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Policy, Politics & Portfolios

A STRONG ECONOMY BRINGS NEW POLICIES, REVISES OTHERS

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As the economic recovery gains steam, the struggle to fill job openings has been a headwind. However, as jobs eventually get filled, we believe the tight labor market could indicate future economic strength.

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We believe an end to decades-long disinflation will nudge the Federal Reserve away from aggressively stimulative monetary policy. Any rethink of monetary policy's guiding principles during inflation's prolonged decline will have important consequences for the economy, the financial market, and investors.

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Public-private partnerships can help leverage additional sources of funding for capital projects and improve efficiency. A new generation of Build America Bonds may be key to financing infrastructure legislation.

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Getting America back to work

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Breaking the unemployment deadlock

Many Americans remain unemployed, leading to the question — what needs to be done to get America fully back to work? Several factors probably complicate someone's decision to look for work in this environment. Some workers may fear exposure to COVID-19 while working in close quarters. In other cases, a lack of childcare may impede the job search or return to work. Another factor may be the availability of extended unemployment benefits. In March of 2020, Congress passed the first of many economic support packages in response to COVID-19. A key aspect of this bill (and subsequent versions) was enhanced federal unemployment benefits, intended to supplement traditional unemployment for those who found themselves in extended unemployment. However, after more than a year and a rapid economic recovery, some feel that enhanced unemployment has run its course.

25 states are ending their participation in federal unemployment programs, including the enhanced unemployment benefit.

Source: Greg Lacurci, "States that will start cutting off federal unemployment benefits this week", CNBC, June 7, 2021.

The jobs market

Concerns about the labor market recovery rose again after a lackluster April jobs report and a May report which could be described as "decent, but not stellar"[1]. Jobs continue to open while unemployment declines, but not quite as quickly as some had expected coming out of a recession. Table 1 illustrates that a significant number of job openings are going unfilled. For example, it may be interesting to note from the table that education and health services as well as trade, transportation, and utilities have some of the highest job openings surpluses while also having below-average earnings and pay increases from 2019–2021.

Workers with no high school diploma are almost three times as likely to be unemployed as those with a bachelor's degree or higher.

Source: "Economic News Release", U.S. Bureau of Labor Statistics, June 4, 2021.

Anecdotally, companies in the fast food space seem to have come to the same conclusion. Fast food restaurants are trying to fill tens of thousands of positions in the next few months and are using hiring bonuses, pay increases, and expanded benefits to try and lure workers back in.[2] Some states have taken a similar stance, tying unemployment benefits directly to an active job search. Enhanced unemployment does currently require a beneficiary to take a job if offered, but that job must be "suitable", meaning some may choose to remain unemployed due to health or childcare concerns.[3] The slow improvement in employment raises concerns that a lack of workers may slow economic recovery and further entrench supply-chain bottlenecks.

1. Jeff Cox, "April's expected hiring boom goes bust as nonfarm payroll gains fall well short of estimates", CNBC, May 7, 2021; Emily McCormick, "May jobs report: economy adds back 559,000 jobs, unemployment rate fell to 5.8%", Yahoo Finance, June 4, 2021.
2. Mary Meisenzahl, "Chains like McDonalds and Taco Bell are offering cash bonuses and other perks to fill thousands of open roles. Here are some of the companies hiring right now", Business Insider, May 10, 2021.
3. Lorie Konish, "More states are eliminating the extra $300 per week in unemployment benefits. What to know about your rights", CNBC, May 21, 2021.

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Table 1. U.S. seasonally adjusted, non-farm payrolls 2019-2021

Job category	Job openings surplus* - Mar. 2019	Job openings surplus* - Mar. 2020	Job openings surplus*- Mar. 2021	Job openings surplus* - Apr. 2021(P)	Average weekly earnings - Mar. 2019	Average weekly earnings - Mar. 2021	Average weekly earnings - Change 2019-2021
Total private	**1,485**	**310**	**1,800**	**2,646**	**$955.65**	**$1,045.60**	**$89.95**
Mining and logging	-17	-7	0	1	$1,527.37	$1,572.03	**$44.66**
Construction	-1	-175	-98	22	$1,199.73	$1,270.65	**$70.92**
Manufacturing	121	-11	315	455	$1,114.37	$1,180.98	**$66.61**
Trade, transportation, and utilities	332	-66	406	481	$823.54	$892.33	**$68.79**
Information	74	53	8	14	$1,514.07	$1,631.22	**$117.15**
Financial activities	187	122	137	221	$1,339.86	$1,498.58	**$158.72**
Professional and business services	267	-74	292	453	$1,209.52	$1,320.02	**$110.50**
Education and health services	581	495	677	707	$908.60	$973.94	**$65.34**
Leisure and hospitality	-76	-29	23	162	$427.78	$460.86	**$33.08**
Other services	15	1	49	128	$795.45	$868.64	**$73.19**

Source: "Economic News Release: Job Openings and Labor Turnover", U.S. Bureau of Labor Statistics, May 11, 2021. "Economic News Release: Employment Situation", U.S. Bureau of Labor Statistics, May 7, 2021. Numbers in thousands. Data for April 2021 is preliminary (P). *Job openings surplus is defined as the difference between job openings and hires.

