The Zoom Room…topics from our recent client Zoom calls

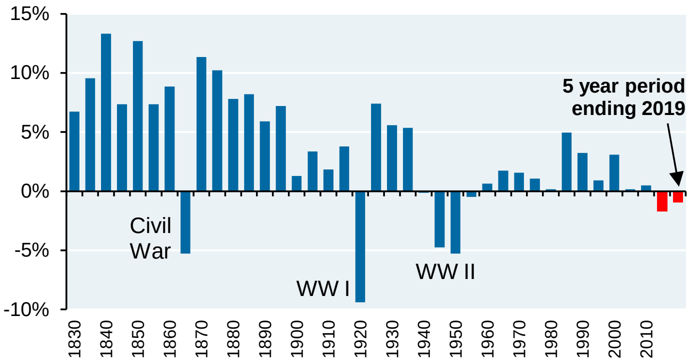
Topics:

- The risk of inflation
- COVID news of the week: US spending rebound, Europe, Second Waves and Oxford Phase II/III trials
- The debate on whether lockdowns help or hurt: be careful what you read
- The exploding US Federal debt and the Eisenhower blueprint
- Biden's taxation and spending agenda

The risk of inflation

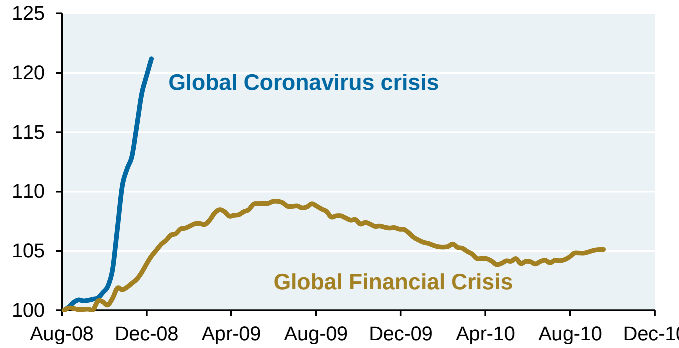
A lot of clients ask about the risk of inflation given what the Fed and the Treasury are up to. Here's how I have been answering that question. Heading into 2020, the US experienced an entire decade of negative short term interest rates for only the second time since 1830, and ran a large fiscal deficit in spite of full employment. And still…no inflation overshoot. We can discuss and theorize on the reasons why[1], but the bottom line is that US inflation did not rise during the prior decade of monetary and fiscal extravagance. The US M2 money supply plus institutional money market fund balances is growing much faster now than during the Global Financial Crisis, and we believe that this crisis will be shorter than the prior one when measured as the time it takes to reach prior output levels. Furthermore, the US-China conflict could dampen the impact of falling US import prices, and wealth redistribution could eventually shift resources to households with a higher propensity to spend. But for the next year or two, I'm more concerned about deflation given the restructuring wave expected to affect public and private companies, and the collapse in purchasing power when/if Federal and state unemployment benefits run out. We will discuss in more detail on the webcast that Mary and I do next Monday.

Lowest real yields on cash since 1830, other than during wartime, T-bill/Funds rate less inflation, 5-year average



Source: FRB, Robert Shiller, GFD, BLS, JPMAM. January 2020.

Faster growth in the money supply this time around
M2 money supply + institutional money market fund balances, index



Source: St Louis Fed, J.P. Morgan Asset Management. May 2020.

[1] In the 2020 Outlook, we included a section entitled "**Why is inflation dead**" which analyzed the decline in labor bargaining power, more frequent price resets due to online retailing, globalization and the negative impact of China joining the World Trade Organization on US manufacturing workers, the falling tendency for companies to pass on rising labor costs to customers, the deflationary pulse of the ICT sector and the rise of industrial robots.

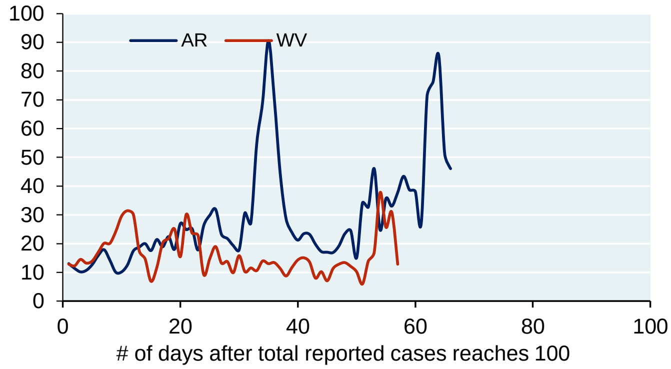
COVID news of the week (see coronavirus web portal sections for more details)

