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Thanks for the Dough, Uncle Sam

by Ben Levisohn

EVERYONE WHO'S ANYONE IS CALLING FOR the government to start spending. Just last month, JPMorgan Chase CEO Jamie Dimon cited "poorly designed corporate and individual taxes" and infrastructure spending as "serious issues that we need to address," a view echoed in recent weeks by BlackRock chief Larry Fink and onetime corporate raider Carl Icahn.

To listen to these Wall Street bigwigs, it's as if the government's hands are still tied by "sequestration," the automatic budget cuts imposed by Congress nearly five years ago. There's just one problem: The government is already spending more than it has in years.

In the past seven quarters, increased government spending has added to U.S. gross domestic product, and the $1.8 trillion budget passed in December should boost spending even more. It might not be the new New Deal that so many appear to want, but for investors, the fresh outlays are an opportunity.

It's not hard to see why fiscal spending has become a hot topic. The economic expansion is seven years old, and yet the U.S. economy grew by just 0.5%, annualized, in the first three months of 2016, the Commerce Department estimated last month. The Federal Reserve Bank of Atlanta predicts far-from-robust growth of 1.7% for the quarter that ends in June.

Monetary policy, meanwhile, appears to have reached the end of its effectiveness—just ask the European Central Bank and the Bank of Japan, which recently pushed their benchmark interest rates into negative territory, with little to show for it. No wonder investors have turned their lonely eyes to the government coffers.

They should be pleased with what they see. The U.S. passed a massive budget in December that boosted spending by $66 billion this year, while cutting taxes by $650 billion over 10 years. It included a $1.4 billion increase for military construction and $2 billion for the National Institutes of Health, and allowed companies to continue to write off half of their capital purchases during the first year, also an attempt to boost spending.

The spending additions and tax cuts could lift U.S. GDP by 0.6 of a percentage point in 2016, according to Strategas Research Partners data. No, that's not enough to knock the economy out of its funk. But it's enough to boost the stocks of companies that are on the receiving end of the government's largess. Tactical investors "should focus on the potential winners and losers," says Jason Ware, chief investment officer at Albion Financial Group in Salt Lake City.

And, boy, have there been winners. Defense stocks have surged. **Northrop Gruman** (ticker: NOC) has gained 12.3% this year and **Lockheed Martin** (LMT), 9.7%, besting a 0.3% rise in the Standard & Poor's 500 index. The companies that benefit from those capital-spending write-offs—including **Honeywell International** (HON), **Masco** (MAS), and **Rockwell Automation** (ROK)—have gained 8.5% this year, according to Strategas data. "The market realized that Congress did something big," says Strategas' Daniel Clifton.

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Other stocks have been less affected. That's because government cash doesn't always flow through immediately. Clifton points to the Strategas Large Cap Austerity Index—a basket of companies that could benefit most when the government spends, including **Harris** (HRS), **Jacobs Engineering Group** (JEC), and **Textron** (TXT). The index has gained 2.5% so far this year, but the companies in that basket could "get a leg up in the second and third quarters as spending starts to increase," Clifton says.

Quantitative easing has had diminishing returns, but that doesn't mean we won't see a fourth round of government bond buying. In fact, the market might already be starting to reflect the possibility, says Citigroup currency strategist Steven Englander. If investors see an economy that is strong enough to handle only one rate hike a year, if that, he says, they also have to factor in the possibility that it is weak enough to warrant more easing. That, in all likelihood, would require the Fed to resume its bond buying in order to jump-start growth.

In the past, that would have been good news for the stock market—QE is widely seen as having been responsible for some of the market's big gains since the financial crisis. Yet investors have long since given up on the Fed's bond buying as a means of repairing the economy. "There is so much skepticism at this point that the equity-market reaction is negligible," Englander says.

Instead, the reaction has been reflected in the dollar, which has tumbled 4.7% this year, and in Treasury bonds, whose yields have dropped well below 2%.

But don't expect a muted reaction if the Fed is actually forced to restart QE. That would mean something has gone truly, horrifically wrong with the economy, a development that would trump any benefits from the Fed's action—and batter stocks. Let's hope it doesn't come to that. ■

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