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MACROCOSM

A Boom in 2021… But What Could Make It Bust?

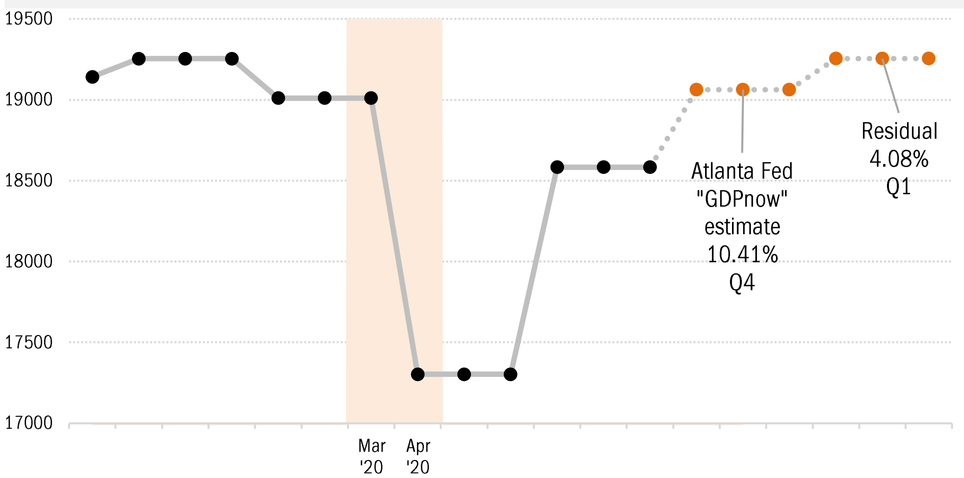
Monday, January 4, 2021

Donald Luskin

Georgia tomorrow is the first threat. Then inflation, rising yields, China and Iran.

The US economy is on track to achieve our seemingly crazy prediction made in early April, that the pre-recession level of GDP would be re-attained or exceeded by Q1-2021 – a classic three-quarters V-shaped recovery (see "On the March Jobs Report, and Being in Recession (Whatever that Means)" April 3, 2020). This will happen if the Atlanta Fed's "GDP Now" extrapolation of a 10.41% Q4-2020 plays out, followed by a 4.08% Q1-2021 (please see the chart below). These growth rates, or some equivalent combination, don't seem like too heavy a lift. If there's a miss, it will be a close one.

Real GDP before, during and after current recession USD billions SAAR



Source: NBER, BEA, Atlanta Fed, TrendMacro calculations

After recovery, we are expecting a downright boom in 2021 (see "Do We Need More Stimulus?" December 14, 2020). We'll briefly cover the reasons why we believe this. But because we're finding a great deal of acceptance of this among clients – a growing plurality consensus – and because there is some evidence of speculative froth in markets – for which we still expect a correction – *we will spend most of this report talking about the events that could happen in 2021 that would bust the boom*.

- *People have already grown risk-tolerant about being exposed to Covid-19*. It's different in the US from city to city and state to state, and different across nations of the world. But as a rule, personal immobility – the best proxy for substantive disengagement from

Update to strategic view

US MACRO, US STOCKS, US BONDS, FEDERAL RESERVE, OIL, ASIA MACRO: 2021 to be a boom year. People are already more risk-tolerant of Covid-19, and vaccines will make them more so. Eager to re-engage economically and socially, a surge of pent-up demand will be fueled by record savings thanks to foregone consumption and now two rounds of stimulus. We expect at least one of the two GOP candidates will win in Georgia tomorrow, but if both lose, Democrat control of the Senate would change the market's present optimistic calculus of policy risk. The most certain negative is imposition of higher corporate tax rates that would reduce after-tax S&P 500 earnings by 12% and punish CAPEX, and the treatment of dividends and capital gains as ordinary income. Restoration of deductibility of state and local taxes would be a partial offset. A consumption boom will lead to temporarily higher prices, but this should not permanently shift inflation expectations too far upward, nor cause the Fed to mistakenly tighten...

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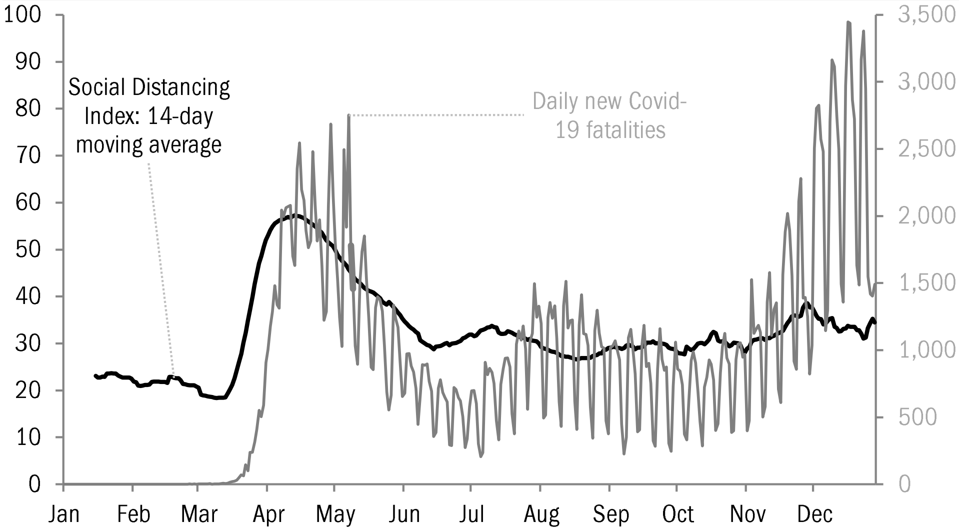
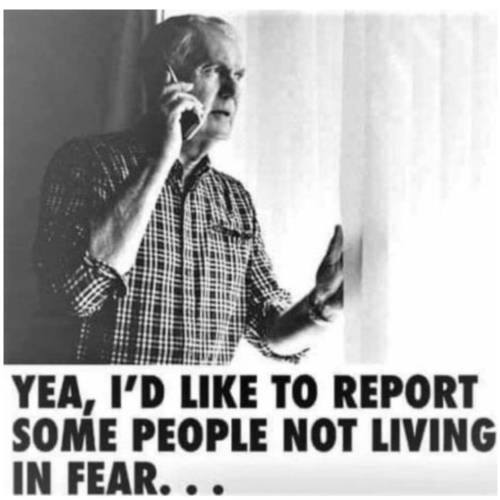
economic life – remains far below levels seen in the March-April lockdowns, even though the number of cases and fatalities is now the same or greater (please see the US chart below).

