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Potential opportunities as Congress weighs infrastructure

We expect President Biden's monumental fiscal package to provide a tailwind for equity investors.

Deeper analysis of investment trends and topics **June 3, 2021**

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Key takeaways

- President Biden's proposed $2.65 trillion American Jobs Plan and his $1.8 trillion American Families Plan seem likely to pass as proposed. We expect Congress to approve the spending proposals largely as proposed.
- We believe that the infrastructure spending plans could lift longer-term productivity and growth, potentially benefiting the Communication Services, Industrials, Materials, and Information Technology sectors and, particularly, the Utilities sector.
- Moreover, beyond the potential opportunities among our current list of favored equity sectors, we anticipate the American Job Plan's emphasis on clean energy, clean water, and improving underserved communities should continue to support environmental, social, and governance research and products and could expand the landscape of private capital investments into digital infrastructure.

Congress seems likely to approve President Biden's proposed $2.65 trillion American Jobs Plan and his $1.8 trillion American Families Plan spending provisions. We addressed the potential tax implications for investors in a pair of earlier reports.[1] Neither do we consider here the economic impact of the proposals. Instead, this report focuses on the potential equity sector opportunities in the proposed infrastructure spending provisions.

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[1] Please see our *Institute Alert* reports: "U.S. Investors Weigh proposed Tax Increases", part 1 on May 4, 2021 and part 2 on May 5, 2021.

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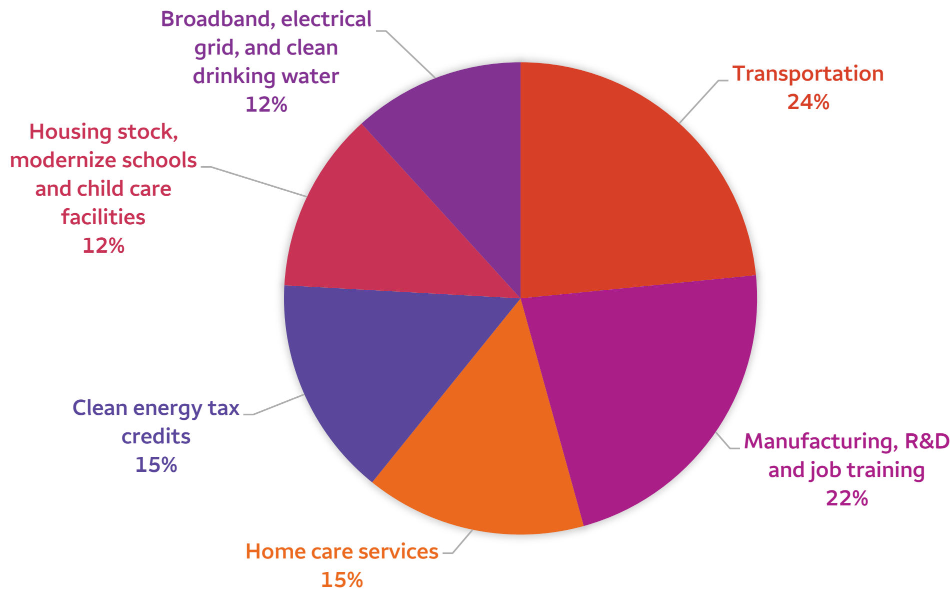
We believe that the legislation will include billions of dollars for projects related to transportation, manufacturing, housing, broadband, and clean energy. Although tax and infrastructure spending have been difficult for Congress to pass in recent years, and unforeseen political roadblocks may yet emerge, the stakes are significant enough for us to consider a high-level analysis of the proposal as it stands now.

