Private Bank

CIO Strategy Bulletin

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Taxes, Valuations and Post-Pandemic Portfolios

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In this 2-part CIO Bulletin we discuss the proposed changes to US corporate and individual taxation that are designed to pay for major spending bills in the US as well as global portfolio changes we have made as valuation disparities between markets and sectors grow in a post-pandemic world.

I. Joe Biden to Markets: I Told You So

You might be surprised to hear about a politician doing exactly what he/she said they would. On July 9, 2020, candidate Biden, speaking in Dunmore, Pennsylvania, said that he would raise the U.S. corporate tax rate from 21% to 28%, ensure that "Amazon" would pay income taxes (via a call for minimum taxes on global operations) and implement policies "laser-focused on working, middle class families." Earlier that day, Biden had proposed a $700 billion manufacturing and innovation plan to improve U.S. competitiveness with China. The campaign pledge for higher taxes was designed to realign incentives and priorities by "rewarding work as much as we reward wealth."

Looking at the news reports of the past week, we can see that President Biden's policy proposals are remarkably consistent with his pitch to voters. He has proposed a 39.6% top capital gains rate to match the top individual income tax rate. This rate excludes the added surcharge of 3.8% to fund Obama-era healthcare initiatives, bringing the top rate to 43.4% for those making $1 million or more from either wages (so called "earned income") or income from assets.

The proposed change in personal taxation follows Biden's recent proposals to increase corporate tax rates, similarly consistent with his campaign messages. The "Made in America Tax Plan" would increase the federal corporate tax rate to 28% from 21%. Taking into account state and local taxes, it would raise corporate taxes to 32.3% in the aggregate. The Tax Foundation estimates that these proposed changes would move the U.S. from 12^{th} highest in the OECD to the highest among all members. This assumes implementation of a global minimum tax, nicknamed "GILTI" (read that again) that imposes a 10.5% minimum tax on income earned abroad.

Given the consistency of Biden's current policy proposals with his prior campaign "promises" and the fact that he is determined to have a legacy of change relative to former President Obama (see our bulletin of March 28), we believe that the passage of a reconciliation bill with significant tax increases is highly likely. What this means is that proposed spending for infrastructure, green initiatives, education, elder care and childcare **will** be funded by the proposed tax increases, both corporate and personal, and **not require** more than the 50 votes held by the Democrats in the Senate. Of course, there is much to come in the negotiations **within** the Democratic party, so major changes in elements of the tax and infrastructure bills are likely. That said, the likelihood that there will be a bill for signature on Biden's desk by the Fall is similarly high.

Given these circumstances, there are several obvious questions for investors:

- Are stocks properly priced for the change in taxes, both corporate and personal?
- What sectors are most impacted?
- Will investor behavior(s) change as a result of these changes in taxes?
- To what degree does the increased government spending offset the higher tax rates?
- Does the change in US corporate taxation change the competitiveness of US corporations?
- Does the nature of infrastructure spending **increase** the prospect of a sustained US recovery?

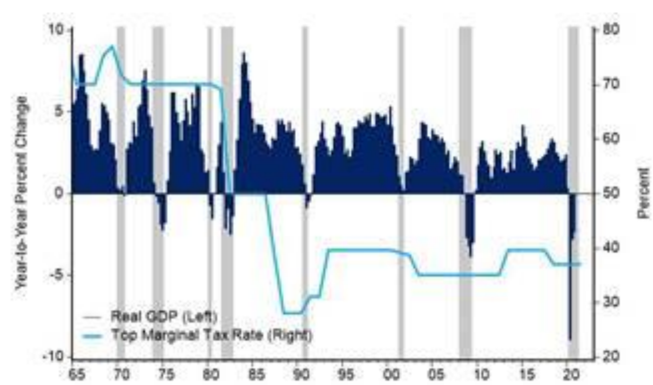
Proposals and Realities

The proposals formally introduced in President Biden's forthcoming address to Congress on April 28th will be aspirational. They will include both mighty increases in spending and taxation to address what his administration believes are chronic shortfalls in government support for working families (see figure 1). With a 50/50 split in the Senate and no likely Republican support for any of this legislation, the final bill will likely be very different than the one outlined in his address. For example, no prior administration has ever doubled the capital gains rate overnight and we doubt that this one will be the first.