US economic immobility (SDI Index) versus Covid-19 fatalities (thousands)

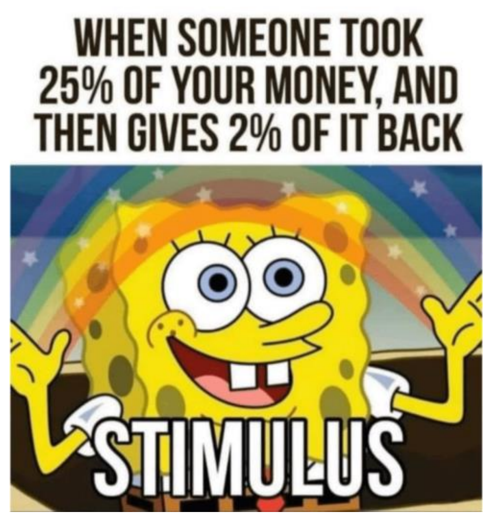


Source: [University of Maryland Transportation Institute], [Covid Tracking Project], TrendMacro calculations

- *Vaccines will increase this risk-tolerance, even for people who are not themselves vaccinated*. We're going to assume that the vaccines will prove to be safe and effective. Since medical workers are getting inoculated in the first wave, there's a lot at stake in the bet that they are safe. So far so good.



- *There is tremendous pent-up demand for re-engagement, economic and social*. Human beings are evolved over 300 thousand years to be hunter-gatherers who work cooperatively in bands – and to enjoy it. Not to work alone, not to work over Zoom. To be sure, there is tremendous variation among human individuals, and the more introverted ones prefer working alone or at a distance. But they, too, will fuel the boom, because *this year of experimenting with teleworking has proven that it is feasible, and if introverts choose to continue in that modality, it is because it will make them more productive participants in the economy*.



- *Pent-up demand for economic re-engagement will be fueled by record levels of personal savings accumulated in 2020*, both because consumption was curtailed during lockdowns, and because record stimulus and enhanced unemployment benefits were paid (again, see ["Do We Need More Stimulus?"]). We didn't see a

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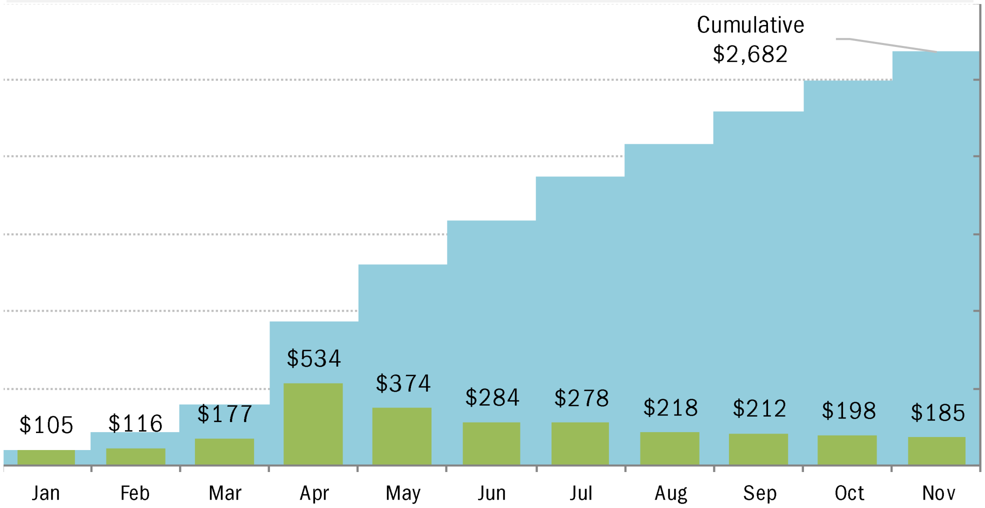
…Yields will rise, but this will be a symptom of growth, not a penalty on growth, as has been the case historically. Biden won't repeal Trump's tariffs on Chinese imports, but markets will enjoy the confidence that they are free of sudden disruptions arising from aggressive and unpredictable trade initiatives. China and North Korea may test Biden's strength with some form of adventurism. Iran is signaling a willingness to restart the Obama-era nuclear deal, and putting pressure on Biden by more aggressive steps toward nuclearization. Europe, Israel and Arab states are not on board without modifications. If the deal is restarted and sanctions are lifted, 2 million barrels per day of Iranian oil would flood an already glutted crude market, and prices would fall to levels that would risk recession in the US.

[Strategy Dashboard home]

second round of stimulus as necessary for economic recovery. And we're sure no one is thinking about the long-term costs and unintended consequences. Be that as it may, it is upon us, and by Q1-2021 it will likely drive the $2.7 trillion of savings accumulated through November 2020 to over $3 trillion by Q1-2021 (please see the chart below).

US monthly net savings (disposable person income minus outlays) USD billions, nominal



Source: BEA, TrendMacro calculations

Markets have already engaged to some extent with this scenario, but differentially. More speculative equities (such as Tesla) and assets (such as Bitcoin) have already caught the mood we think will prevail in 2021. This gives something of the impression of a bubble, and we continue to expect a near-term correction because of it (again, see "Do We Need More Stimulus?"). But cyclical stocks (such as energy, banks) have only just begun to return to life, as though finally tentatively believing that we are in a true business cycle, despite its strange origin, and that we will indeed complete the recovery from recession. Credit spreads are at record tights – capturing the exuberant element – yet long-term yields of government bonds languish near the lowest in history, with real yields still negative. *As our boom scenario plays out, we expect a rotation away from speculative securities that have already partially discounted it, into the cyclicals that mostly have not. We don't expect credit spreads to widen much, but we expect long-term government bond yields to rise.*

Now let's take a look at what could make us wrong…

GEORGIA *We expect the Republican party to retain Senate control by winning at least one of the two run-off elections tomorrow in Georgia. We think markets expect this, too.* They don't seem to be reacting to reversals in the polls last week, shifting from a tiny advantage for both GOP candidates to a tiny advantage for both Dems (after all, the polls were wrong in November for these races, as they were for nearly all races). *So a win by both Democrats – and the consequent loss of GOP Senate control – would be a surprise.*

