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AN UPDATE FROM PAUL DIETRICH

BIDEN'S $6 TRILLION BUDGET: WHAT WILL PASS & WHAT WILL NOT

INFLATION UPDATE

As of the market close on June 9, 2021, the S&P 500 Index is up 12.54% year-to-date. The Dow Jones Industrial Average is up 13.05% year-to-date, and the tech-heavy NASDAQ Index is up 8.04% year-to-date.

While I have urged investors to stay fully invested in the stock market in all of my *Market Commentaries* throughout this past year, I still believe we could see some stock market volatility and a possible pullback sometime this summer.

While most of the economy is starting to reopen fully, we cannot return to normal until we get at least 70% of Americans fully vaccinated. This is now projected to take place in late August or early September.

Also, the economy faces other potential risks in the short-term, like inflation and product shortages caused by supply chain disruptions, foreign cyberattacks on crucial infrastructure, and political uncertainty in Washington, D.C.

The stock market continues to be **overvalued**. According to FactSet, the forward 12-month Price Earnings Ratio (P/E) for the S&P 500 Index was 21.1 as of last Friday. That means the S&P 500 Index could be overvalued by more than 17% compared to the 5-year forward P/E average of 18. However, the forward 12-month P/E for the S&P 500 Index has dropped from 21.8 recorded at the end of the first quarter (March 31). That is a good sign that the market overvaluation is moderating without a significant correction.

Currently, FactSet's consensus earnings growth projections for 2021 have increased to 34.4%, and revenue growth projections are now at 12% for the S&P 500 companies. Its bottom-up target for the next 12-months is a price increase of 13.6% for the S&P 500 Index.

Expect Continued Volatility Through The Rest Of The Summer

Here are where the year-to-date indexes stand as of Tuesday, June 8, 2021:

Investors can see how volatile all three indexes have been since the beginning of 2021.

The current price of the NASDAQ Index is about the same as where it was on February 5.

I expect this volatility to continue over the next six weeks to two months, and then I think we will see smoother sailing.

President Biden's $6 Trillion Budget

President Biden's proposed $6 trillion budget represents the most significant increase in federal spending since World War II.

However, except for infrastructure spending and normal government operations, the rest of his new proposed budget and tax proposals are "dead on arrival," at least until after the 2022 elections.

Infrastructure Negotiations

Infrastructure negotiations between the White House and a group of Republicans, led by Senator Shelley Moore Capito (R-WV), have officially broken down. Biden now plans to try to negotiate an agreement with a separate, bipartisan group of senators.

This is a group called the "G20" group of Democratic and Republican senators, led by Senators Rob Portman (R-OH), Mitt Romney (R-UT), Joe Manchin (D-WV), and Kyrsten Sinema (D-AZ).

It is expected that this group will agree on a specific infrastructure proposal of about $900 billion focused on roads, bridges, and other traditional projects.

How Will We Pay For The Infrastructure?

The key sticking point is how to pay for the package. Everyone likes infrastructure spending, but no one wants to pay for it.

The Republicans have suggested unspecified user fees. But, when pressed by the White House, they say they are opposed to raising the gas tax. However, they have yet to identify any other user fees they would enact or raise to pay for this legislation.

They have also suggested using unspent money from the recent Covid stimulus legislation. But, that money has already been appropriated and sent to the states. The states' governors have already started to appropriate that money, and they are not giving it back to the federal government. Even Republican governors have vehemently opposed this plan. This idea is a non-starter.

Biden initially proposed raising the corporate tax rate from 21% to 28%. However, Democratic Senator Joe Manchin (D-WV) said no to that proposal. But, he did say he could live with a 25% corporate tax increase.

When Republicans said they would never undo the Trump tax cuts, Biden came back with a new proposal to enact a 15% to 20% minimum tax on large, global corporations who use foreign tax havens and loopholes to pay little or no taxes in the U.S.

Nike, Amazon, and many other very large and profitable corporations pay essentially no corporate taxes to the U.S. government (and less than the average main street mom-and-pop store). This may be an idea that some Republicans could support.

Democrats' Infrastructure Plan B

Senate Majority Leader Chuck Schumer said that Democrats are working on a reconciliation bill (that could pass with just Democratic votes) as a backup plan if talks fall through. He added that their plans were to move forward with an infrastructure bill in the Senate in July, whether a deal between the two sides is reached or not.

How Will It All End? Both Republican and Democratic Washington political operatives believe that Biden will agree to a scaled-down infrastructure bill that can pass with bipartisan support, even if the "pay-fors" in the legislation are vague.

After that bipartisan legislation passes, the White House will then pass another approximately $1 trillion in spending that includes many of the original American *Jobs Act* programs that were left out of the bipartisan infrastructure bill. They will also include a 25% corporate tax rate hike and a new minimum 15%

corporate tax for large, global companies to pay for all of the infrastructure spending in both bills.

What Is Not Included In Biden's Budget?

Many of Biden's core campaign promises are not included in his budget. Investors may find it interesting that these items were not included in the budget and are not budget priorities.

- No $15 an hour minimum wage
- No forgiveness of student debt
- No lowering the Medicare age to 60
- No reduction of prescription drug costs
- No public healthcare option

What About The Rest Of The New Spending?

Biden's new budget proposes a wide range of spending on climate initiatives, universal pre-K and free community college tuition, new safety-net entitlement programs, and expanded home health care for the elderly. These programs, if passed, would be the most massive expansion of the federal government's role in the U.S. economy since World War II.

Besides raising corporate taxes, he also intends to raise capital gains taxes for incomes over $400,000 and raise estate taxes.

The Good News Is—Most Of This Budget Will Not Pass!