The media have shown a variety of ways to group the proposed spending categories, but most show physical infrastructure between 70% and 80% of the total. Chart 1 shows one way of grouping the proposed spending items, this one by the nonpartisan Committee for a Responsible Federal Budget.[2]

Chart 1. American Jobs Plan spending allocation proposed by the president



Sources: Wells Fargo Investment Institute and Committee for a Responsible Federal Budget, May 13, 2021

Digging into the infrastructure details

The American Jobs Plan (AJP) targets 40% (as of the time of this writing) of the benefits toward climate and clean infrastructure investments to disadvantaged communities. And, the plan invests in rural communities and areas impacted by the market-based transition to clean energy.

- In its current form, over $600 billion would be appropriated toward enhancing physical infrastructure, such as roads and bridges, railways, airports, and water systems, including replacing 100% of the nation's lead pipes and service lines.
- The plan sets aside funds for worker training, research and development (R&D), and manufacturing incentives, in addition to $400 billion for in-home medical care for the elderly and people with disabilities. Another feature of the plan is the $20 billion worth of Neighborhood Homes Investment Act tax issued over five years to build approximately 500,000 homes for low- and middle-income families.
- As previously mentioned, climate change is a primary focus of Biden's plan, with over $200 billion set aside to modernize the U.S. electrical grid and foster the adoption of electric vehicles nationwide.

This magnitude of spending is well above what we saw from the Obama administration and the 2009 American Recovery and Reinvestment Act. Under that

2. "What's in President Biden's American Jobs Plan?" Committee for a Responsible Federal Budget, April 2, 2021, https://www.crfb.org/blogs/whats-president-bidens-american-jobs-plan

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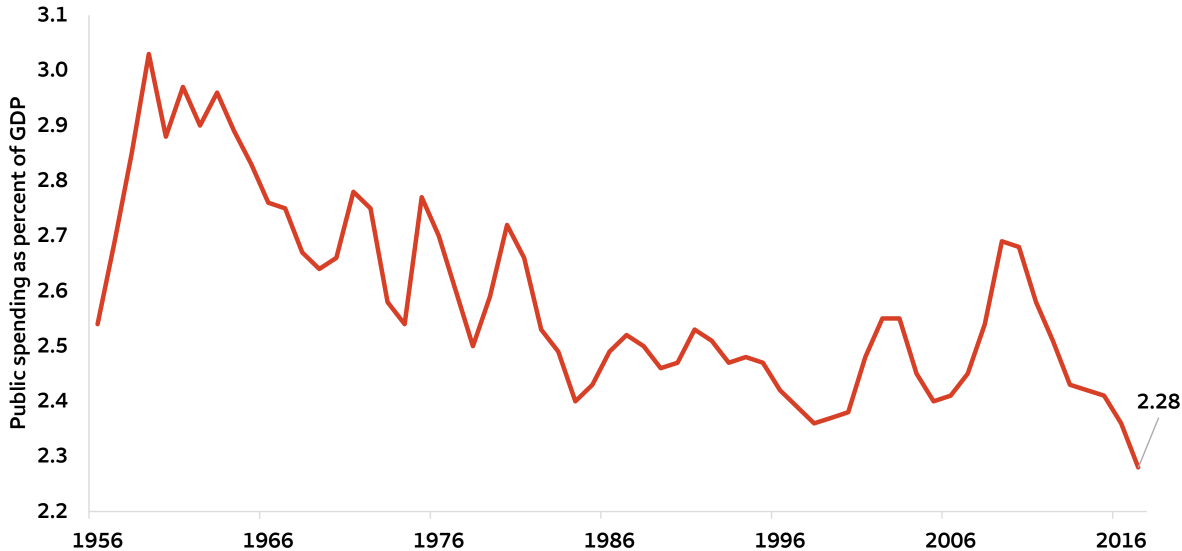
bill, approximately $308 billion was earmarked for highways, transit, energy efficiency, broadband, etc. Only 72% of this total was actually spent, and the bulk of the spending occurred later than anticipated — roughly 11% was spent in the first year, with the remaining 61% spent in the next two subsequent years (Chart 2). This level of spending was approximately 2.5% of U.S. gross domestic product (GDP); however, spending has been on a downward spiral since then. According to the Biden administration, the proposed package would amount to roughly $250 billion a year, or about 1% of annual GDP.