- **US real time spending**. US new business/mortgage applications and petroleum demand are rising at a rapid pace vs March lows, and our new credit/debit card tracking tools show that "social distancing" spending (on retail, lodging, restaurants, parks, theaters, etc) **in reopened states with low virus infection rates** is improving sharply as well (Section 1)

- **US healthcare capacity**. ICU bed utilization rates in NY and NJ have finally fallen below 75%; the median ICU utilization level for the rest of the states is just 7%. Combined with a median hospital bed utilization rate of 50% (with none above 70%), US states appear to have sufficient excess healthcare capacity to handle a second wave, if/when it occurs (Section 1)

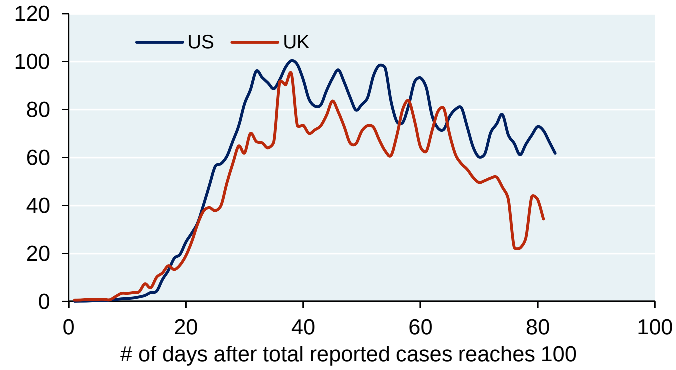
- **US second waves**. Only West Virginia and Arkansas qualify as second waves as per our definitions, and second waves are modest so far. It's not herd immunity at work given serology testing results, so the lack of second waves is either the result of a time lag (it will happen eventually) or reflects weather factors, individual variation of susceptibility, social distancing and other factors that suppress transmission of disease. Results are similar in Asia/Europe: limited second waves so far (Section 2). To be clear, the US is still struggling to end the first wave of infections, as shown below (right)

US new daily infections per mm people [2nd waves]
Linear scale, 3 day trailing average



Source: Johns Hopkins University, IMF, JPMAM. May 25, 2020

New daily infections per mm people
Linear scale, 3 day trailing average



Source: Johns Hopkins University, IMF, JPMAM. May 25, 2020

- **Oxford vaccine.** The US Biomedical Advanced Research and Development Authority agreed to provide $1.2 billion to AstraZeneca/Oxford to support Phase II/III studies and scaled-up manufacturing of its recombinant "viral vector" vaccine. In return, 300 million doses would be secured for the US, with first doses delivered as early as October if trials are successful. Oxford released results of its monkey trials; reception was mixed due to concerns about low antibody response levels and ongoing virus replication. Due to the decline in new UK infections, it may take longer to prove effectiveness of the Oxford vaccine (unless enough placebo participants become infected, it could take longer to prove that the vaccine is working as designed). Large-scale tests in the US this summer could be a better opportunity for AstraZeneca to prove that the vaccine works as intended (Section 4)

- **Europe**. As a response to the virus, France/Germany proposed that the European Commission borrow €500 billion (2-3% of EU GDP) on behalf of the EU to distribute as grants to member states most in need. The proposal is a small step towards greater burden-sharing and fiscal transfers that could someday reduce pressure on the ECB to do all the heavy lifting to keep the monetary union together. Italy and Spain trade at the lowest relative equity valuations in 20 years, and may be worth a look given the chance that this proposal is approved by all EU member governments (Section 3)

COVID lockdowns: do they do any good?

There's an effort underway to analyze how lockdowns affect COVID mortality rates, and how they affect outcomes for other life-threatening conditions. This will take time to complete, and culminate in peer-reviewed studies which analyze counterfactuals. Until then, **be very cautious when someone pings a hyperlink at you referring to a non-peer reviewed paper from someone who already claims that lockdowns had no mortality benefit for countries that used them**. I often see the arguments below, but just because (A) and (B) are true does not mean that (C) is true. This is grade school logic we're dealing with here; any mortality benefit Italy might have derived from lockdown cannot be inferred from Germany's experience, and must be analyzed in the context of Italy's own demographic/healthcare dynamics.

