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CIO Strategy Bulletin

All Eyes on Washington: The Fiscal Trifecta Fireworks Show

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SUMMARY

- **US tax and spending negotiations will deliver plenty of drama in the month ahead.**
- **The administration and Congressional Democrats have already scaled back the scope of several proposed tax hikes affecting corporate income, capital gains and carried interest, with more changes likely. However, prediction markets place the probability of passage of some form of sweeping tax legislation at 70%.**
- **Equities most impacted by potential tax changes have rebounded, perhaps relieved by the absence of a corporate minimum tax in House legislation. Statutory corporate tax rates would rise just 5.5 percentage points after a 14-percentage-point cut at end 2017 (and likely even less on an effective basis). Individual income taxes – including a lower threshold for the top tax rate – carry a larger share of the revenue grab.**
- **Partisan conflict could turn the annual debt ceiling ritual into one of the more troubling episodes. However, unlike 2011, Democrats control both houses of Congress, and could likely pass a debt ceiling increase by folding it into their reconciliation legislation with a simple majority.**
- **The proposed gross fiscal expansion of $3.5 trillion over 10 years is modest compared to the nearly $5 trillion in emergency spending measures during the past two years. However, as markets now look to even modest tax increases, government support for the economy will not come "cost free" for investors.**
- **US equity returns have been rapid year-to-date with the S&P 500 advancing over 20% following a similar gain in 2020. As we discussed last week, the rally has been strongly supported by what is likely to be 45% EPS gain this year.**
- **In 14 cases during the past seven decades, US equities fell in years featuring tax increases only once. We would not alter our equity and bond allocations around US tax issues alone. Some of the areas to receive more concentrated government support (infrastructure and green energy) may revive.**

The Fiscal Trifecta Fireworks Show

There is plenty of fiscal drama in DC. The last of the COVID-related legislation, a $3+ trillion Biden "social infrastructure" bill, is being finalized. There is a debt ceiling vote required to allow the US to keep borrowing. And then there is a bill to fund the government's fiscal year 2022 initiatives. All of these require action in September/October and the divided Congress is likely to erupt in fireworks as the deadlines loom.

The "Biden Bill"

House Democrats are scrambling to finalize the details of the Biden Administration's "social infrastructure" bill before a self-imposed September 27th deadline. Unlike the deficit-financed COVID emergency spending measures of 2020-2021, the proposed new federal spending requires funding by higher taxes on the wealthy and corporations. With an exceedingly narrow majority in the House (3 votes) and a 50-50 Senate, the Democrats must agree on what to spend the money on and how it will be paid for with no room to spare.

In a parallel process, the House also plans to vote on a "traditional" infrastructure bill by September 27 that has bipartisan support and has already been passed in the Senate by a 69-30 vote. This bill might serve as a "fall back" in the event more sweeping legislation fails.

The Debt Ceiling

The debt ceiling "is the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations." Moving the ceiling up will allow the US to meet all of its existing legal obligations, from debt service on Treasury securities to funding for Social Security. A failure by Congress to raise the debt limit would cause the government to default. The Treasury letter of September 8, 2021 does not define the exact date by when the US will default, but the date would come before the end of October without legislation.

The US has raised or suspended the so-called "debt ceiling" 86 times in the past 80 years without serious economic consequences. However, the current political setting might unsettle financial markets as it did previously. After a game of brinksmanship, US equities markets fell sharply in 2011 (if temporarily) when ratings agency Standard and Poor's stripped the US of its triple-A credit rating. This time, Republicans have vowed not to assist in the process. One Senator has even vowed to filibuster any attempt to pass a debt ceiling increase with a simple majority.

Funding 2022 Spending

And finally, there is one very firm government deadline, September 30th, by when Congress has to pass a bill to fund the government's fiscal year 2022 initiatives. Failure to do so will "shut down" the government, closing all non-essential operations.

Tax and Spend or Spend and Tax?