Chart 2. U.S. infrastructure spending as a share of GDP has declined



Sources: Wells Fargo Investment Institute and Congressional Budget Office, May 13, 2021. The solid grey line depicts the latest available data.

The sluggish dissemination of funds for the 2009 American Recovery and Reinvestment Act may somewhat dim the full anticipated impact of the proposed bill. Even if the bill fast-tracks through the legislative process, there are still potential bottlenecks that could occur from disbursing such a big increase in federal spending. Indeed, Biden's proposal is unlikely to have an immediate effect on the economy as spending is spread out over multiple years. Even so, we expect many company-specific beneficiaries, including a modest positive impact for some broader industries and sectors. As it stands today, we anticipate the S&P 500 Utilities sector likely would benefit the most. However, we expect proposed spending could also boost areas within the Communication Services, Industrials, Information Technology (IT), and Materials sectors.

It's important to note that the financial improvements to firms from the spending plan will take place over multiple years, and therefore we continue to maintain our current tactical guidance over the coming 6 to 18 months. Fortunately, many of our current sector preferences align with those sectors we believe most likely to benefit over the longer horizon of the planned AJP spending — including the Communication Services, Industrials, and Materials sectors. One notable exception is Utilities, which may benefit the most from the AJP as proposed but where we maintain a current unfavorable tactical view.

Utilities

The Utilities sector sits at the core of clean energy and emission reductions. It's likely to be a direct beneficiary of the AJP as President Biden reinforces his commitment to zero emissions by the year 2050. To this avail, the Utilities sector may receive a massive amount of funding, estimated to be roughly $384 billion over the next eight years. The spending will span multiple markets, including the electric vehicle market ($174 billion), water infrastructure ($111

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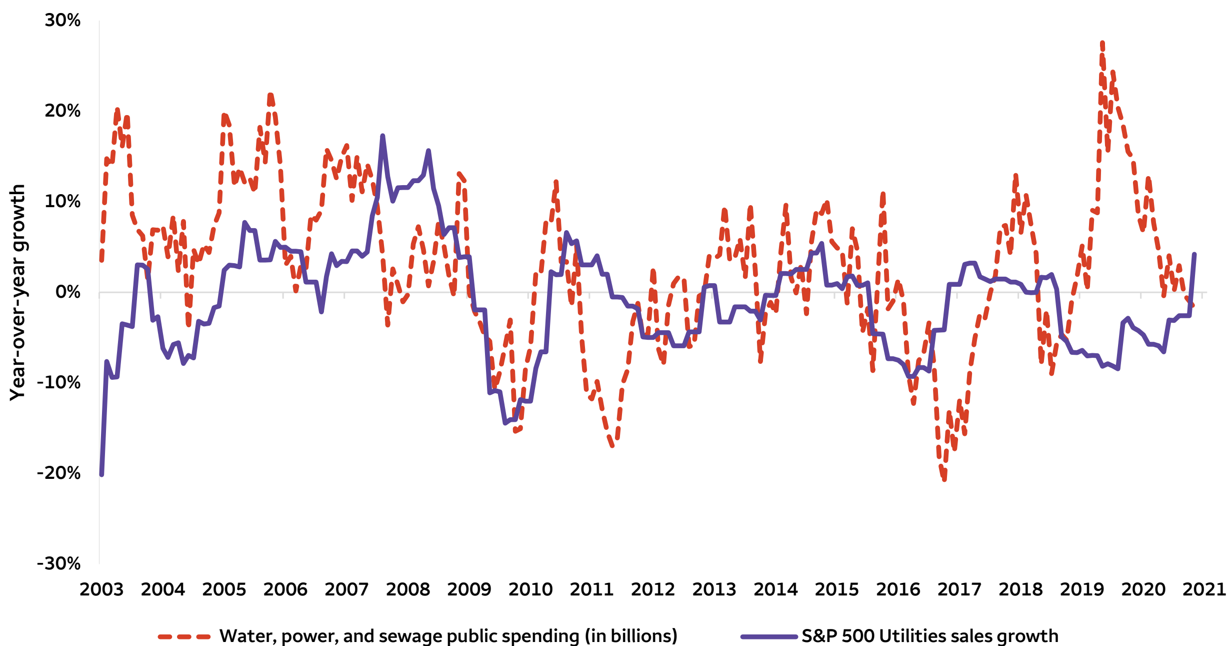
billion), and power infrastructure ($100 billion). As impressive as these numbers may be, they still fall short of the nearly $450 billion funding need estimated by the American Society of Civil Engineers.[3]