[A] Germany experienced lower COVID infection and mortality rates than Italy

[B] Italy had more stringent lockdown policies than Germany

[C] Therefore, lockdown policies had no benefit for Italy [**not proven by A and B**]

One paper that has been circulating (and which has been cited publicly by other groups within JP Morgan) makes the assertion that lockdowns had no beneficial impact in Europe. Aside from the fact that its author is an **oceanographer** at Woods Hole research center (!!!), mathematical biologists specializing in epidemiology that I asked to read it had plenty of concerns about its assumptions and methodology[2].

Instead, I'm paying more attention to research from Jeff Shaman at Columbia's Mailman School of Public Health (Jeff specializes in environmental determinants of infectious disease transmission and infectious disease forecasting). Using county-level observations of infections/deaths and human mobility data, Jeff and his colleagues concluded that if lockdown and other control measures had been implemented in the US just 1-2 weeks earlier, **55% of deaths that occurred between March 15 to May 3 might have been avoided**. This conclusion is just one person's view, but at least it's a more informed one.

I have **no objection** to the concept that lockdown costs exceeded their benefits but it will take properly peer-reviewed research to convince me, not random missives on the internet, not newspapers articles[3], and not drive-by opinions from scientists airlifting in from other disciplines.

[2] **Methodological concerns about the oceanographer paper include** (but are not limited to) the following:

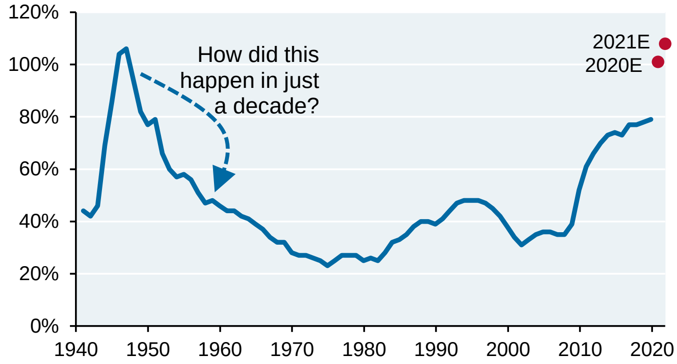
- No pre-lockdown data in a paper alleging that lockdown had no impact, which is a severe limitation
- The assumption that *everyone* follows the median disease course when there is a wide distribution around the median (which papers like J. Shaman et al incorporate), and which muddies some of the paper's key conclusions
- The author categorizes the UK as a "full lockdown" country when it wasn't; in fact, the Oxford Stringency Index has been rating the UK as one of the *least* stringent in their dataset
- Substantial overestimation of initial reproductive numbers (the author's estimates of 4 to 7 are double consensus estimates), which leads to follow-on misinterpretations
- No statistics supporting vague assertions of no lockdown impact differentials across countries
- Daily COVID reporting anomalies are enormous, which makes this kind of day-specific analysis more difficult

[3] The London Daily Mail has published articles on the uselessness of lockdowns, including assertions that reproductive numbers have not been rising again in Germany and the UK, which appears to be false. NewsGuard currently ranks the Daily Mail with a red "**X**" rating with respect to "gathers and presents information responsibly".

The explosion in the US Federal debt and the Eisenhower blueprint

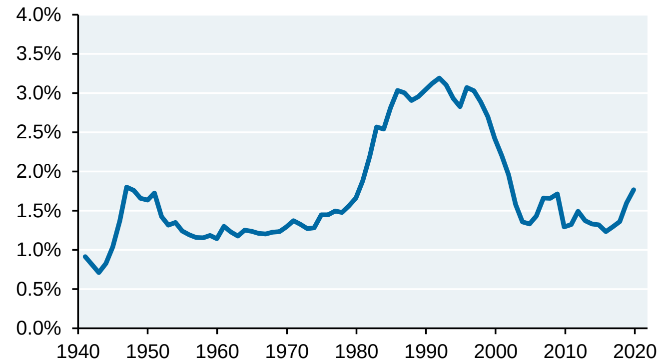
The red dots showing projected Federal debt levels need little explanation.

Gross federal debt held by the public
% of US GDP



Source: Congressional Budget Office. May 2020.

Interest burdens don't always track debt levels
Interest payments on federal debt as a % of US GDP



Source: The Office of Management and Budget. May 2020.