To get the Biden Bill through Congress will require agreement by the fractured Democrats on what to spend the money on and what to tax. Because there are "no votes to spare", it is likely that the bill will be smaller than the original $3.5 trillion target. It is also likely, therefore, that the levels of "higher taxes" required to fund the bill will be lower than expected. Just one Senator, Joe Manchin (D-WV), the so-called "50th Democrat", holds the key to everything.

Recent changes to the funding proposals for the bill have increased its chance of passage. Betting marketplace PredictIt currently assigns 70% odds that the US corporate tax rate will rise to a level between 24.6% and 27.9% in 2022. This is up from 46% odds a few days prior to the release of the Committee report.

Spending

If the bill passes, social spending will include outlays for pre-kindergarten education and community colleges. Traditional infrastructure spending will include increased funds for roads, highways and bridges. Unlike past efforts, it would include enhanced support for the nation's utilities and electrification, including electric vehicle charging stations, or so-called "green infrastructure."

Taxing

About a week ago, the House Ways and Means Committee released the funding details of the Biden Bill. The Ways and Means proposal to fund the Biden Bill touches affects both individuals and corporations. There would be about $1 trillion raised from high earners and $900 billion from corporations over 10 years. Around $700 billion would be realized by cost savings and fees from drug price controls, while approximately $600 billion would be funded by "dynamically scoring" the impact of the bill's outlays. Earlier proposals would have lifting the corporate tax rate from 21% to 28%, -- it was 35% before the 2017 tax cut -- but the recent Ways and Means Committee proposal has reduced this rate to 26.5%, a figure closer to what Senator Manchin prefers.

Looking at the details, the maximum capital gains tax rate would rise to 25% from 20%. There would be a 3.8% Medicare surtax for high earners bringing the top income tax rate up to 39.6%, as well as a reduction of 50% in the estate and gift tax exemption. The bill would also lower the income threshold to enter the top tax bracket and add a 3.0% surcharge to income above $5 million. The provision to tax Carried Interest at a lower rate would be preserved, but the holding period would be 5 years. Of course, all of this could change materially. (Please see the Appendix for details.)

Stock Market Winners and Losers

US equity returns have been rapid year-to-date with the S&P 500 advancing over 20% at its recent peak following a similar gain in 2020. As we discussed last week, the rally has been strongly supported by what is likely to be 45% EPS gain this year. Therefore, investors are watching intently for what will be in and out of the bill, as well as how it will be funded.

Despite the uncertainties facing the bill's details and passage, shares of the firms benefitting most from the corporate tax cuts of 2017 have rebounded, retracing some of their underperformance incurred around the 2020 election which handed control to Biden and Democrats in both houses of Congress **(Figure 1)**. These shares – dominated by Tech, Healthcare and Utilities - may be taking some comfort in the reduced scope of the tax increase. Their strength might also reflect the absence of a minimum book income tax that was included in earlier plans.

As **Figure 2** shows, many firms are able to use the complex tax code to pay a lower effective rate than the statutory maximum. This is why the tax rate they paid in 2018 fell only 7% when the statutory rate fell 14 percentage points. Without strict legislation on a minimum rate, this suggests effective tax rates could rise even less than the 5.5% proposed.

Figure 1: Relative Performance of Tax Cut "Winners" vs. Tax Cut "Losers"