To pay for the infrastructure program, it is possible that corporate taxes could rise to 25% in a reconciliation vote. A minimum corporate tax of 15% could pass for large, multi-national corporations.

But, because there are an estimated eight Democratic senators who oppose the capital gains and estate tax proposals, these taxes don't have a chance of passage before the 2022 elections. They will fail, not because of Republican opposition, but because of Democratic opposition.

Biden's other major legislative initiative, the *American Families Plan*, contains all of the progressive left's key social programs "wish lists." It is supported by the vast majority of progressives in the Democratic party—but it has less support from Democratic moderates.

This bill will not receive any support from Republicans. For the legislation to pass by "reconciliation" with only Democrats voting for it, it has to be supported by all 50 Democratic senators.That seems highly unlikely. Several Democratic senators have already criticized many provisions in the legislation as "wasteful and unnecessary." This is not a good sign for the Administration.

Several Democratic senators have also said they opposed either the capital gains tax increases or the estate tax increases proposed in the legislation. Almost all farm-state Democratic senators will have farmers who vehemently oppose the step-up basis and other provisions on estate taxes. Most farmers are land rich but cash poor. They do not consider themselves to be part of the multi-millionaire ultra-wealthy. The **eight Democratic sena**tors who have expressed opposition to the tax provisions are **Menendez (D- N.J.), Manchin (D -WV), Warner (D-VA), Tester (D-MT), King (I-MA), Kelly (D-AZ), Schwartz (D-HI),** and **Murphy (D-CT).**

With at least eight Democratic senators opposing the tax provisions of this bill, it is doubtful Biden can get all 50 Democratic senators to support this legislation.

Although they will not admit it publicly, I am told by White House Democratic staffers that President Biden introduced this legislation simply to appease the progressive left in his party, but that even he doesn't expect or believe it will pass in its current form.

The Democrats plan to use the policy provisions in this bill, which are extremely popular with the progressive base of the Democratic Party, as a campaign tool to get out the Democratic grassroots in the 2022 midterm elections.

The 2022 Elections Could Change Everything

Right now, the U.S. is tied 50-50 between Democrats and Republicans in the U.S. Senate, with Vice President Kamala Harris breaking any ties in favor of the Democrats.

With several current vacancies, the Democrats have a slim, eight-seat majority in the House of Representatives.

The 2022 elections are expected to be close and hard-fought. Democrats know they will have a difficult battle to maintain control of the House and Senate after the 2022 midterm elections.

Even a minor electoral setback could cost them control of Congress.

Historically, the president's party has lost seats in every midterm election since 1938, with only two exceptions—in 1998 and 2002. Democrats are also at a disadvantage because redistricting heavily favors Republicans in many swing Congressional districts.

The one major hope Democrats have in keeping and possibly increasing seats in both the House and Senate is the economy. Most political and economic analysts believe that if Biden can substantially decrease unemployment with an infrastructure bill, the Biden Administration could oversee a massive historical economic rebound. Moody is forecasting historical GDP growth of 7.4% in 2021 and 4.3% growth in 2022—which is higher even than the Congressional Budget Office projections.

If Biden can keep his focus on the economy, jobs, and defeating Covid, that may be the Democrats' best way to win new seats in Congress.

One Democratic staffer told me, "No matter what Bernie, or Elizabeth Warren, or AOC think, right now, the Democratic Party can't be more liberal than Senator Joe Manchin (D-WV). He's holding all the cards in a 50-50 Senate—at least through the 2022 elections."

Inflation Update

Prices rose in April by 3.6% compared to January 1 when they were up only 1%. That is a significant increase.

Most of those price increases were powered by the surge of government stimulus spending. Consumer spending has now completely recovered from the Covid crisis lockdowns of last March. After adjusting for inflation, consumers again accounted for 70% of the total U.S. economy.

This increase in April inflation is unlikely to force the Federal Reserve to raise interest rates. They have argued that most of the current inflation is temporary and that most price increases will retreat as the economy reemerges from the pandemic. They believe it would be a mistake to raise interest rates now and slow down the recovery, especially before the labor market has time to recover.

Last week, Treasury Secretary Janet Yellen said she expects 3% plus inflation to last for several more months and could last through the end of this year.

Federal Reserve Chairman Jerome Powell gave the following reasons why higher inflation will continue through the end of this year, but will eventually return to a more sustained 2% to 2.5% annual rate.

Consumer Supply & Demand: Consumer demand for goods and services, from airline tickets and hotels to restaurant reservations, is rebounding faster than anyone anticipated, as people unleash pent-up savings as the economy reopens.

Supply Chain Bottlenecks: There are supply chain bottlenecks that are temporarily causing increased prices until factories and businesses ramp back up to full capacity and workers come back on to payrolls. Unfortunately, this won't happen immediately. After a nationwide lockdown, and after businesses sold off inventory, sawmills sold off stock, rental car companies sold off their vehicle fleets, farmers sold off cattle, and car manufacturers can't get enough computer chips. It is going to take time to get back to normal.

Wage Inflation: Historically, the most significant driver of "sustained inflation" has been wage inflation. When there are more jobs than workers, people can demand higher wages and benefits. Right now, because of generous government stimulus unemployment benefits, many workers at the lower end of the wage scales are making more money in government benefits than they did at their full-time jobs. Also, many women will need to wait until school reopens in the fall before they can go back to work. Depending on what government figures you use, there are between 7.2 to 10 million people unemployed today that had a job in February 2020 before the Covid lockdown. Currently, all of the enhanced stimulus payments for unemployment insurance will end on September 6, 2021. When that happens, a large portion of that 7 to 10 million workers will reenter the job market. It is unlikely that we will see much in the way of wage inflation after September 6.

NOTE: This report is authorized for distribution to clients

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as a frequent on-air commentator and regularly contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*