What does need explanation: after WWII, how did the US reduce its debt/GDP ratio almost by half by the end of the 1950's? As shown in the table, government spending wasn't cut and there were no sharp increases in tax collections (other than a temporary rise during the Korean War). The Fed did not engineer negative interest rates to jumpstart growth, and the Fed did not inflate its way out. **If that's the case, how did the US Federal debt/GDP ratio fall so far, and so fast?**

	Gross federal debt held by the public (% of GDP)	Gross federal debt held by the public (bn)	Nominal GDP (bn)	Real GDP (bn 1950 USD)	Outlays (% of GDP)	Receipts (% of GDP)	Average real 10-year rate
1950	80%	$219	$273	$273	16%	14%	1.3%
1951	67%	$214	$320	$302	14%	16%	-5.3%
1952	62%	$215	$349	$322	19%	19%	0.5%
1953	59%	$218	$373	$341	21%	19%	2.0%
1954	60%	$224	$377	$343	19%	19%	2.1%
1955	57%	$227	$396	$354	17%	17%	3.1%
1956	52%	$222	$427	$368	17%	18%	1.7%
1957	49%	$219	$451	$377	17%	18%	0.3%
1958	49%	$226	$460	$377	18%	17%	0.6%
1959	48%	$235	$490	$398	19%	16%	3.3%
1960	46%	$237	$519	$415	18%	18%	2.7%
Compound annual growth rate:		0.8%	6.6%	4.3%			

Source: OMB, BEA, Robert Shiller data set, Bureau of Labor Statistics. 2020.

Answer: the US did not reduce its debt *levels*; instead, the US grew real GDP at a rapid pace which reduced its debt *ratio*. Yes, the US had a competitive advantage over recovering Axis Powers at the time, but that's only part of the story. During Eisenhower's two terms, the US also adopted pro-business policies[4] that contributed to 3% real and 5% nominal growth from 1952-1960, and a record high 86% of all employment coming from the private sector, a level not seen since:

- Lower taxes on small business which culminated in a bill eliminating double-taxation (Subchapter S)
- Accelerated depreciation to promote investment in plant and equipment, allow write-off of current spending on R&D, reduced taxes on profits earned abroad, reduced excise taxes
- Elimination of wage and price controls, reduction of agricultural price supports, reduction of tariffs on foreign imports
- Vigorous antitrust policy applied to both vertical and horizontal mergers, designed to limit monopolies and reduce price-fixing; revitalization of the Sherman Act to streamline the process and allow the government to more quickly identify instances of monopolistic practices (see p.7 for an update)
- Reduced use of super-easy gov't underwritten mortgage loans (i.e., no down-payment, and closing costs included in the loan balance)
- Reduced military spending and foreign assistance, in opposition to Truman
- And for all the hyperbole about changing personal tax rates on the wealthy, even Saez/Piketty/Zucman concede that effective Federal, state and local tax rates on the Top 1% in 2015 were only 5%-7% lower than in 1955 (see our January 28, 2019 *Eye on the Market* for more details)

Some Eisenhower policies might not be as suitable given today's aging US population, and maybe a Keynesian approach with more wealth redistribution could work as well. But from an historical perspective, **the Eisenhower blueprint is the only one we have for a rapid reduction in the Federal debt**.

Recent *Eye on the Market* topics

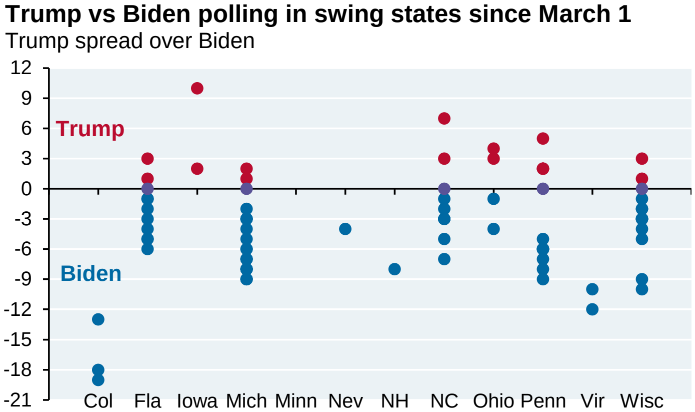
- Tracking the rebirth of the US consumer with real-time data as lockdowns gradually end (May 19)
- Regional equity performance: Europe and Japan trailing the US and Emerging Markets, again (May 11)
- Monoclonal antibodies and applications for COVID patients (May 11)
- The impact of COVID on leveraged loans and corporate profits (May 11)
- COVID impact on unfunded state pension obligations and the Chapter 9 bankruptcy debate (May 4)
- Is US fiscal stimulus "enough"? (May 4)
- COVID, food/energy supplies and the Electoral College (May 4)
- The questionable premise that the BCG vaccine is a driver of COVID severity (April 27)
- The most ambitious vaccine timetables we have seen so far (April 27)
- Latest serology results (April 27)
- History of market bottoms (April 20)
- COVID infection rates and the connection to collectivism vs individualism (April 20)

