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WAITING FOR CONGRESS: WHAT TO LOOK FOR IN TAXES, SPENDING

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Spending bills now being debated in Congress would add to government debt and its vulnerability to higher interest rates. For now, however, they also would reduce the fiscal “drag” on economic activity from an end to aggressive fiscal stimulus of the past 18 months.

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U.S. lawmakers are under pressure to finalize tax and spending legislation by early December. As Congress works toward passing budget reconciliation legislation, individual tax laws will likely be affected in ways that have yet to be determined.

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Tax policy and the economic outlook are key considerations for business capital expenditure (capex) decisions. Our outlook for the economy through 2022 is constructive, and a combination of tax and technology incentives may further strengthen capex spending.

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Deeper in debt?

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Deficit implications of the 2021 fiscal debate

Lost in the debate over government funding, the debt ceiling, and the makeup of the spending bills on infrastructure and human capital are the implications for future federal deficits and the buildup of government debt. That may add to the longer-term vulnerability of government finances to rising interest rates. However, the good news in the near term is that the deficits from the two proposed spending bills should reduce the headwind to economic growth as the deficit narrows more gradually than it would without the legislation. Over the longer term, tax relief and increased spending afford lower-income families support and potentially lift productivity via infrastructure upgrades.

The Congressional Budget Office has estimated that the infrastructure bill alone would add $256 billion in deficit spending over the next 10 years.

Eleventh-hour legislation has pushed the deadlines for government funding and for a debt ceiling increase or suspension back to December, allowing Congress to focus on the two spending bills. A logjam is being cleared by a compromise on a reduced size of the partisan human-capital bill, reducing the headline total to a range of $1.9-$2.2 trillion from an earlier $3.5 trillion proposal. Next up are negotiations over the details of spending and the revenue sources to pay for it. That will set the stage for both a vote on this bill and for the House to approve the infrastructure bill already cleared by the Senate. We believe that Senate leadership will pass a scaled-down version of the human-capital bill through budget reconciliation, requiring only a simple majority vote.

Deficit spending peaked at 15% of gross domestic product (GDP) during the depth of pandemic but has been narrowing since then.

Sources: Federal Reserve Bank of St. Louis and Bloomberg, September 30, 2021

Some early thoughts on the spending bills' ultimate cost

The full impact of the two spending bills on federal deficits and debt won't be clear until Congress agrees on the size and composition of the budget resolution bill on human capital. However, we can make a few early observations on both bills. First, the Congressional Budget Office (CBO) already has estimated a cumulative $256 billion budget deficit over the next 10 years created by the $1.2 trillion infrastructure bill previously approved by the Senate (including $550 billion in new spending). Those projections anticipate deficits attributable to the infrastructure bill to peak at nearly $60 billion in fiscal 2026.

Second, the ultimate cost of the reconciliation bill depends on how Congress achieves the spending cuts. Keeping all programs in place but shortening the time horizon from the original 10 years could be more costly than simply eliminating some of the programs. It often is easier for Congress to extend programs already on the books than to vote new programs into the budget. The Committee for a Responsible Budget estimated that the true cost of the earlier $3.5 trillion spending proposal could be $5-$5.5 trillion for just that reason.[1] However Congress ultimately trims spending, odds favor

[1] "True cost of budget plan could exceed $5 trillion," Committee for a Responsible Federal Budget, July 19, 2021.

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childcare and other tax relief skewed toward lower-income groups hit hardest by the pandemic and its aftermath.

Revenues to finance a portion of the spending bill are another loose end in the budget debate. The appetite in Congress for tax increases may be no more than $1-$1.5 trillion. That could leave a cumulative deficit from the reconciliation bill as much as $1.2 trillion if the spending cap is $2.2 trillion. The choice of tax increases — between those affecting consumption vs. investment, for example — would be nearly as important as their size in determining the spending bill's net stimulus. Their structure could mitigate their drag on economic growth. First, higher tax rates could have a negative impact on some business formation, but the overall condition of the economy could be more important for the path of equity prices, as measured by the S&P 500 Index. For more details, please see the next section of this report. Second, business research and development (R&D) spending on equipment will likely support longer-term growth through enhanced productivity. As we explain in the final section of this report, we anticipate that tax policy and technology trends will encourage stronger business investment.