As we discussed in our Bulletin of April 3, the size of government will not single-handedly determine the overall growth rate of the US economy (see figure 2). However, tax and spending hikes will, to some degree, alter the distribution of income and wealth in the US economy as intended.

Figure 1: Private and Public Share of US Economy (%) (Excluding Government Transfer Payments of Income)

Figure 2: Real GDP Growth and Top Marginal Tax Rate



Source: Haver Analytics as of April 23, 2021. Note: Shaded regions are recessions.

In fact, the capital gains tax rate does not have much correlation with US equity market performance. It is certainly a less significant factor in determining asset price values than the economy itself. And the strength of the economy is only partly explained by tax policy (see figures 3 and 4). With that said, comparisons with the most recent period of rapid growth in the US economy – the 1990s – and the widespread gains in wealth at that time will not be that relevant. In our view, the Biden Administration's proposed fiscal tightening will create some headwinds for investments and spending Which will have some impact on the overall rate of US asset returns.

Figure 3: US Capital Gains Tax Rate and S&P 500

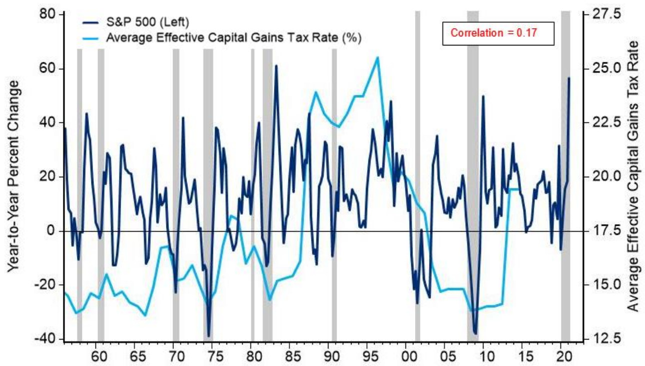
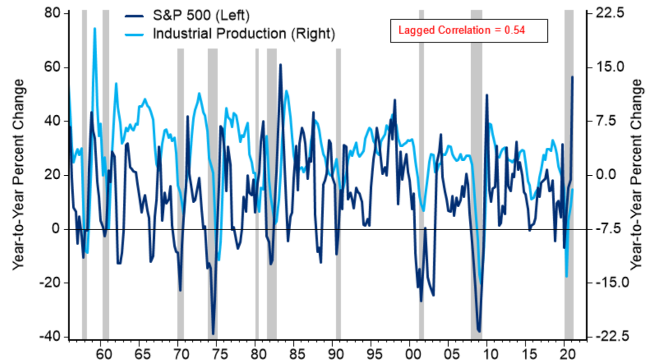


Figure 4: US Industrial Production vs S&P 500



Source: Haver Analytics as of April 23, 2021. Note Shaded regions are recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Lessons from 1993

The **Tax Reform Act of 1993** included increases in personal income tax rates, corporate tax rates and capital gains tax rates. It is the closest comparison to the current legislative proposals from the Democrats. The 1990s expansion – built upon seeds planted in the1980s - was driven by world-changing technological breakthroughs. It was coupled with a very strong rise in labor force participation by female workers and a sustained drop in inflation. Unlike what is planned by the Biden administration today, Federal spending grew *very slowly* in the 1990s. Private sector investment boomed.