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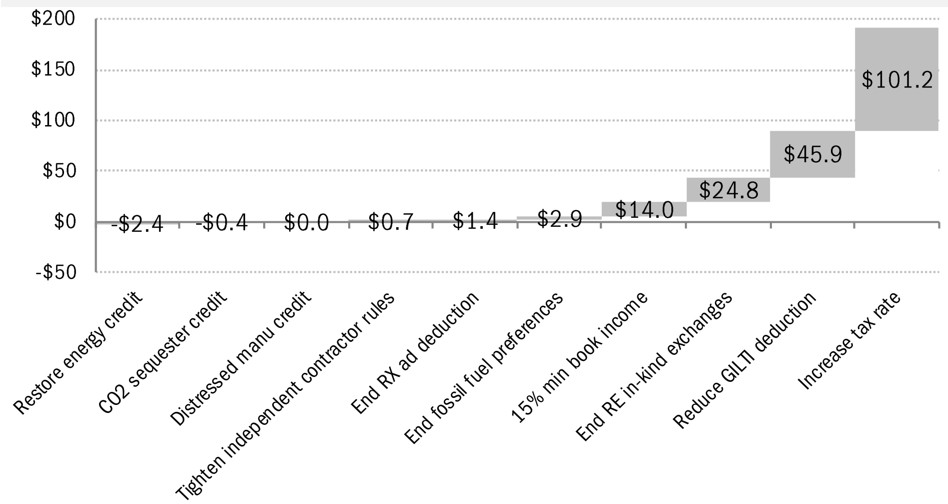
[About us]

- We think one of the reasons markets have been so "risk-on" after the November 3 election, despite the seeming loss of pro-growth Trumponomics, is that continued GOP control of the Senate is a firewall against the growth-unfriendly elements of Bidenomics. The election was not a "blue wave" that would have reflected an anti-growth shift in the electorate and the culture – that is, the election excised Donald J. Trump but not Trumponomics (see "No Blue Wave, But Now What?" November 6, 2020).
- Now, looking to tomorrow's Georgia run-offs, the GOP losing two Senate races in one state wouldn't signify a turning in the culture. Joseph R. Biden, the most conservative among the large Democratic primary field, would not suddenly have a "progressive" mandate that would fuel radical moves like packing the Supreme Court or admitting Puerto Rico to the union – though control of the Senate would technically make such things possible.
- *We worry more about anti-growth policies that are fully embraced by mainstream Democrats, such as the repeal of Trump's 2017 cut to corporate income tax rates*. According to estimates by the left-leaning Tax Policy Center, repeal would cost corporate America $188 billion per year, which from today's levels would reduce after-tax S&P 500 earnings by approximately 12% (please see the chart below, and "When Is Mr. Market Going to Start Worrying About President Biden?" July 27, 2020).

Corporate income tax burden: Biden plan 2022 change versus current law USD billions



Source: Tax Policy Institute, TrendMacro calculations

- *Biden also campaigned on taxing dividends and capital gains as ordinary income.*
- *Taken together, these moves would be a one-two-three punch to equity prices. First, it would reduce after tax earnings. Second, it would reduce earnings growth by disincentivizing capital investment. Third, it would reduce the after-tax returns to equity ownership. This would necessitate a downward revaluation.*
- There would likely be offsets, such as the reinstatement of the federal deductibility of state and local taxes. Setting aside the question of interstate fairness of SALT deductibility, at least it's a

tax cut (and as Milton Friedman said, we never met a tax cut we didn't like). *But a blow to capital by taxing its earnings and its returns to investors is a direct blow to growth, which would be difficult to easily offset by tax cuts on labor income.*

- To be sure, with the 50-50 Senate that the Democrats would have if both Republicans lose in Georgia tomorrow, while budget legislation is filibuster-proof and Vice President Kamala Harris could break a tie, all it would take to derail the legislation would be one defection by one Democrat such as West Virginia's Joe Manchin. Democrat control in the House of Representatives will be very narrow, too.
- *All that said, we see this kind of tax legislation as so plain-vanilla in the minds of mainstream Democrats that we have to believe it would have a good enough chance of passage that markets would have to regard loss of GOP Senate control as an adverse event – and a surprise.*

BIDEN'S HEALTH We didn't put our political disclaimer on page one of this report, so maybe we shouldn't venture into this topic. We'll keep it brief. Just think of it as one of those Byron Wein pseudo-predictions – something that probably won't happen, but it might, and people may not be thinking about it enough (and we will look like visionary geniuses if it does). Namely, *Biden – inaugurated as president at age 78 – could die or become ill enough to have to leave office* (actuarially, his life expectancy from here is 9.8 years, but who knows).

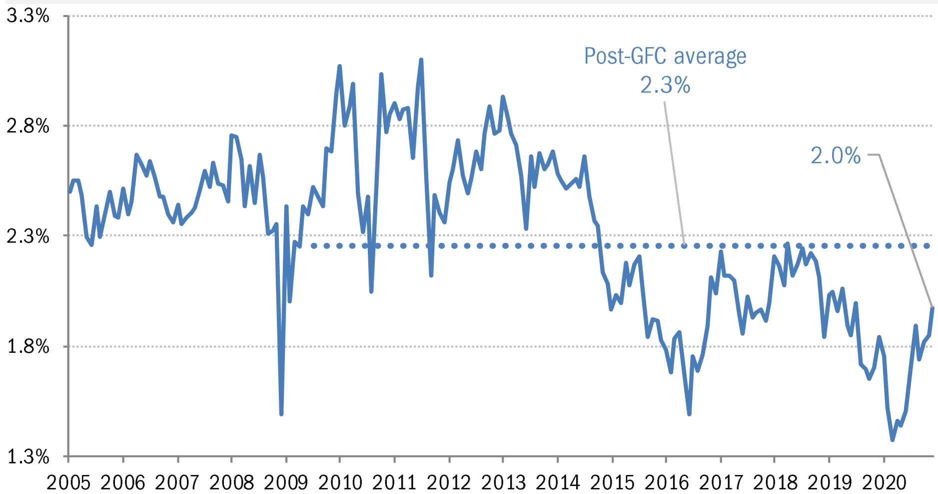
US stocks famously experienced an 11% correction over just a couple weeks when Dwight D. Eisenhower had a heart attack in September 1955. Markets apparently were skeptical that Richard Nixon would be a steady hand on the tiller – as indeed ultimately they judged him not to be 13 years later. We think it is worth considering that markets could be skeptical that Kamala Harris would be ready this year, if Biden's incapacity were to call upon her. That wouldn't have to bust the boom, but we think it would at the very least be a risk-off time for markets.