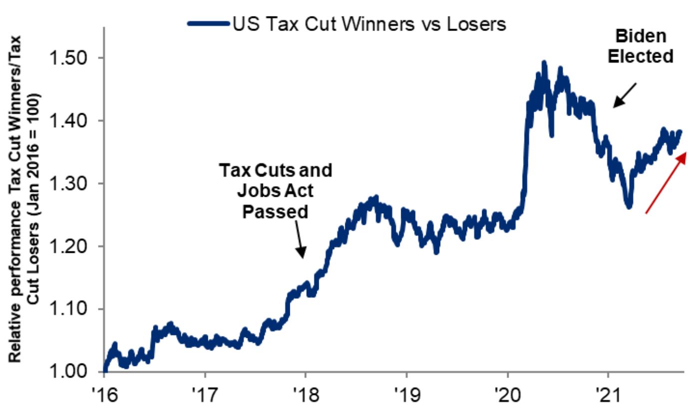
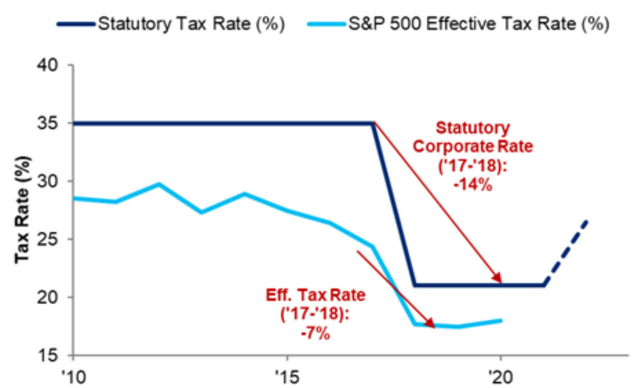


Figure 2: Effective vs Statutory Tax Rates



Source: Bloomberg, FactSet as of September 15, 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. S&P 500 as proxy. "Tax cut winners" are a sector neutral basket of companies which saw the largest decline in effective tax rates following the passage of the Tax Cuts and Jobs Act in 2017. "Tax cut losers" saw the smallest decline in effective tax rate.

Projected Tax Rates May Impact the US Market Less Than Expected

The impact on financial markets to changes in the US tax code may not be as large as many assume. Historically, legislators have been careful (or lucky) to time tax hikes to periods when the economy is in recovery and can growth through them. A review of the last 14 US increases to top income, corporate, or capital gains tax rates since 1950 reveals just one instance where the U.S. stock market posted a negative return in the year tax increases were enacted **(see Figures 3-4)**. That occurred in 1969 when the US economy experienced a recession as President Johnson tried to close a budget deficit caused by the Vietnam War while the Federal Reserve tightened monetary policy.

The 13/14 cases of rising stock prices and higher taxes is a statistically higher ratio than the overall long run average. This shows that a growing economy is more important than tax policy in generating returns. Periods of tax cuts – when driven by a weakening economy - have been less robust for markets despite the fiscal support.

Figure 3: Changes in the US Tax Code vs. US Stock Market Returns and Real GDP

Marginal Income Tax Rate Increase						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1968	70.0%	75.3%	LBJ	Revenue and Expenditure Control Act of 1968	11.04%	4.91%
1969	75.3%	77.0%	LBJ	Revenue and Expenditure Control Act of 1968	-8.40%	3.13%
1991	28.0%	31.0%	Bush Jr.	Revenue Reconciliation Act of 1990	30.47%	-0.11%
1993	31.0%	39.6%	Clinton	Omnibus Budget Reconciliation Act	10.08%	2.75%
2013	35.0%	39.6%	Obama	American Taxpayer Relief Act of 2012	32.39%	1.84%
				Average:	15.11%	2.51%

Marginal Income Tax Rate Decrease						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1964	91.0%	77.0%	LBJ	Revenue Act of 1964	16.43%	5.76%
1965	77.0%	70.0%	LBJ	Revenue Act of 1964	12.46%	6.50%
1970	77.0%	71.8%	Nixon	Tax Reform Act of 1969	3.89%	0.19%
1971	71.8%	70.0%	Nixon	Tax Reform Act of 1969	14.22%	3.29%
1981	70.0%	69.1%	Reagan	Economic Recovery Tax Act of 1981	-4.88%	2.54%
1982	69.1%	50.0%	Reagan	Economic Recovery Tax Act of 1981	21.50%	-1.80%
1987	50.0%	38.5%	Reagan	Tax Reform Act of 1986	5.18%	3.46%
1988	38.5%	28.0%	Reagan	Tax Reform Act of 1986	16.61%	4.18%
2001	39.6%	39.1%	Bush Jr.	Economic Growth and Tax Relief Reconciliation Act of 2001	-11.89%	1.00%
2002	39.1%	38.6%	Bush Jr.	Economic Growth and Tax Relief Reconciliation Act of 2001	-22.10%	1.74%
2003	38.6%	35.0%	Bush Jr.	Jobs and Growth Tax Relief Reconciliation Act of 2003	28.68%	2.86%
2018	39.6%	37.0%	Trump	Tax Cut and Jobs Act of 2017	-4.38%	3.00%
				Average:	6.31%	2.73%