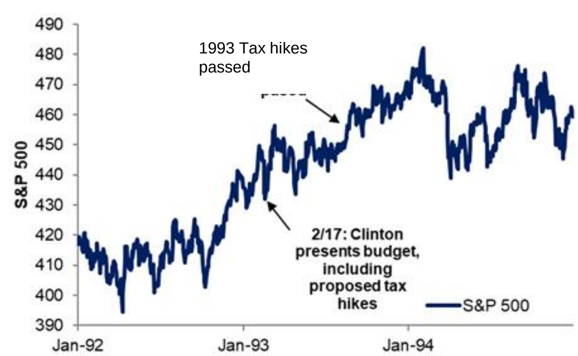
While strong technological innovations are everywhere now, in the 1990s they required massive new capital investments from a relatively low base. This was enabled by a plunge in the cost of capital and disinflation. Our *current* starting point of already low inflation and a slow baseline growth rate in the working-age population makes a repeat of the “1990s growth miracle” unlikely. Furthermore, as historical data on wealth and income distribution show, the 1990s did not provide widespread benefits to all industries and workers.

This past week, we did see shades of the 1990s reaction to news of the Biden capital gains tax plan. US shares fell 1% Thursday only to rebound (by that and more) on Friday. When the Clinton tax hike plan of 1993 was leaked to the press on February 15,1993, US shares fell 2.4% that day. Within a month, they had recovered. As the law was passed in the late summer of 1993, US shares were almost unchanged and finished the year with a total return of 10% (see figures 5-6).

Figure 5: S&P 500 Performance Around 1993 Tax Hikes

		1 Day	1 Week	4 Weeks
Clinton Tax Hike Leaked	15-Feb-93	-2.4%	-2.1%	1.5%
Passed Out of Committee	13-May-93	0.1%	2.6%	1.4%
Signed into Law	10-Aug-93	0.2%	0.8%	2.0%

Figure 6: S&P 500 Performance 1993



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Already last week, we saw liquidation of assets on the view that investors could lock in today’s 20% long-term base rate. But do not count on that. Much like the 1993 law, it seems likely that the Biden administration will push for the higher tax rate to be retroactive to January 1st, 2021. While unclear, it may already be too late to sell at the present tax rate if you are an investor subject to paying capital gains in the US. In fact, we expect that only municipal bond income may remain untouched in 2021.

Growth Will Continue…

As we wrote this past month, we believe a stepped up pace of US infrastructure spending will be stimulative for the US economy and a "net positive" in part because of the nature of the spending, and in large part because the corporate tax increases will be smaller and more drawn out than the increased expenditures. We do not expect a net decline in US corporate profits, but we do expect lower after-tax margins. We expect US competitiveness will suffer somewhat at the margin given that the likelihood foreign governments will move in tandem to equilibrate tax policies is very low.

As figures 7-8 show, the tech and healthcare sectors will see higher corporate tax rates relative to some other sectors. (In particular, the tech sector has a large share of firms that would be hit by the new minimum, global corporate tax rate). But the relative valuations of the two sectors favors healthcare (see figure 9). In fact, as discussed in the latest *Quadrant*, valuation and risks in other sectors led us to double our position in Healthcare even as we scaled back other equity holdings. In our view, Biden's "infrastructure" plan would likely see more revenue flow to the healthcare sector.

Figure 7: Potential change in effective tax rates by sector

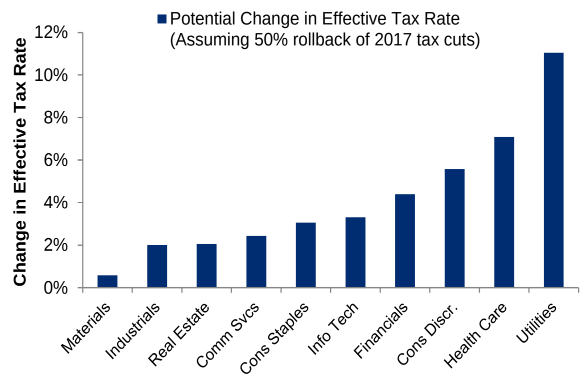
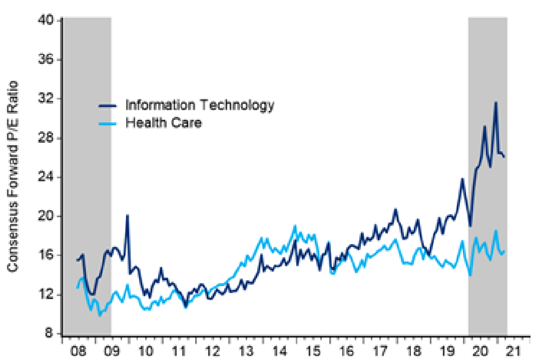