Deficits and the economy

Deficits created by the two spending bills likely would lessen the headwinds to economic growth from narrowing deficits as pandemic-related fiscal support ebbs. Reduced deficits reflect both the economic and revenue growth recovery from the freefall during the pandemic and the end of aggressive budget stimulus contributing to what's called "fiscal drag" on economic activity. Put another way, even moderate support from spending in excess of increased revenues would be welcome by an economy feeling the effects of more moderate growth in a maturing economic expansion.

Investment implications

Deficit spending tied to the two spending bills, however moderate, would likely support economic growth and reinforce our favorable view of cyclically sensitive Industrials, Financials, and Energy sectors that have typically done well during the middle stages of an economic expansion.

Beyond the short-term volatility, we expect the economy to grow at above-average levels next year. We expect higher economic and earnings growth rates, but pullbacks could accompany fiscal debates along the way. In an effort to manage volatility in the continued positive equity environment that we expect, we favor allocating cash in a disciplined and incremental way. Stronger economic growth also is typically consistent with the moderate, sustained rise in interest rates we anticipate in the next year. That, we believe, will continue to favor higher-quality preferred, asset-backed, and municipal securities.

Key takeaways

- Added budget deficits from the two spending bills now under consideration are a double-edged sword for the economy and the financial markets. The shortfalls add to federal debt and its longer-term vulnerability to higher interest rates while supporting economic growth now in a maturing expansion.
- For investors, support to economic growth from the two proposed spending bills reinforce our favorable view of cyclically sensitive, mid-cycle sectors of the stock market and certain high-quality bonds outside the Treasury sector.

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Individual taxes and budget reconciliation

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Potential tax changes

Although the U.S. government averted a shutdown and a potential default since late September, lawmakers are under the gun to finalize tax and spending legislation by their self-imposed deadlines in December. As Congress works toward passing infrastructure and budget reconciliation legislation, tax laws will likely be affected in ways that have yet to be determined. The Senate-approved infrastructure bill included few tax provisions and nontax offsets (rescinding unused funding from COVID-19 relief). Most tax provisions are attached to a budget reconciliation package that is separate from the infrastructure legislation.

Reconciliation requires only a simple Senate majority (not 60 votes) to pass.

As of this writing, the House has a version of the human infrastructure bill and accompanying tax provisions, but Congress does not have a compromise version yet. And the fluid situation could spark bouts of market volatility as negotiations heat up ahead of the December deadline. Yet, we do expect the bill will likely propose increases in capital gains taxes and personal income tax rates for some high-income earners. One potential offset to higher tax bills, particularly in high-tax states, is reinstatement of the state and local tax (SALT) deduction that was eliminated under President Trump. Build America Bonds (BABs) might be issued to help fund the bill as well.

Since 1980, Congress has sent 26 reconciliation bills to the president; 22 were enacted.

Source: "Budget Reconciliation: The Basics," House Budget Committee Democrats, August 11, 2021

Tax rates and the markets

If the proposed reconciliation bill passes in its current form, the U.S. could see tax law changes in 2022 and possibly in 2021 (see sidebar 1). The House version had an effective date of September 13, 2021 for the capital gains increase, which would limit taxpayers' ability to take advantage of the previously lower rate. However, it is unclear at this time whether an effective date in 2021 or 2022 will become a compromise point in the negotiations.

Instead of focusing on specific provisions of a bill that is still taking shape, we would like to consider the economic and market effects of individual tax rates since the 1970s. The top personal income tax brackets and capital gains rate are key components of tax policy, partly because these taxpayers supply much of the capital needed to fuel small business — the largest job-creating engine of the U.S. economy. A tax-rate increase's impact on the economy and stock market depends on several assumptions and key inputs, including geopolitics, demographics, U.S. dollar, and monetary policy.