INFLATION AND INTEREST RATES *We think a 2021 surge in pent-up demand, fueled by record savings, will result in inflation*. It's important to clarify that all we mean is a temporary increase in the price level driven by a temporary mismatch of demand over supply, measured against a year-ago baseline when there was a temporary mismatch of supply over demand. We do not mean "monetary inflation," that is, a debasement of the unit of account by the central bank. *Such debasement hasn't happened. All the Fed has done is provide bridge-loans in an emergency, and a fixed-for-floating swap with the banking system* (see "On the Fed's

Massive Intervention" March 23, 2020). *It is the Congress, through two stimulus programs, that has performed a "helicopter drop of money."*

- There have been two stimulus programs, but markets are unlikely to think they will be regular events, especially as the economy booms. As time passes, the low Q2-2020 baseline will pass out of the data. And supply will arise to offset any shortages. *So there is no reason to think that rational inflation expectations would be permanently shifted higher. Therefore this inflation episode will only be temporary, a pig in a python.*
- Long-term inflation expectations have already rallied back from their lockdown lows, but are still well below their post-Global Financial Crisis average, an average which itself is thought uncomfortably low by central bankers (please see the chart below). So as inflation runs in 2021, there's plenty of space in expectations where "higher is better" before we get to the territory where "higher is dangerous."

5-year TIPS inflation breakeven, five years forward (based on Consumer Price Index)



Source: Bloomberg, TrendMacro calculations

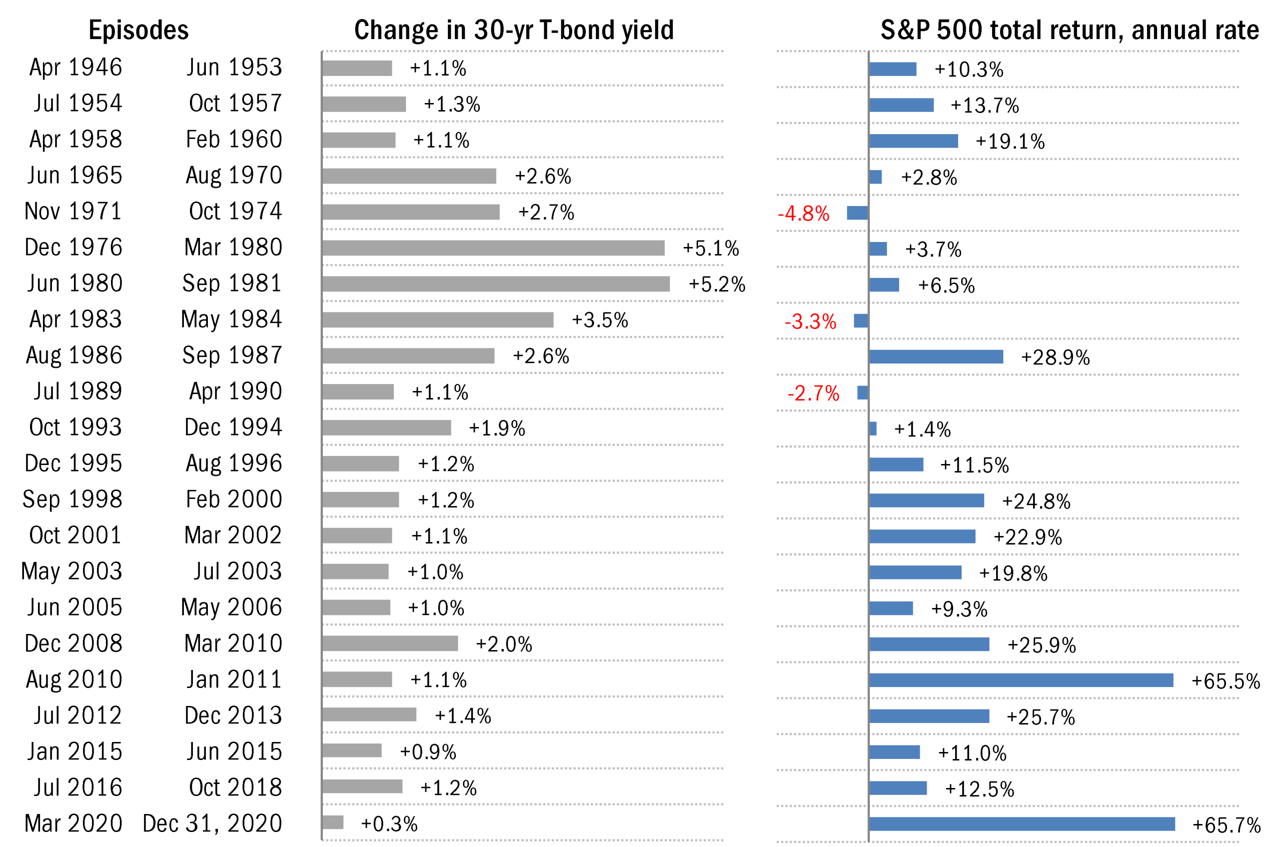
- An unlikely dangerous shift higher in inflation expectations isn't the only risk. *It is also possible that the Fed will mis-read the temporary bump in inflation we expect, and falsely believe it requires policy tightening that will, in fact, be totally unnecessary and destructive*.
- We see this risk as quite remote. Remember, the Fed avowedly wants to shift inflation expectations somewhat higher. That, after all, is the explicit purpose of the new "average inflation targeting" regime (see "Powell at Jackson Hole, and the Inflation Makeup Strategy" August 27, 2020). The Fed will permit overshoots above its 2% target so that *average* inflation will be 2% (on the theory that inflation expectations reflect an average which, under the prior regime in which 2% was a cap, would have had to always be below 2%).
- Separately, it is comforting that Fed chair Jerome Powell seems to see, as we do, that an inflation bump in 2021 won't be a durable monetary phenomenon requiring a monetary policy response.