Figure 6: Number of US firms potentially subject to 15% minimum tax

Source: Bloomberg as of April 22, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 9: S&P 500 Healthcare and IT Sector Forward Valuation



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But Higher Taxes May End US Equity Outperformance

Higher Federal Spending and higher individual and capital gains tax rates will most certainly influence the economy in 2022 and beyond. However, it may be the US's decision to raise corporate tax rates in isolation that finally ends US equity outperformance (see figures 11-12).

Therefore, while we are more bullish on US growth this year than in any other Developed Market economy, the performance of US shares in 2020 and 2021-to-date suggests potentially more limited returns for domestic equities opportunities. We believe now is a time when risk management – for example, using hedging tools to potentially limit downside risk, generate income and control entry points for equities investments may be appropriate.

Figure 10: S&P 500 EPS level and Price including consensus estimates for 2021 and 2022

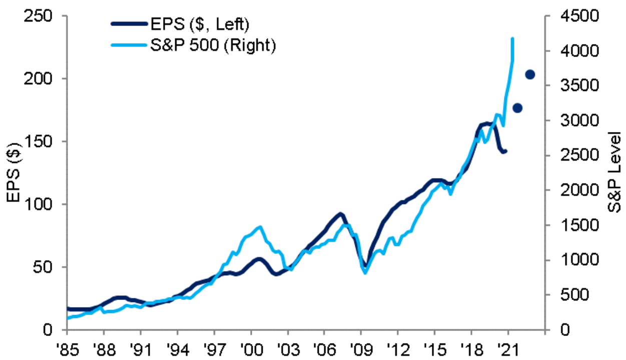
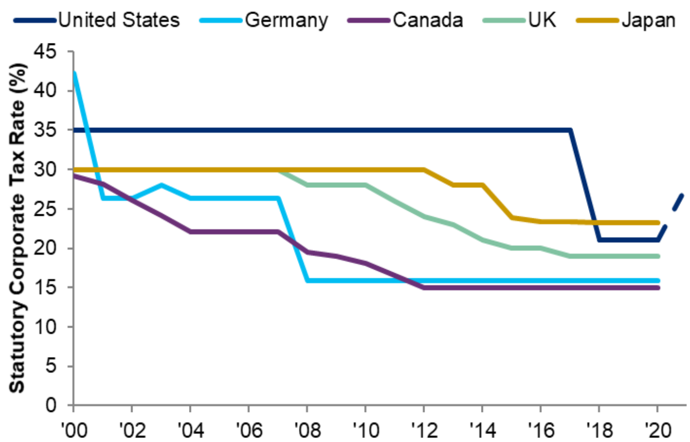


Figure 11: **US vs Non-US Forward P/E**

Source: Haver Analytics as of April 23, 2021.. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Figure 12: US Corporate Tax Rates vs Trading Partners (Including Prospective US Increase)



Source: Haver Analytics as of April 16, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

II. Post-Pandemic Portfolio Positioning: What We Are Doing Now

As the end of the pandemic is in sight, it is important to step back and look at “where we are” in markets relative to “where we are” in the global economy. The world is likely to see a multi-stage recovery as COVID is eradicated more slowly in some regions than in others. It is, therefore, important that we assess relative valuations. Do regional and sector valuations reflect the past, current or future states of the economy? By doing this, we can optimize portfolio allocations and re-examine our future return expectations to align them to the realities of how markets are priced today.