Both historical income tax levels and capital gains rates, individually, should be negative factors for economic growth. Yet, they are only two of many factors that can affect the path of the economy, earnings, and equity prices. The chart below illustrates that the S&P 500 Index can still rise, irrespective of the tax regime. And so can economic growth. Annualized gross domestic product (GDP) growth rates advanced at a pace near 4% while returns on the

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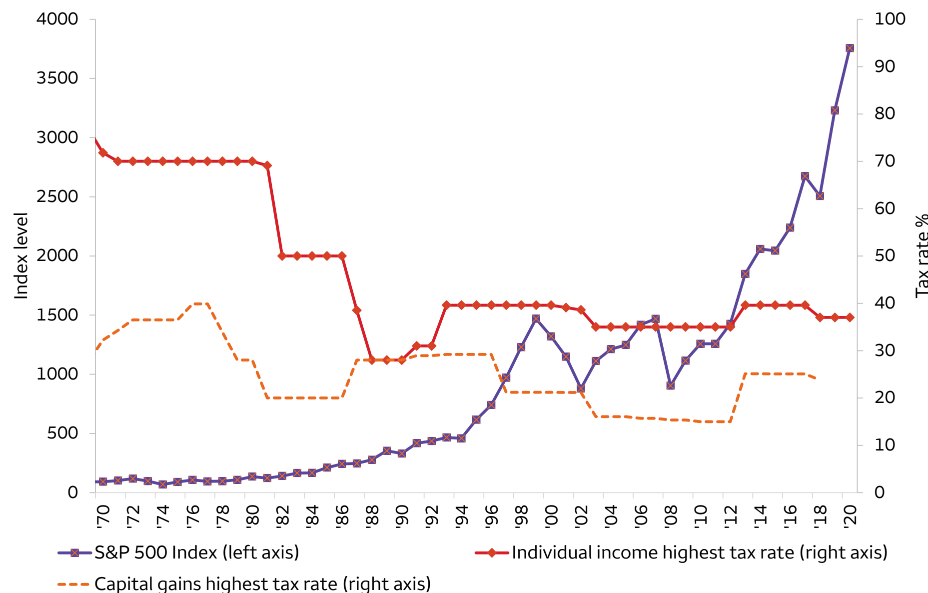
S&P 500 Index advanced over 15% annually from 1981-1988, a period when the top marginal tax rate was reduced from 70% to 28%, and from 1993-2000, when the top rate increased from 31% to 39.7% (see chart below). High top capital gains tax levels between 30% and 40% throughout most of the 1970s coincided with two recessions, an inflation spike, and weak stock market performance. Yet, capital gains tax rates jumped by 10 percentage points in 2013 (15% to 25%), which was followed by solid economic growth with no recession and annualized equity returns of 12% until the COVID-19 pandemic.

Chart 1. Tax rates vs. U.S. equity returns



Sources: Bloomberg, Tax Foundation, and Wells Fargo Investment Institute, October 11, 2021. Yearly data 1970-2020 for the S&P 500 Index and individual income tax rate; 1970-2018 for the capital gains tax rate. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Investment implications

BABs are a potential investment opportunity that we will be watching for in the proposed legislation. These are subsidized taxable bonds that offer the ability to refinance future debts on a tax-exempt basis. BABs allow municipalities to float debt with interest costs subsidized by the federal government. Under President Obama, the 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.

BABs in the past were used by good-quality municipal borrowers, so the default risk of muni issuers borrowing under the BABs program was low. Taxable municipal bonds, such as BABs, offer potentially attractive yields for investors. As taxable municipal issuance increases, so does selection, which can help to improve diversification. We currently favor municipal bonds, including taxables.

Key takeaways

- As Congress works toward passing budget reconciliation legislation, individual taxes will likely be affected in ways that are yet to be determined.
- The U.S. economy and equity markets appear to have performed independent of income tax levels and capital gains rates.
- Build America Bonds (BABs) are a potential investment opportunity that we will be watching for in the proposed legislation.

