a longer phase-in of the $15 per hour target than the four-year proposal by the Biden administration. The difference between an $11 and $15 minimum would be material for earnings of exposed industries.

State-level increases in the minimum wage since 2009 have raised the effective U.S. figure to $13, by one estimate, nearly double the federally mandated $7.25.

Weighing the trade-offs

Essentially, the minimum-wage debate is about equality and trade-offs. For workers, it's the balance between income and jobs. For businesses, profit margins and, in some cases, survival hang in the balance. That trade-off is epitomized by a study last month from the nonpartisan Congressional Budget Office concluding that an hourly $15 minimum wage would raise income for 27 million workers and lift 900,000 families out of poverty (lowering the cost of public assistance). However, those gains would come at a cost of 1.4 million jobs, some due to automation, some due to other productivity enhancements, and some, perhaps, due to business closures.[6] Minimum pay as a percent of the median full-time wage, useful in gauging its alignment with the market, shows the U.S. ratio of 40% (including higher state minimums) below the accepted norm of 50% among other major advanced economies.

However, the issue is more nuanced than that. A uniform minimum wage has a varied effect on worker purchasing power across the country, where prices range from 84% of the national average in Mississippi to 119% in Hawaii. Those same figures approximate selling-price differences, signaling a varying impact on business profit margins and on the ability to hire. Put another way, a seemingly low minimum may align well with a low overall average rate in a less dynamic state with low prices and weak productivity growth. The

4. Ernie Tedeschi, "Minimum Wage of $15: Unlikely This Year, But Would Get Phased in if Passed," Evercore ISI, January 26, 2021
5. Andrew Husby and Eliza Winger, "Red States Seeing Red if Minimum Wage Hiked to $15," Bloomberg Financial News, February 24, 2021
6. "The Budgetary Effects of the Raise the Wage Act of 2021," Congressional Budget Office, February 2021

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importance of productivity and economic growth may help explain why retailing and other low-wage businesses in economically stronger states have been able to expand and to thrive despite minimum-wage increases.

There's also the divide between large and small businesses, the latter typically with narrower profit margins and more limited resources to absorb minimum-wage and other pay increases or to adapt by investing in labor-saving equipment. Large employers have the resources to support federally mandated wage increases. The National Federation of Independent Business (NFIB) estimates that only 20% of members pay workers at the federal $7.25 per hour minimum.[7] However, limited resources would leave small businesses exposed to a disproportionate share of the 1.4 million in job losses if the minimum wage was raised to $15 per hour.

Nonetheless, we still view small-cap stocks favorably, partly because many in the benchmark indexes are less labor-intensive than firms in the NFIB survey and partly because any increase in the minimum wage likely would be more modest than the president's proposal. Moreover, labor-intensive retail and hospitality firms most exposed to mandated wages would benefit most from powerful economic growth expected into 2022, countering a more extended minimum-wage phase-in.

Regional variations in prices, worker productivity, and overall economic performance are behind the piecemeal increases by many states since the last federal minimum increase in 2009, muting the impact of any future U.S. hike. The summary table below shows states with over 60% of the nation's population already require higher minimum wages than the federal rate. Accounting for those increases raises the current effective minimum nationwide to $13 per hour.[8]

Table 1. Minimum-wage levels by state

Minimum wage level	At $7.25	Above $7.25 and below $10	Between $10 and $15	Scheduled to reach $15	$15 or above
States	AL, GA, ID, IN, IA, KS, KY, LA, MS, NH, NC, ND, OK, PA, SC, TN, TX, UT, VA, WI, WY	DE, MI, MT, NE, NV, OH, SD, WV	AK, AZ, AR, CO, HI, ME, MN, MO, NM, OR, RI, VT, WA	CA, CT, FL, IL, MD, MA, NJ, NY	DC
Share of population	39.9%	9.6%	14.3%	35.9%	0.2%

Sources: Cornerstone Macro and Wells Fargo Investment Institute, data as of January 2021

Key takeaways

- The federal minimum wage likely will be increased with bipartisan support, but to a phased-in level short of the $15 hourly rate proposed by the Democrats.
- An increase in the minimum wage approaching the $15 proposed by the Democrats would have a varied impact on worker purchasing power and business profitability across the country, likely widening the gap between large and small businesses created by the pandemic.

7. "Many Businesses Back Higher Wage," The Wall Street Journal, March 2, 2021
8. Ernie Tedeschi et al.