When asked about the prospect for a 2021 inflation up-tick at the press conference following the December FOMC meeting (see "On the December FOMC" December 16, 2020), Powell said:

"…that has all the markings of a transient increase in the price level. So you can imagine that as people really want to travel again, let's say, you know that airfares – I'm just imagining this, right – that they go up. But what inflation is, is a process whereby they go up year upon year upon year upon year. And given the inflation dynamics that we've had over the last several decades, just a single sort of price level increase has not resulted in ongoing price level increases."

- *So we can be confident that the Fed won't even breathe a word about lift-off from zero policy rates in 2021.*
- *A related concern is that a 2021 boom will drive yields higher, choking off growth and providing competition for equities for which, now, "there is no alternative."* We entirely dismiss such concerns, although we acknowledge that yields will very likely move higher in 2021, and that will at least provide some headline risk.
- *First and foremost, we hew to the axiom that there is nothing wrong*

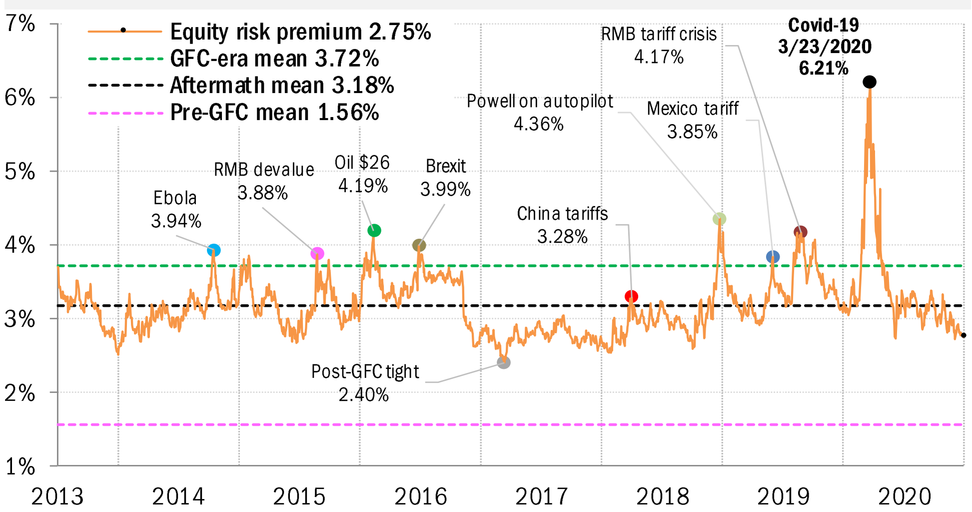
Back-ups in 30-year Treasury yield (Month-end data except for most recent end date)



Source: Various, Bloomberg, TrendMacro calculations *with rising yields when they were too low to begin with. Too-low yields imply safe-haven demand for bonds, deflation risk, and the lack of economic opportunity in riskier assets. From that starting point, rising yields imply a renaissance of risk-tolerance, reflation and growth opportunities.*

- History clearly bears us out on this. In the post-war record, there have been 22 episodes in which long-term Treasury yields have notably backed-up (we include the present episode, in which the 30-year yield has backed up from all-time lows at 70 bp in March). *In all but three yield back-up episodes, equity total returns were positive* (please see the chart on the previous page).
- So far in the present episode, the reflationary element of the back-up in long-term yields predominates. It's clearer to use the benchmark 10-year Treasury yield to explain. Bottoming at 0.31% on March 9, the nominal 10-year yield has backed up 63 bp to 0.94%. However, from the same starting date, the TIPS inflation compensation component has backed up by 101 bp from 0.99% to 2.00%. That means *real yields have actually fallen by 38 bp since the worst of the lockdown crisis. At negative 1.09% now, they are not far from their August low at negative 1.12%, the lowest in the history of the data. This is one reason that while we note certain sectors of the equity market seem frothy, underlying confidence in a booming 2021 is far from universally discounted.*
- The equity risk premium between the S&P 500 forward earnings yield and the 30-year Treasury yield is a little below the post-GFC mean (please see the chart below). A back-up in the 30-year yield lowers the ERP linearly, basis point for basis point. All else equal, it would take a further 50 bp back-up to lower the ERP to its post-GFC low in March 2017 (which was the occasion for a small and brief correction in an unusually low-volatility year).
- But the history of good equity performance in the face of yield back-ups is because all else is rarely equal. *The reflation and improved*

S&P 500 equity risk premium versus 30-year US Treasury in the post-GFC era



Source: Various, TrendMacro calculations *growth prospects implied by higher yields are typically reflected in growth-sensitive and reflation-sensitive nominal forward earnings*.

CHINA AND TRADE In our post-election round-up of our views on Biden's policy framework, we deferred dealing with his approach to China (see "How Will Biden Govern?" November 20, 2020). *We don't expect to see a lot of change. But that is a significant prediction, because when it came to China, Trump made markets deal with a lot more change than they wanted. Gone are the days when markets will wake up to Trump tweets announcing unexpected new tariffs on China* (see "On Trump's Tariff Tweets" May 6, 2019), *or for that matter, announcing tariffs to be used as weapons to achieve non-trade goals* (see "Video: What you're not hearing about Trump's tariff gambit with Mexico" June 9, 2019).