Key takeaways

- The current jobs market seems to provide workers with leverage over employers.
- State governments and companies are implementing a variety of solutions to incentivize the return to work.
- We believe that the eventual resolution of the jobs deadlock will further reinforce the economic recovery.

Implications for economic recovery

Both state governments and corporations have explored methods for incentivizing the return to work. The federal government has made efforts to remove other obstacles, such as vaccinations to help with concerns about COVID-19 in the workplace or President Biden's American Families Plan to provide childcare assistance.[4] We believe that a combination of these efforts, as well as the expiration of enhanced unemployment in various states over the next three months, will make a powerful tailwind for the return to work.

As we have discussed in previous reports, demand for various products and services has been high across a variety of industries in the U.S.[5], leading to significant backorders and pent-up demand. We believe that the eventual return to work will help companies better address this demand, resulting in a significant boost to business and furthering the economic recovery. As a result, we would reiterate our favorable views on equities over fixed income. Within equities, we favor U.S. equities over Developed Market ex-U.S. Equities due to our conviction in a further economic recovery in the U.S.

4. "Fact Sheet: The American Families Plan", The White House, April 28, 2021.
5. See WFII's April 2021 Policy, Politics & Portfolios report titled "Supply-chain reaction" for more information.

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Monetary policy at a crossroads

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A decades-long battle against disinflation …

Old habits die hard, as we may be about to learn with monetary policy.

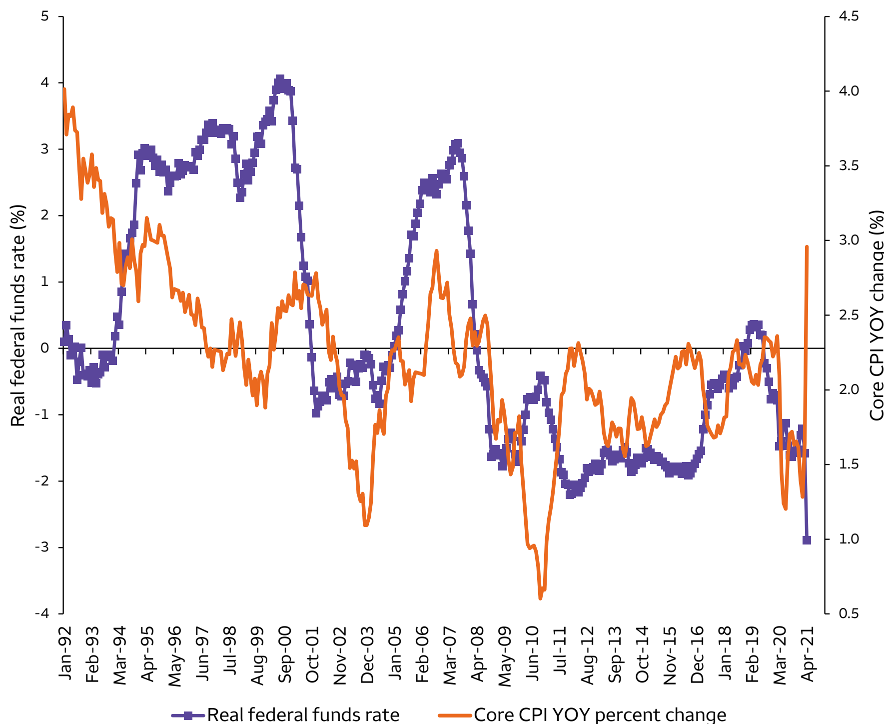
Policy innovations triggered by the Global Financial Crisis and by the more recent pandemic have included special credit facilities, quantitative easing, and the Federal Reserve's (Fed's) decision to pay interest on banks' excess reserves deposited with the central bank. All have boosted and better managed the wave of central-bank financing in a market awash with funds. This liquidity has been the centerpiece of the Fed's reinflation strategy since last August's decision to shift from a preemptive to a reactive role for monetary policy by allowing inflation to exceed and to hover, for a time, above the official 2% target rate.