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A primer on the budget reconciliation process

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Cure-all or snake oil: The budget reconciliation process

The biggest obstacle in the path of legislation in the Senate has historically been the filibuster, which allows opponents of a bill to continue discussion unless and until 60 senators vote to end the discussion. Cloture can be difficult to achieve, especially when majorities are thin. Budget reconciliation provides a way to avoid this with a simple majority for budgetary legislation.

Historically, the prospect of passage with a simple majority has attracted riders and amendments that are tangential to the bill, posing the question: Why not just make the scope of the reconciliation as wide as possible? The answer to this is referred to as the "Byrd rule," which, among several other tests, requires that all reconciliation bills have a non-incidental impact on government outlays or revenues.[9] The Senate parliamentarian[10] has the final say on whether or not the rule applies, providing some subjectivity in the process. This may seem clear-cut when using reconciliation for tax cuts, welfare reform, and various amendments to the Affordable Care Act. It is less clear whether, for example, a proposal to open the Arctic National Wildlife Refuge to oil and gas leasing is allowable under reconciliation.[11]

In a recent example, the Senate parliamentarian struck a proposal to raise the minimum wage to $15 from the most recent round of COVID-19 stimulus. After establishing the limits associated with reconciliation, there is a chasm between what senators wish for reconciliation and what it can actually accomplish.

Policymakers have enacted just 21 budget reconciliation bills since 1980; 4 others were vetoed by the president.

Source: Richard Kogan and David Reich, "Introduction to Budget 'Reconciliation,'" Center on Budget and Policy Priorities, January 21, 2021

Reconciliation was used in an attempt to repeal parts of the Affordable Care Act in 2017 but failed even in a Republican-controlled Senate.

Source: David Wessel, "What Is Reconciliation in Congress?" The Brookings Institution, February 5, 2021

Likely and unlikely targets

The Byrd rule as well as the thin Senate majority make some items on the Democratic wish list a hard sell, as dissension by even one Democratic senator would spell failure. We believe extreme health care solutions like Medicare-for-all seem unlikely to pass either obstacle, but more moderate plans like Medicare expansion are a possibility. Similarly, controversial changes to energy policy are also unlikely. Negative decisions regarding fossil fuel leasing on government land (in a reversal of the Arctic National Wildlife Refuge decision discussed earlier) may be a possibility. We would also expect to see increased tax credits and green energy as a potential avenue.

9. "The Budget Reconciliation Process: The Senate's 'Byrd Rule,'" Congressional Research Service, December 1, 2020
10. The parliamentarian of the Senate is appointed by the Senate majority leader and advises on interpretations of parliamentary procedure and the standing rules of the Senate. The last two parliamentarians have served under both Republican and Democratic Senate rule. "After Nearly 20 Years, Senate Parliamentarian Alana Frumin to Retire," The Hill, January 31, 2012
11. Patricia J. Beneke, "Budget Reconciliation: Taxes and a Wildlife Refuge on the Chopping Block", Environmental Law Institute, November 13, 2017

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Tax reform is another effort that will likely be made easier by budget reconciliation, as we saw with the Tax Cuts and Jobs Act of 2017. We believe that these efforts will largely be aimed at increasing corporate and top-tier income taxes, shying away from more controversial tax changes.[12] These efforts appear to have enough Democratic support under reconciliation despite robust Republican opposition.

Infrastructure spending may be another target, as it was a key part of both presidential campaigns. The recent COVID-19 stimulus included a token amount of spending for various infrastructure projects, mainly focusing on transportation,[13] which we feel may be a taste of what's to come. However, we do believe that both parties would rather pass non-reconciliation legislation on infrastructure, as it will allow a wider scope.

We reiterate our current guidance with the belief that reconciliation will prevent more controversial legislation. Legislation passed through reconciliation seems unlikely to significantly affect the Health Care or Energy sectors but may provide a slight boost for Materials or Industrials depending on the scope of potential infrastructure spending. These two sectors are already among our favorites. Again, for more on the likely specifics of an infrastructure bill, please see the "Infrastructure spending under the Biden administration" section in this month's report.

Key takeaways

- The scope of available policies unlocked by reconciliation may at times seem arbitrary and cryptic.
- Aside from COVID-19 fiscal support, legislation that is passed through reconciliation likely will have a limited scope and impact on our investment outlook.
- For a more in-depth discussion on infrastructure legislation and its investment impact, please see the section of this report titled "Infrastructure spending under the Biden administration."

12. For more information on the Biden tax plan and which proposals we think are most likely to gain congressional approval, please see our Politics, Policy & Portfolios report from February titled "A New Administration: First Take on the First 100 Days"
13. Marisa Schultz, "GOP Tries to Strip $175M in Transportation Projects From Democrats' Coronavirus Bill," Fox News, March 5, 2021

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