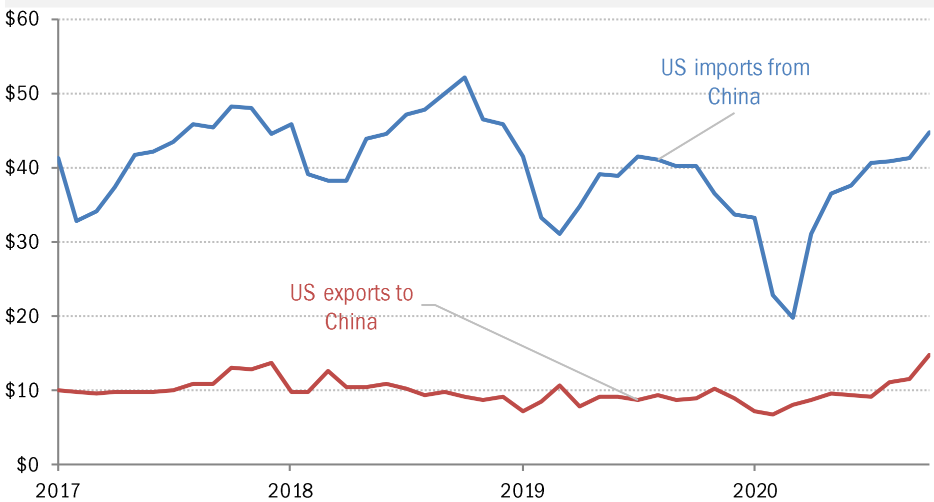
We applaud Trump for calling out China as a bad faith trading partner and an increasingly tyrannical force in the world, and having the courage to act on it when no other nations would. And we understand that his negotiating posture was strengthened by acting unpredictably. But calm is good. At least it's good for the equity risk premium. Note that three of the five Trump era peaks in the ERP were associated with tariff threats (please see the chart on the previous page).

- We don't accept the simple paradigm that Trump was a "protectionist" and Biden is a "globalist." Yes, they likely have different concepts of how America should exert leadership in the world. And they likely have different tastes for risk-taking on the global stage. *But Trump's China-bashing only channeled and amplified an American mood already in place when he arrived – a mood that Biden will have to cater to no matter what he may personally wish.*
- Biden explicitly campaigned on a "Biden-Harris Plan to Fight for Workers by Delivering on Buy America and Make It in America."
- After the election, Biden told globalist *New York Times* columnist Thomas Friedman he will "make sure we're going to fight like hell by investing in America first." Friedman explains: that means Biden will use "some good old American industrial policy — massive, government-led investments" – that is, subsidies.
- By the way, *neither Biden nor Friedman seem to have noticed that Biden used Trump's slogan, "America first." That's appropriate, because Biden seems to be committing to carrying on Trump's policies by different means: subsidies are the equivalent of tariffs in the algebra of protectionism.*
- As to Trump's tariffs, Biden told Friedman he has no immediate plan to repeal them, nor withdraw from Trump's Phase One trade deal with China (see "Trump's Beautiful Monster" January 16, 2020).
- Why shouldn't he keep them? Just because during the campaign he told reporters he wouldn't? Besides, if the Democrats don't control the Senate and can't raise corporate taxes, they'll want the tariffs as revenues (they are, after all, corporate taxes). Biden would also need the Senate to legislate the subsidies he may see as a replacement for the tariffs. *So assuming at least one GOP*

candidate wins in Georgia on Tuesday, the tariffs likely aren't going anywhere.

- Biden repeated to Friedman the often-heard but chimerical idea that China can be dealt with by the US getting "back on the same page with our allies" – a version of carrying out protectionism via globalism, one might say. It's hard to make this work because [China does the same thing](#).
- *And then there is the fact that, by the numbers, it may be the case that Trump's go-it-alone tariffs have actually worked, at least if what we wanted to accomplish was to narrow the trade deficit with China*.
- US *exports* of goods *to* China are now at all-time highs, while US *imports* of goods *from* China are well below the 2017-2018 highs (please see the chart below). It's hard to tell how much the Covid-19 crisis has affected the trade numbers, but at least at a casual glance at this point they seem to have absorbed it and moved on.

US trade in goods with China Monthly, USD billions, nominal, not seasonally adjusted



Source: Census Bureau, TrendMacro calculations

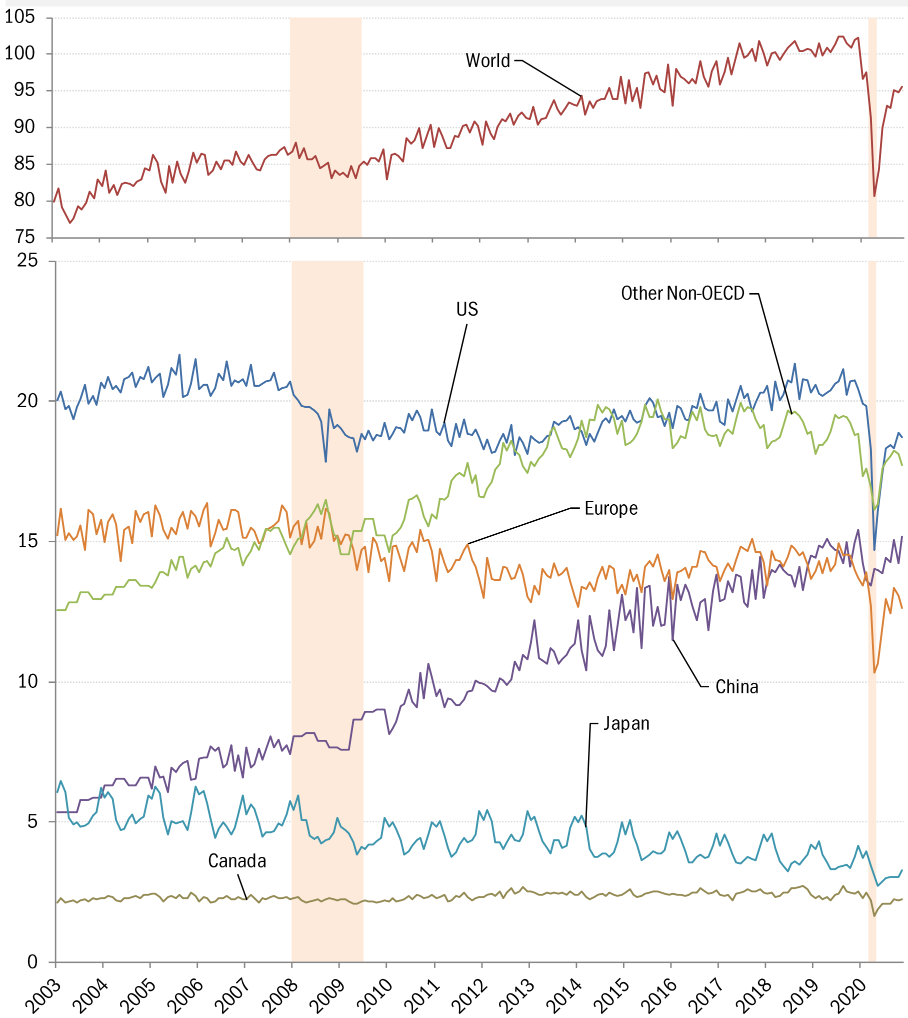
- Biden won't want to be seen as being "soft on China" by removing Trump's tariffs – but he can't be seen as "tough on China" unless he "does something." The lowest-hanging fruit would be sanctions as punishment for human rights abuses. Trump has already done a lot of that, but it's not hard to think of more entities to sanction for more reasons, perhaps environmental.
- *We worry that after Trump, an especially belligerent and mercurial president, China might test Biden by carrying out some aggression – with the unlikely worst case example being an attack on Taiwan*.
- We note that China artfully made its move to politically absorb Hong Kong – having waited over twenty years to do so – at the very bottom of the Covid-19 economic depression. That was a moment in which the US, even under Trump, was too weak to risk the damage that would have arisen from a robust economic counter-response (see ["How Worried Should We Be About Hong Kong?"](#) May 28, 2020). Other than Trump's rescinding China's