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Policy and capex

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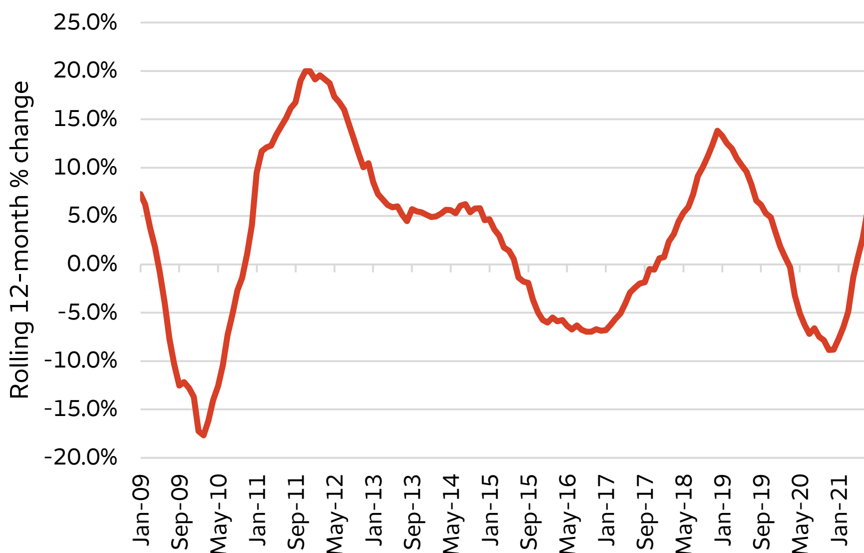
What is the outlook for capex?

In a typical economic cycle, consumer spending has led the charge out of the recessionary or slowdown hole and then eventually passed the baton to businesses as they engaged in capital expenditure, or capex, campaigns while the recovery continued and factory capacity tightened. In this current economic cycle, government stimulus payments and wage increases have aided consumer spending. While business capital spending understandably contracted during the deep but short pandemic-induced recession in early 2020, the trend reversed as capex growth gained momentum in the second half of last year. Part of this increase was due to catch-up from a lack of spending during the depths of the pandemic as well as the natural cycle that occurs as machinery wears out and needs to be replaced to meet basic consumer demand.

U.S. economic output surpassed the prepandemic high in the second quarter of this year (according to Bloomberg data). This occurred even though there were more than 6 million fewer workers in the labor force.

Source: Bloomberg, July 29, 2021

Chart 2. S&P 500 Business Capital Spending on the rise



Sources: FactSet and Wells Fargo Investment Institute, data as of September 1, 2021. Monthly data: January 2009 – September 2021. Represents total capital expenditures for the period. This is calculated as the sum of Capital Expenditures - Fixed Assets and Capital Expenditures - Other Assets.

Looking beyond the next few months, we expect additional support for capex from both technology trends and government policy. One of the lessons learned over the last 18 months is that technology can help push productivity gains as automation has allowed companies in a number of industries to fill some of the gaps resulting from a lack of workers to fill open jobs. Based on Job Openings and Labor Turnover Survey (JOLTS) data from October 15, 2021, there are nearly 11 million current job openings in the U.S. Many investors might be interested to know that in the second quarter of this year, total economic output surpassed the prepandemic high with more than 6 million

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fewer workers on the job than in the pre-COVID-19 period. Enhanced productivity and the desire of businesses to maintain margins have been part of the reason why this has occurred. The application of technology has been a meaningful contributor to this phenomenon.

The Biden administration has proposed a number of changes to corporate and individual tax rates. Investors are wondering how the corporate proposals might affect not only earnings but business capex. We see higher corporate taxes being approved by Congress but do believe the rate will be lower than the 28% the administration initially proposed and more likely in the 25% to 26% area versus the current 21%. A higher tax rate might push some businesses to increase capital spending rather than pay taxes on their profits. In addition, the current full expensing tax policy initiated by the last administration allows businesses to fully deduct the cost of their investments immediately rather than depreciating that cost over a number of years. This policy will likely spark investment, especially since it is currently scheduled to begin phasing out after 2022 and will fully expire at the end of 2026.

Higher labor costs and economic policies favoring investment spending will likely be particularly beneficial to labor-saving high-tech equipment, whose share of total business investment has climbed steadily since 1990.

Tax policy considerations are a critical part of capex decisions businesses make along with the outlook for the economy. Our outlook for the economy through 2022 is good, but we expect a moderation in the growth of capital investment relative to gains we have seen in recent quarters.

Key takeaways

- Higher corporate tax rates and continued full expensing of capex through 2022 should lead to moderate growth in business investment.
- Technology should benefit as labor shortages push businesses toward automation.

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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. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **Build America Bonds (BABs)** 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. **Preferred securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. **Asset-backed securities** are 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 to purchase. These risks may be heightened for longer maturity and duration securities.

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