The Federal Reserve's response to stubbornly low inflation has resulted in persistently negative real, or inflation-adjusted, interest rates in the past decade.

The accompanying chart illustrates just how stimulative monetary policy has become in the past decade, showing inflation's decline accompanied by persistently negative real, or inflation-adjusted, interest rates. Stimulative monetary policy has been more supportive of economic growth and Consumer Price Index (CPI) inflation indirectly, through an increase in the value of stocks, bonds, home values, and borrowing capacity, than through the more traditional cut in borrowing costs.

Inflation may not return soon to the sub-2% pace of the past decade, encouraging the Federal Reserve to shift away from aggressive monetary stimulus.

Chart 1. Lower inflation prompts more stimulative monetary policy



Sources: Federal Reserve Board, U.S. Labor Department, and Wells Fargo Investment Institute, June 14, 2021. YOY = year-over-year.

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… set to become less stimulative.

The Fed's decision to stay the course on policy follows from policy makers' frustration with stubbornly low inflation and a belief that its current spike is temporary. The decline in longer-term rates even as inflation moves up seems to corroborate the Fed's view, at least for now. The Fed's case for a temporary spike of inflation is built on reversible supply-chain disruptions and dislocations in the labor market tied to a V-shaped economic cycle. The question is whether inflation's rise will last long enough to become self-perpetuating after the initial shock wears off. Our view is that inflation will decelerate as spending slows and as factories and stores rebuild inventories to erase today's supply shortages. Inflation seems unlikely to return to its rate of the 1970s, but it also may not return soon to the sub-2% rate of the past decade. We believe that the Fed will respond to firmer inflation by moving away from aggressive stimulus cushioning the economy from the effects of the pandemic. Our view is that the Fed will begin that move with reduced purchases of Treasury and mortgage-backed securities near year-end 2021. The Federal Open Market Committee meeting in June conveyed a hawkish tone, and added to our conviction that the time horizon for Fed actions has been shortened.

As inflation decelerates, interest rates are likely to rise further and produce real rates that are less negative. Meanwhile, economic growth persistently above its post-World War II average of 3.3% should drive strong earnings growth and support equity market gains. Consequently, we continue to favor stocks over bonds and, within the U.S. Large Cap Equities sector, our favorites include those cyclical sectors that should benefit the most from the economy's continued strength — namely, Industrials, Materials, Financials, and Energy.

Key takeaways

- Decades-long disinflation not only shapes the Federal Reserve's policy decisions but encourages innovations in the policy tools and strategy used in making those decisions.
- We believe that higher inflation will prompt a move by the Federal Reserve away from aggressively stimulative monetary policy, with potentially important consequences for the economy, the financial market, and investors.

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A primer of public-private partnerships and infrastructure financing

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Public-private partnerships and infrastructure

The U.S. economy could not function effectively without its networks of roads and bridges or its water and sewer systems. Yet, delivering world-class infrastructure requires funding to bankroll projects coupled with productive partnerships between the federal government and state and local municipalities — and sometimes the private sector. Most infrastructure project and procurement decisions are made by state and local governments. The federal government is primarily a grant maker and regulator of the nation's infrastructure.

Public-private partnerships are collaborations between government agencies and private-sector companies to develop and manage capital projects. They combine private-sector innovation with public-sector incentives. Build America Bonds (BABs) were used to finance capital projects under President Barack Obama's American Recovery and Reinvestment Act (ARRA). A similar issue of bonds may be key to financing President Joe Biden's infrastructure plan.

The federal government owns 3% of the nation's infrastructure.

Source: Cato Institute, June 2017.

The U.S. municipal bond market exceeds $3.9 trillion. In 2020, 30% of newly issued municipal bonds were taxable versus 10% historically.

Source: Securities Industry and Financial Markets Association and Wells Fargo Investment Institute, June 2021.

BABs issued in 2009–2010 topped $181 billion and were issued in all 50 states.

Source: Politico, April 21, 2021.

What are public-private partnerships?

There is no single definition of public-private partnerships (PPP). The PPP Knowledge Lab defines a PPP as "a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility and remuneration is linked to performance".[6] Most PPPs have 20- or 30-year terms and fall into two categories: "greenfield" for developing new projects and "brownfield" for managing or upgrading existing projects.