[4] "*Eisenhower and the Cold War Economy*", William McClenahan Jr and William Becker, Johns Hopkins University Press, 2011

Biden's taxation and spending agenda

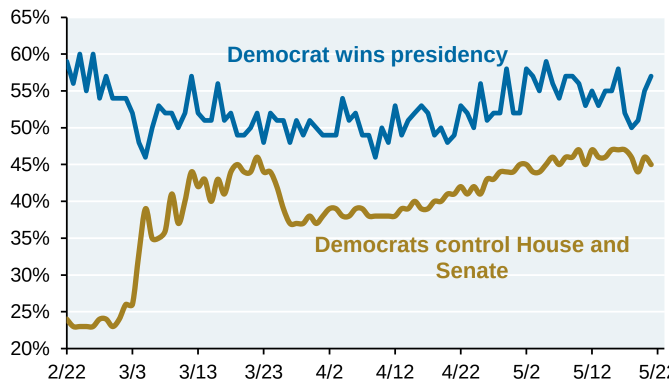
First, the polls: there has been a shift in swing state polling in favor of Vice President Biden compared to what this chart looked like in February. And as shown on the right, the market's assessment of the chances of a Democratic sweep are rising, although they're still below 50%.

Trump vs Biden polling in swing states since March 1



Source: FiveThirtyEight. May 2020.

Betting odds of a Democratic sweep



Source: Predictit, J.P. Morgan Asset Management. May 21, 2020.

I was talking to my 25-year old about the election, and he mentioned that some of his friends are loath to vote for an "establishment" candidate like Biden. I wonder whether the people in question have actually looked at Biden's policy positions and not just at Twitter. See the table below: this is a **very progressive economic agenda, particularly as it relates to taxation**. No more income cap on the payroll tax…taxing capital gains as ordinary income…further limitation on itemized deductions…no "secret ballot" worker elections… Federal gov't negotiation of Medicare drug prices…increased antitrust enforcement, including on big tech companies…minimum level of corporate income taxes…elimination of tax breaks for real estate and fossil fuels, and other "base broadening" measures…and the deployment of tax increases into a wide range of progressive causes.

Biden's taxation and spending agenda

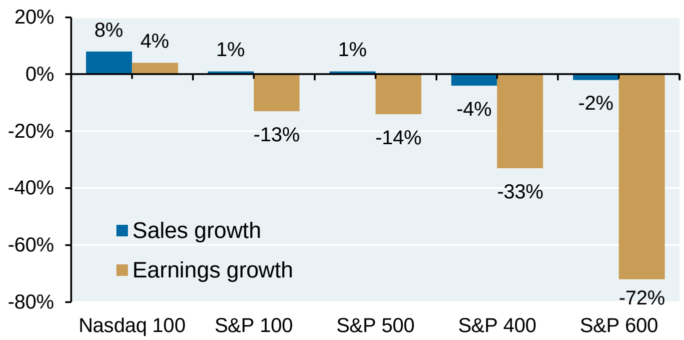
Taxation	$ (bn)	Taxation commentary	Spending	$ (bn)
Apply 12.4% payroll tax above $400k, split evenly between employers and employees	962	Any changes to Social Security require a supermajority in the Senate, assuming no invocation of "Nuclear Option"	Healthcare (Public Option, Expand ACA)	2,250
Raise corporate tax rate to 28%	1,300	Eliminate roughly half the benefit of Trump corporate tax cuts (which cut corporate tax rates from 35% to 21%)	Infratructure	1,300
Raise Top Rate & Limit Itemization	520	Return top rate to 39.6%, limit whatever deductions remain	Pre K and K-12	850
Tax Cap Gains as Ordinary Income	448	Only applied to people with AGI greater than $1 mm; No step up in basis on death above a given exclusion	Higher education	750
Industry specific taxes	343	Primarily commercial and multifamily real estate ($294 bn of total), based on changes to depreciation schedules	Clean energy research	400
Raise Global Intangible Low Tax Income rate	309	Raise minimum effective corporate tax rate paid on non-US profits	Expand social security	450
Phase out pass through deduction above $400k	219	Consistent with increase in corporate tax rates on incorporated companies, higher taxes on pass-throughs as well	Paid family leave	430
15% minimum tax on book income	166	Conceptually, a corporate version of a minimum tax, except applied based on book income	Drug price reforms	-400
Various tax reductions	-273		**Total spending increases**	**6,030**
Total tax increases	**3,994**			

Source: Cornerstone Macro Research, J.P. Morgan Asset Management, May 2020.