Government spending could bode well for revenue growth in the Utility sector. Historically, an increase in public spending has helped boost sales growth for Utilities firms. However, $1 invested today doesn't necessarily translate into $2 of sales immediately (Chart 3). The full ramifications of the AJP will take multiple years to convert to growth for Utilities firms — we estimate this could be anywhere between three and five years. While new federal spending could take several years to benefit Utilities generally, we favor patience over the shorter term. We maintain a most unfavorable tactical rating over the next 6 to 18 months, due to the near-term prospect of unattractive valuations as Treasury yields encroach on Utilities dividend yields and high fixed costs limit profitability.

Chart 3. Total public spending and S&P 500 Utilities sales growth



Sources: Wells Fargo Investment Institute, Bloomberg, and U.S. Census Bureau, May 13, 2021. An index is not managed and not available for direct investment**.** The red dotted line represents total spending. **Past performance is not a guarantee of future results.**

Industrials and Materials

The AJP could mean a substantial revenue boost for construction firms and their suppliers over the eight years of the proposal. We estimate this to be $322 billion, including improvements to roads, highways, waterways, and airports. This amount is over twice the amount spent last year, according to the Congressional Budget Office. In the past, spending focused on highways and other transportation contributed to the outperformance of the Industrials sector compared with the S&P 500 Index (Chart 4). Although Industrials have had an impressive run since the recovery began, we still believe there is more upside for the sector. Some of the beneficiaries of the proposed policy are firms under the capital goods industry group. All nine subindustries have seen multiple expansion since early this year; however, seven of the nine still have price/earnings valuations below the industry group average.

We already favor the Industrials and Materials sectors and believe other factors also will propel the sectors. Both sectors are cyclical and tend to perform well in

3 ."2021 Report Card for America's Infrastructure," American Society of Civil Engineers, 2021, https://infrastructurereportcard.org/