most favored nation status, there was pretty much no response at all.

- In a booming 2021, China won't have that kind of moment of weakness to exploit. And Taiwan's military is different from Hong Kong's – it has one.
- If we had to nominate a candidate for the number one geopolitical risk, it would be North Korea's return to testing nuclear weapons and ICBMs. Such a move would not be made without China's tacit consent or encouragement. We don't see how that, alone, could interrupt the 2021 boom we're expecting. As an aside, if it happens, it will be interesting to see how the Biden administration and the media manage to blame Trump for it (rather than his absence).

OIL PRICES, IRAN AND REGULATION We find that convincing clients of the salience of this risk is a heavy lift, but here goes. *In 2021, oil prices will likely drift higher as demand returns, but there is a real risk they will remain too low under certain policy scenarios. Too-low oil prices are a recession risk for the US and global economies* – we saw it when they were a precursor to a near-recession in 2015-2016 (see "On the December

Crude oil consumption, millions barrels per day Recession



Source: DOE EIA, NBER, TrendMacro calculations

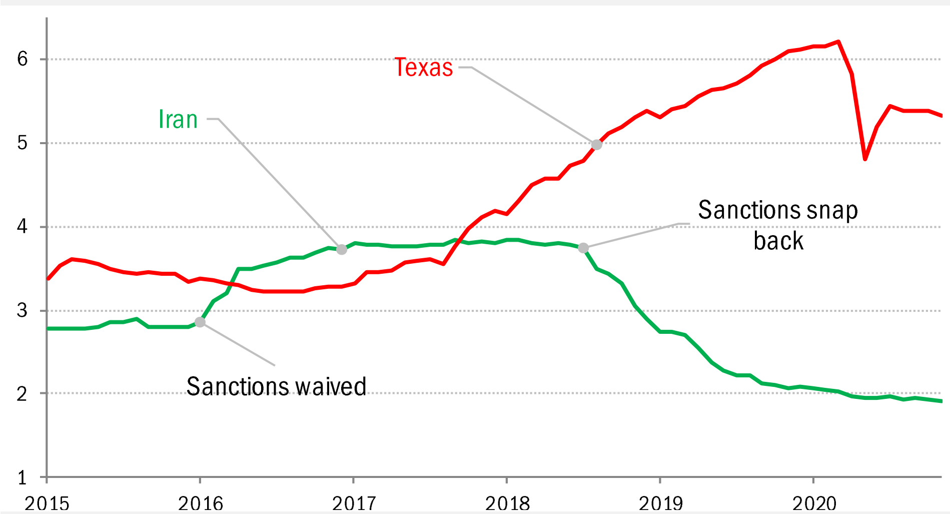
Jobs Report" January 8, 2016), and again when they multiplied the severity of 2020's lockdowns (see "Just What We Didn't Need: An Oil Price War" March 8, 2020).

- In a nutshell, oil prices are too low – that is, they are recessionary – when they deprive the global petrodollar economy of liquidity, lead to political instability in third world oil producing countries, create unemployment or CAPEX collapse in first world producers, or, worse, threaten systemic financial risk in countries where oil production is highly leveraged (the US is the leading example, with 17% of the high-yield bond market issues by the energy sector). The near-miss recession of 2015-2016 is an example of these forces at work (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- We have long argued that the innovation of fracking for crude will, in the long run, restore the oil price to its long-term mean – $38 in today's dollars, since 1861 (see "I Have Seen the Future, and It Fracks" February 24, 2015). We're not that many years away from that being a feasible equilibrium between buyers and sellers, but cost-functions today are such that $38 is still low. Not catastrophically so – but what we worry about a bust case that could derail the 2021 boom is a price lower than that, driven by policy error as demand gradually recovers.
- Crude demand has already substantially recovered world-wide, but it still has a long way to go to get back to pre-lockdown peaks, and even further to get back to pre-lockdown trend levels to which prior CAPEX had been targeted (please see the chart on the previous page). Because *oil is primarily a mobility fuel*, and because the world has learned during the lockdowns ways to be more productive with less mobility, oil consumption will likely recover tardily compared to other economic indicators during a booming 2021.
- *The key to restoring pre-crisis prices is policy – to coordinate the restoration of supply to the restoration of demand. The burden of it falls primarily on the OPEC-Plus cartel, which always wrestles with the trade-off between supporting prices with production quotas (on the one hand) and earning market share with increased production (on the other hand)*. The cartel made this trade-off very poorly in March when demand collapsed, opting for a horribly destructive price war (again, see "Just What We Didn't Need: An Oil Price War") that ultimately saw US prices briefly go outright negative (see "On the WTI Crash" April 20, 2020).
- OPEC-Plus appears to have learned its lesson, and we expect at most a modest easing of quotas, synchronized with the recovery in demand, at its meeting today (which is still in session as of this writing).
- At the same time, US shale production is gradually recovering, assisted by the unexpected discovery that shut-in shale wells, when brought back online, seem not to need to be re-fracked to return to their prior levels of production and decline-curves (see "Shale Survives, and May Soon Thrive" December 8, 2020). For now, it's not policy that guides the path of restored US production –

it's the sheer economics of survival. Producers must not produce so much that they find themselves anywhere near where they were in April, with no place to store oil for which there was no demand. On the other hand, they have to produce enough to meet the next junk bond coupon payment. At least it's good news they can do that, simply by bringing back online shut-in wells that, today, are underground repositories of free cash-flow.