Implications for investors. The biggest possible impact on markets from policies in the table above may result from a reversal of corporate tax cuts. Our estimates range from 200-300 points on the S&P 500 given the magnitude of the corporate tax reversal at a time of high P/E multiples.

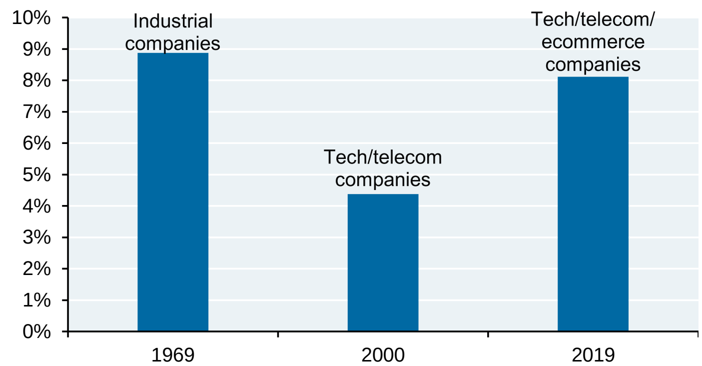
An **antitrust revival** is also a potential market headwind at a time when tech and other megacap stocks are generating the highest sales and earnings growth. If such a revival targets the tech sector, it could have an adverse impact on markets since (a) the tech sector has the largest degree of concentration and consolidation, (b) the tech sector has more than doubled the return on the rest of the stock market since 2010 and (c) the largest tech companies have been active acquirers of revenues and intellectual capital. Below, we include charts on sales and earnings growth for larger/tech companies, how industry consolidation is now close to the 1969 peak and some history on falling antitrust enforcement actions.

Q1 2020: tech/large cap surviving pandemic best
y/y % change



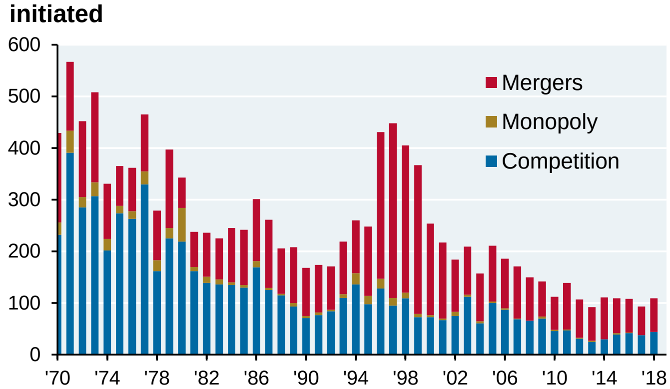
Source: Factset. May 24, 2020.

Industry consolidation now approaching prior 1969 peak
Revenues of largest 15 companies as % of US GDP



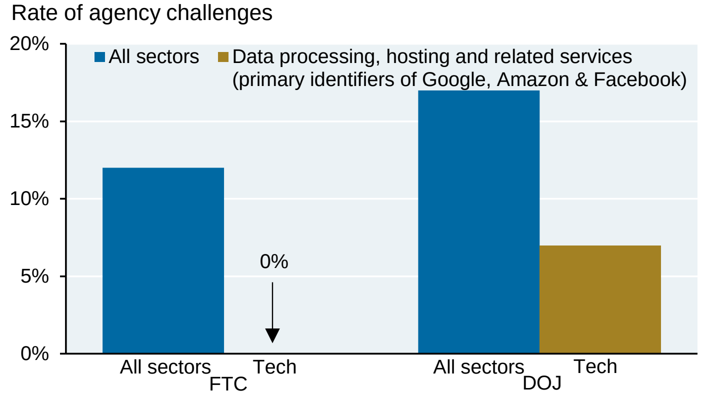
Source: Bloomberg, BEA, Fortune 500, JPMAM. 2020.

Number of Department of Justice antitrust investigations initiated



Source: United States Department of Justice. 2018.

Lower FTC/DOJ antitrust enforcement rates on tech sector
Rate of agency challenges



Source: Dr. Diana Moss, American Antitrust Institute. 2019.