The U.S. PPP market is growing thanks to government support for private investment in infrastructure. PPPs can leverage additional sources of funding for capital projects and improve efficiency, which often leads to expedited timelines. A private party creates a special purpose vehicle financial structure allowing for the segregation of equity and debt. Project shareholders include engineering and construction companies and private-equity funds. Lenders include commercial banks and financial institutions. Remuneration to private partners is typically linked to performance metrics.

U.S. infrastructure needs could top $6.1 trillion over the next decade.[7] President Biden recently proposed $4.1 trillion for infrastructure and human development, but the legislation's form and provisions are still being negotiated. Lawmakers are split on how to fund the bill. A new generation of BABs may be issued to finance it.

6. "PPP Reference Guide", PPP Knowledge Lab, 2017.
7. American Society of Civil Engineers, March 2021.

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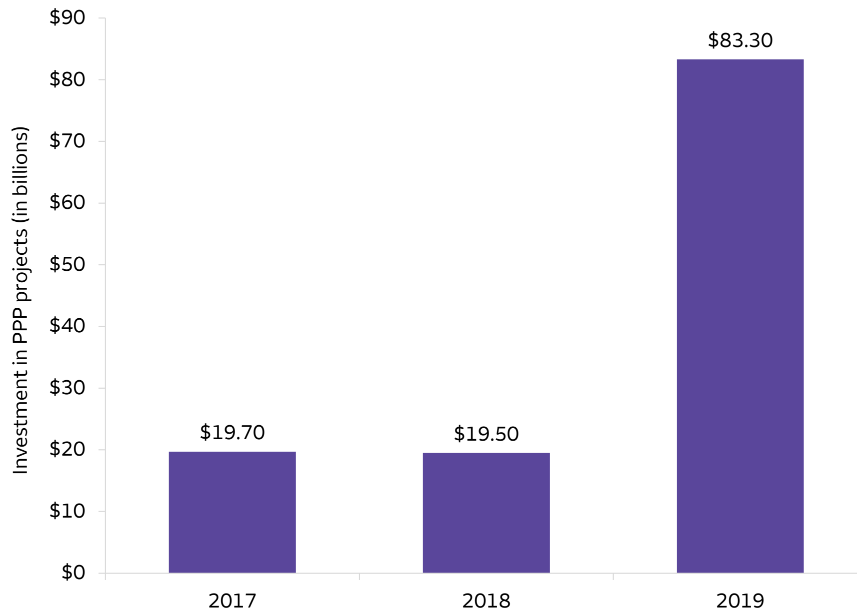
Chart 2. U.S. PPP market has grown in recent years



Source: InfraPPP, 2020.

Key takeaways

- Public-private partnerships (PPPs) are collaborations between government agencies and private-sector companies.
- PPPs help leverage additional sources of funding for capital projects and improve efficiency.
- Build America Bonds (BABs) used to finance capital projects after the Great Recession may be key to financing infrastructure legislation.

Investment implications

BABs are taxable municipal bonds with federal tax-credit benefits for bondholders or issuers. BABs were introduced in 2009 under President Obama's ARRA to stimulate the economy. They helped finance transportation and infrastructure projects. The BAB program expired in 2010 after Republicans took control of the House during midterms.

BABs allowed states and counties to float debt with interest costs subsidized by the federal government. The federal government paid 35% of annual interest costs of BABs through tax credits or direct payments. Tax-credit BABs gave bondholders and lenders a 35% federal subsidy on interest paid through tax credits. Direct-payment BABs offered a 35% subsidy of the interest issuers paid to investors.

A bipartisan group of legislators has introduced bills in both chambers to create American Infrastructure Bonds.[8] The bonds would resemble BABs issued in 2009, providing federal interest subsidies to state and local governments that would sell bonds to finance projects. BABs do come with certain risks, mainly from potential subsidy cuts. A midterm change in House leadership could lead to subsidy cuts through sequestration — which reached 8.7% in 2013 — or termination, like in 2010.

8. "Build America Bonds may stage a comeback in Biden's infrastructure plan", Reuters, March 31, 2021.

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Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to interest rate, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. Income from **municipal securities** is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT). **Build America Bonds** are taxable municipal bonds created under the American Recovery and Reinvestment Act of 2009 that provide federal subsidies to the issuer for a portion of the borrowing costs. These municipal bonds are backed by the issuing municipality and are not obligations of the U.S. government. BABs are subject to federal taxes but may be exempt from state and local taxes. As with all bonds, BABs are subject to interest rate, credit and market risks.

In addition to the risks associated with investment in debt securities, a fund's investments in **mortgage-backed securities** will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that If called prior to maturity, similar yielding investments may not be available for the Fund to purchase. These risks may be heightened for longer maturity and duration securities.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

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