There are wide disparities in how markets are priced for the “post-Covid” world. Overall, global equities are 25% higher than they were at the end of 2019, even though economic output, employment and corporate investment are below -- and sometimes well below -- their pre-pandemic peak. World-leading equity gains of 30% in the US and China, reflect the enormous fire power of their fiscal, monetary, policy and health care actions. Powerful stimulus packages in the US and strenuous virus management in China have boosted confidence in their recoveries and accelerated their actual economic growth sharply higher. The remainder of the world has seen equity market gains half as large as the US since end 2019, with Latin America still down 16% in USD terms.

There are many areas of the globe where optimism is not the base case. In Brazil, national equity markets have lost 25% of their value from the end of 2019 measured in US dollars. In India, markets have suddenly slumped 9% over the past month as new surge in COVID cases has shocked previously bullish forecasters and investors.

In Europe and the UK, investors remain skeptical of the incipient recovery in the face of faster Covid vaccinations (see *Quadrant* for discussion). Thus, our view is that “mean reversion” is still a theme for investors to be mindful of as we do not see markets across the globe fully repositioned for a “Post COVID World,” – far from it.

Our investment allocations reflect two elemental factors.

The first is that the pandemic will end. We remain confident that the level of vaccinations will increase globally, that variants of Covid, while expected, are unlikely to cause a second pandemic, and that momentum in the world economy will continue to grow through 2022 with gains thereafter.

The second is that we must be coldly realistic about earnings, interest rates and growth versus today’s valuations. If certain markets have priced in most of the good news, we must take steps to identify and invest in areas of opportunity for further gains. If interest rates are likely to rise in the future, we must still remain defensive on certain fixed income exposures even when equity prices have exceeded expectations. In short, there are a myriad of considerations, but “waiting and seeing” is not a viable investment strategy in a tumultuous time.

From the Top of the House

Our recent Global Investment Committee actions reflect the disparities in market valuations and the need to shift our allocations to anticipate future opportunities. We continue to see a robust global economic rebound following the COVID pandemic. Though we continue to expect positive returns in the equity asset class globally over the year ahead, further appreciation will moderate after the powerful rebound we have experienced from the nadir in markets a year ago.
Let’s start from the top.

The Global Investment Committee (GIC) moderated its global equity allocation, reducing our equity overweight from +10% to +8%. The global fixed income allocation was raised from -9% to -7% in parallel. These changes were highly sector specific, reflecting our view of opportunities below the surface of global indices. The sectors where we reduced exposures reflect their powerful recoveries to date. Thus, we have doubled the size of our overweights in both global healthcare and variable rate loans. However, our substantive overall tilt toward global equities remains intact.

Within equities, we increased our overweight in Healthcare by reducing Global Small- and Mid-Cap shares to a slight underweight. In fixed income, we added to our overweight in variable rate bank loans by slightly shifting down our overweight in Large Cap Developed Markets Equities, including the US. We also reduced our Emerging Markets equity overweight with cuts in Central Europe, the Middle East and Africa (CEMEA). These shifts within equities reflect both a maturing market recovery and changing return opportunities within the equity asset class. They signal our views on relative valuations.

Here is the before and after of the changes made by the Global Investment Committee:

Figure 13: Global Investment Committee **Previous** vs **New** Asset Allocation: Largest Overweights and Underweights

Largest overweights	Largest overweights
+3.0% Developed Non-US Large Caps	+2.5% Developed Equities (Non-US)
+2.0% Emerging Markets	+1.5% Emerging Markets
+2.0% Global Healthcare (majority US)	+4.0% Global Healthcare (majority US)
+2.0% Global REITS (majority US)	+2.0% Global REITS (majority US)
+1.0% Developed Non-US Small and Mid Caps	**+8.0% Total Equities and REITS (+10% prev)**
+10.0% Total Equities and REITS	
+2.0% US Treasury Inflation Protected Securities	+2.0% US Treasury Inflation Protected Securities
+1.0% High Yield Debt (loans) and EM Debt	+3.0% High Yield Debt (loans) and EM Debt
Largest underweights	Largest underweights
-6.5% European Government Bonds	-6.5% European Government Bonds
-3.2% Japan Government Bonds	-3.2% Japan Government Bonds
-2.9% Cash, Short-Term US Treasuries	-2.9% Cash, Short-Term US Treasuries
	-1.0% Global SMID
-10.0% Total Fixed Income and cash	**-8.0% Total Fixed Income and cash (-10% prev)**