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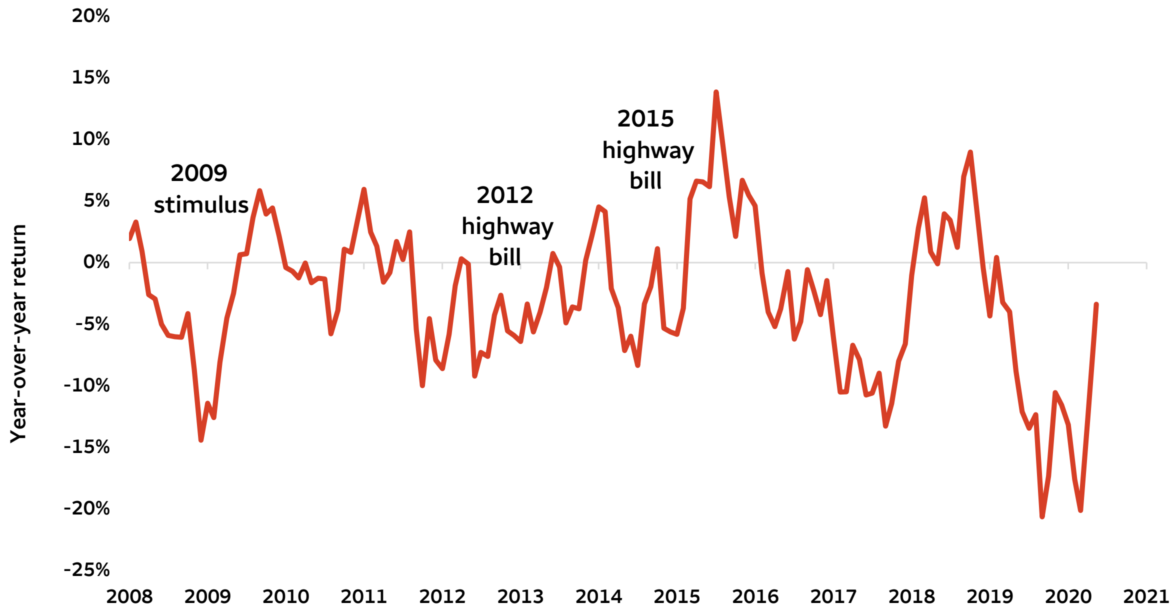
the early stages of a bull market. A key driver of revenue growth is global industrial production, which continues to edge higher as countries reopen. In addition, the halt in demand experienced last year has promoted supply-chain bottlenecks and shortages. This imbalance has increased the pricing power of Industrials and Materials firms, which we believe should support higher margins and free cash flow (amount of cash left over after expenses) over the next 12 months. Thus, unlike the Utilities sector, the Materials and Industrials sectors already have a favorable tactical (that is, 6- to 18-month) outlook. For them, the AJP is an additional tailwind.

Chart 4. Industrials sector performance relative to the S&P 500 Index



Sources: Wells Fargo Investment Institute, Bloomberg, and Congress.gov, May 13, 2021. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

Communication Services

The American Jobs Plan also allocates money over eight years to another sector we currently favor, Communication Services. The proposed AJP allocation of $100 billion is projected to expand high-speed broadband to underserved areas, mainly expanding access to rural communities. This expansion should directly benefit wireless carriers in the telecommunication industry group, representing approximately 15% of the overall sector. According to Organisation for Economic Co-operation and Development, the U.S. has some of the highest broadband prices compared with other countries. The proposed broadband infrastructure plan has a goal of reaching 100% high-speed broadband coverage within 10 years. According to the Federal Communications Commission, only 65% of Americans in rural areas have access to high-speed internet or broadband, and on tribal lands, barely 60% have access. In total, nearly 30 million Americans lack access.[4] We believe the wireless carriers could benefit from the plan as they continue to build out the infrastructure and deploy the large swaths of the recently acquired spectrum. The carriers will likely use the spectrum to fill gaps and densify existing infrastructure over the years in urban and rural locations.

Media and entertainment represent the remaining 85% of the sector's market capitalization. Lower broadband cost and increased coverage should increase sales for this group as demand broadens across more rural areas. Revenues for the sector proved to be resilient during the pandemic as consumers redirected their attention

4. "Bridging the Digital Divide for All Americans," Federal Communications Commission, March 2, 2021

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to firms with virtual capabilities. We anticipate that much of the customer flow will be sticky and should continue to generate revenue growth for firms in the sector as we move past the pandemic. We maintain a favorable rating.