- *Other than another OPEC-Plus price war, the policy error that we worry about most is Biden's potential lifting of sanctions against Iran as part of a restart of the Joint Comprehensive Plan of Action – known best as the "Obama Iran nuclear deal." Setting aside arguments about regional stability and nuclear non-proliferation, a certain consequence would be Iran's re-emergence as a global oil exporter, adding 2 million barrels per day of supply to a market already facing a severe residual demand shortfall.*
- The global crude market was already in a glut before the Covid-19 crisis hit demand, requiring OPEC-Plus production cuts to keep prices stable, even with Iran on the sidelines (see "Don't Panic Over the Saudi Attack and the Oil Supply" September 18, 2019). This is because, since Trump pulled the US out of the Iran nuclear deal in May 2018 (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018), US production has expanded enormously. By the time the Covid-19 crisis began, Texas production alone had grown by almost the entire amount that sanctions had taken away from Iran (please see the chart below).

Crude oil production **Million barrels per day**



Source: Bloomberg, DOE EIA, TrendMacro calculations

- With the deal restarted and sanctions lifted, Iran would put 2 million barrels per day into an already glutted market. We believe OPEC-Plus would be unable and unwilling to make production cuts to accommodate this, so prices would fall to levels we would regard as too low – that is, recessionary. The positive offset to consumers would not compensate, just as it did not in 2015.
- Biden campaigned on getting back into the deal. Post-election, the advisors he has appointed are confirming it. Iran's president

Hassan Rouhani has said Iran would rejoin the deal "an hour after the US does so." The US would have to go first – lifting sanctions – followed by Iran's compliance with enrichment limits, materials storage and centrifuge deployment. Rouhani insists that the deal be restarted as originally constituted, that it is "non-negotiable." Or at least that's the opening position – but it does signal Iran's interest in getting back in the deal. *A stronger indication of interest is Iran's pressure-play over the weekend, its announcement that it will immediately move even further out of compliance – and its claims today that it seized a South Korean tanker in the Persian Gulf.*

- *So Iran's interests seem clear, but the question is what Biden's interests are.*
- With Rouhani up for election in six months, Biden may see a short window of opportunity that might match his desire for an early win on a signature initiative.
- But it's complicated, because the world has moved on since the deal was originally struck, and since Trump pulled the US out of it. Trump's Israel-centered approach to Middle East diplomacy racked up several big wins in the form of bi-lateral peace deals. Now Israel and several Arab nations are demanding a seat at the table if the deal is to be renewed, having been virtually excluded from the conversation at the beginning in 2015.
- And there are growing voices in Europe – the "allies" Biden says he wants to repair relationships with – that the deal should be renegotiated to include constraints on Iran's support of terrorism by non-state actors. *Europe has scope to take a tougher stance now than they did in 2015, precisely because the rise of the US as a crude oil production powerhouse has reduced dependency on Iranian crude.*
- *It's complicated for Biden domestically, too, because nuclear diplomacy has to interlock with green energy policy.*
- On the face of it, a US environmentalist would like to see Iran's oil stay in the ground (they would like to see *all* fossil fuels stay in the ground). And a US environmentalist would not want to see oil prices fall – and we think they *would* fall a lot if Iran's sidelined 2 million barrels a day come back on the market – because that would make fossil fuels not only more abundant but cheaper in comparison with green alternatives. *For the moment, that gives US environmentalists and US frackers a common cause – they both want higher prices.*
- *On the other hand, a certain kind of US environmentalist would like to see the US fracking industry destroyed by too-low prices.*
- Without flooding the global market with Iran's oil, such environmentalists will have to be content chipping away at US fracking's growth. There are many ways to do it.
- The US Fish and Wildlife Service will rule early this year on the "endangered species" status of the dunes sagebrush lizard, a reptile that co-inhabits the Permian Basin with oil field workers. If ruled "endangered", it could slow down drilling in West Texas and New Mexico.
- At the same time, growth of drilling in New Mexico would be curtailed by cessation of permitting on Bureau of Land

Management-controlled federal lands.

- In the past, both Kamala Harris and Debra Haaland (Biden's nominee for Secretary of the Interior) have voiced support for shutting the Dakota Access Pipeline down. Haaland has personally participated in protests against it. The DAPL barely averted a shutdown last year, even under the energy-friendly Trump administration, after a court ruled to close it pending another environmental review. This would take Bakken crude off the market – which in the short-term would help support oil prices globally, but would obviously impose asymmetrical costs on producers in the Bakken.

Bottom line

We expect the V-shaped recovery to be completed by Q1-2021, and for 2021 to be a boom year. People are already more risk-tolerant of Covid-19, and vaccines will make them more so. Eager to re-engage economically and socially, a surge of pent-up demand will be fueled by record savings thanks to foregone consumption and now two rounds of stimulus. We expect at least one of the two GOP candidates will win in Georgia tomorrow, but if both lose, Democrat control of the Senate would change the market's present optimistic calculus of policy risk. The most certain negative is imposition of higher corporate tax rates that would reduce after-tax S&P 500 earnings by 12% and punish CAPEX, and the treatment of dividends and capital gains as ordinary income. Restoration of deductibility of state and local taxes would be a partial offset. A consumption boom will lead to temporarily higher prices, but this should not permanently shift inflation expectations too far upward, nor cause the Fed to mistakenly tighten. Yields will rise, but this will be a symptom of growth, not a penalty on growth, as has been the case historically. Biden won't repeal Trump's tariffs on Chinese imports, but markets will enjoy the confidence that they are free of sudden disruptions arising from aggressive and unpredictable trade initiatives. China and North Korea may test Biden's strength with some form of adventurism. Iran is signaling a willingness to restart the Obama-era nuclear deal, and putting pressure on Biden by more aggressive steps toward nuclearization. Europe, Israel and Arab states are not on board without modifications. If the deal is restarted and sanctions are lifted, 2 million barrels per day of Iranian oil would flood an already glutted crude market, and prices would fall to levels that would risk recession in the US.