Source: Office of the Chief Investment Strategist as of April 16, 2021

Our revised GIC asset allocation remains substantially off global benchmarks, reflecting a very wide dispersion of valuations, risks and return opportunities in world markets. With global equities up another 10% YTD in 2021, we reduced our allocations to the regions that have seen a surge in valuation but believe there is value in “off benchmark” that provide opportunities for excess risk-adjusted returns.

Why Healthcare Now?

Healthcare has been an underperformer even in that face of the pandemic and the evidence that technology in the development of treatments, like vaccines, has vastly improved the value of this sector. Despite consistent revenue and earnings gains, healthcare shares have risen by just 15% since end 2019, including a 5% rise in the year-to-date, lagging sharply behind other sectors. This underperformance is even more striking given the unusually large 25% valuation discount healthcare shares have to the S&P 500 index. While discounted by political uncertainties in the US, the sector’s revenues and profits are likely to continue rising faster than other world industries simply due to unstoppable demographic trends. Finally, the potential “value” of healthcare shares in portfolios when overall valuations are high is increased. This is because historically healthcare has the lowest “down market capture” of any sector when broad markets correct.

Underweight Fixed Income, But Shifting to High Yield, Variable Rate Loans

Broadly speaking, valuations have not improved for global fixed income or cash. Despite our large global underweight to fixed income, we remain neutral long-duration US Treasuries as a risk hedge, and overweight US Treasury Inflation Protected Securities to earn what we believe will be rising inflation compensation over the next 18 months. While the trend rate of inflation will likely “tilt” somewhat higher in the longer-term, we believe the largest consumer price gains will be seen this year. Our largest fixed income underweights remain European and Japanese government bonds with nominal yields near zero.

Within fixed income, the GIC added to its overweight in US high yield credit through variable rate loans given that there yields near 4 ½% with roughly one third the volatility of equities. Current falling default rates strongly support this asset class and they will benefit from an eventual normalization of US policy rates. Unlike fixed coupon securities, variable rate loans would benefit from both a recovery in credit quality that comes with economic expansion and a possible rise in base rates if the US expansion exceeds expectations. Cash remains underweight 1%.

The US and China…

We have sector overweights in US Healthcare and Real Estate (with asset prices still below pre-COVID levels overall). However, certain data suggest excessive optimism in US share markets overall. High levels of speculative activity and short-term trading in US markets adds to near term risk. These include investor sentiment gauges, new investor account openings, and call option volumes (see April 18th Strategy Bulletin for more). And it is quite common during Mid-year periods to see declines in US indices. We would urge investors concerned with short-term corrections to consider risk hedges rather than liquidating portfolio holdings. A recent sharp drop in equity implied volatility has improved the economics of hedging. In short, there are times when "insurance" premia are low. This is one of them.

We have also maintained our neutral allocation to China. There is no doubt that the China has seen a less severe weakening in its national balance sheet owing to its handling of the pandemic with social restrictions rather than massive monetary policy easing. That said, China continues to embark on a credit tightening, particularly in the local government enterprise area, which is likely to keep liquidity conditions relatively difficult in the current quarter. Against this backdrop, serious concerns have arisen over central government owned debt-consolidator Huarong. We believe that Huarong will require a government backed bailout to avoid its failure and the resultant loss of confidence in China's policymakers.

Given all factors, we would look at 5-10% declines in either the US or China's markets as a potential opportunity to increase our allocations. After leading world markets higher, we would see a substantial correction to US large cap growth shares as a potentially appealing entry point. Similarly, a rise in 10-year US Treasury yields above 2% would argue for a *slightly* higher allocation to global fixed income.