Information Technology

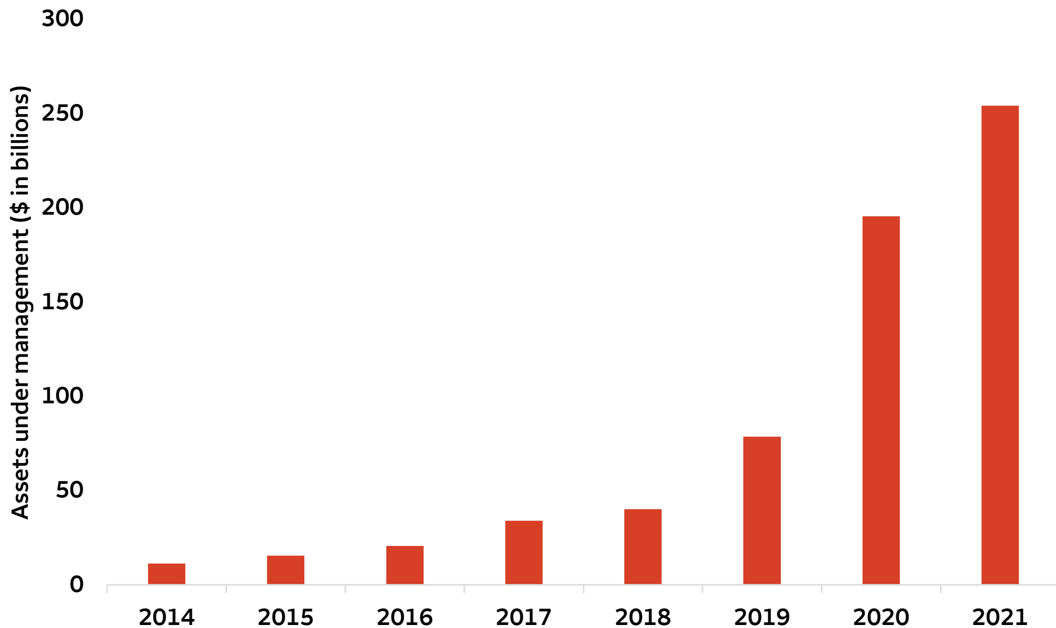
We expect the semiconductors and equipment industry group (representing roughly 50% of the IT sector) to benefit from the AJP. The sector industry group has experienced several supply constraints, which could worsen in the near term as demand strengthens from an improving global economy. President Biden's proposal has allocated $50 billion toward investments in domestic semiconductor manufacturing. While spending is a positive for the sector, higher corporate taxes are a negative. The Biden tax proposal disproportionately targets the IT sector (in particular, multinational semiconductor firms), which could offset some of the government funding.

Similar to Communication Services, IT exhibited resilience throughout the pandemic, and the sector remains a pillar for high-quality assets with low leverage and high cash flows. However, valuations remain well above historical averages, leaving the sector vulnerable during periods of rising interest rates. The balanced risk outlook leave us neutral on the sector.

Nontraditional investment opportunities

Embedded in the infrastructure package is spending related to climate change. The segments that we believe stand to benefit include renewables (wind, solar), clean transport (electric vehicles, batteries, fuel cells), clean fuels (hydrogen, biofuels), and clean energy infrastructure in general (transmission, battery storage). We believe these areas of investment could be attractive to investors who have interest in an environmental, social, and governance (ESG) approach to selecting investments. ESG investing has become an ever-growing and intricate part of investment portfolios (Chart 5). Some investment managers now include ESG considerations as part of their process for selecting investments.

Chart 5. Demand for ESG assets reaches new records in terms of assets under management



Sources: Wells Fargo Investment Institute and Bloomberg, May 18, 2021

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Final thoughts

Infrastructure is evolving. It used to be toll roads and bridges, and now it covers digital and social components from increased broadband down to Medicare for the elderly. The massive American Jobs Plan has elements that reach across a vast spectrum of sectors and industries. We believe this could provide opportunities for companies in traditional equity sectors, such as Communication Services, Industrials, Materials, and IT, and nontraditional assets, such as ESG products and private capital.

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Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks smaller, less-seasoned companies, tend to be more volatile than the overall market. The telecommunications sector is subject to the risks associated with rising interest rates which could increase debt service costs, competition, increased costs to providers due to potential for large equipment upgrades. Utilities are sensitive to changes in interest rates, and the securities within the sector can be volatile and may underperform in a slow economy.

Sustainable investing (ESG) focuses on companies that demonstrate adherence to environmental, social and corporate governance principles, among other values. There is no assurance that social impact investing can be an effective strategy under all market conditions. Different investment styles tend to shift in and out of favor.

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