Corporate Tax Rate Increase						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1950	38.0	42.0	Truman	Revenue Act of 1950	31.45%	8.68%
1951	42.0	50.8	Truman	Revenue Act of 1951	23.97%	8.05%
1952	50.8	52.0	Eisenhower	Revenue Act of 1951	18.16%	4.09%
1968	48.0	52.8	LBJ	Revenue and Expenditure Act of 1968	11.04%	4.91%
1993	34.0	35.0	Clinton	Omnibus Budget Reconciliation Act	10.08%	2.75%
				Average:	18.94%	5.70%

Corporate Tax Rate Decrease						
Year	Old Tax Rate	New Tax Rate	President	Legislative Act	S&P 500 Total Return	Real U.S. GDP (YoY%)
1964	52.0	50.0	LBJ	Revenue Act of 1964	16.43%	5.76%
1965	50.0	48.0	LBJ	Revenue Act of 1964	12.46%	6.50%
1970	52.8	49.2	Nixon	Tax Reform Act of 1969	3.89%	0.19%
1971	49.2	48.0	Nixon	Tax Reform Act of 1969	14.22%	3.29%
1979	48.0	46.0	Carter	Revenue Act of 1978	18.45%	3.17%
1987	46.0	40.0	Reagan	Tax Reform Act of 1986	5.18%	3.46%
1988	40.0	34.0	Reagan	Tax Reform Act of 1986	16.61%	4.18%
2018	35.0	21.0	Trump	Tax Cut and Jobs Act of 2017	-4.38%	3.00%
				Average:	10.36%	3.69%

Source: Bloomberg as of June 3, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 4: Summary of US Stock Market Reaction During Tax Increases Since 1950

US personal income tax	US corporate income tax	US capital gains tax
Only 1 of 5 cases coincided with a yearly decline in US share prices	0 of 5 cases coincided with a yearly decline in US share prices	0 of 4 cases coincided with a yearly decline in US share prices

Average annual gain in US shares when	Tax increases %	Tax cuts %
Personal income tax rates change	15.1	6.3
Corporate tax rates change	18.9	10.4
Capital gains tax rates change	16.3	18.9

Source: Citi Global Wealth Investments as of June 2021. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Will the Stock Market React to the Debt Ceiling Drama?

Raising the debt ceiling is a common affair with Congress acting to either permanently raising, temporarily extending, or revising the definition of the debt limit 78 times since 1960. The key takeaway is that despite the finger-pointing, Congressional leaders in both parties have always recognized that it is necessary to service the nation’s legal obligations. This is why the constant reoccurring debate over the debt ceiling historically hasn’t moved financial markets very much **(see Figure 5)**.

An exception to this came in 2011 when the US sovereign debt rating was lowered by Standard & Poor's from AAA to AA+ after a particularly long and rancorous period of brinksmanship. Among the issues, the ratings agency cited a decline in the predictability of US policymaking for the cut. Notably, this had no observable long-term impact on US funding costs.

We do not expect a full repeat of the 2011 dynamic in 2021 because Democrats maintain a majority in both Chambers in Congress. In 2010, the Obama administration lost control of the House in mid-term elections and was dependent on the opposition to take action.

While Democrats are currently seeking to approve the debt limit increase with a bipartisan 60 vote majority, they do not technically have to. Should Republicans refuse, Democrats can raise the debt limit with a simple majority via the budget reconciliation process. They may also choose to include it in a hurricane relief spending bill to test Republican support.

Figure 5: Summary of US Stock Market Reaction to Debt Ceiling Debates

Historical Debt Ceiling Levels and S&P 500 Performance Between 1993 to 2021					
Date	Debt Ceiling (Bils. of $)	Change in Debt Ceiling (Bils. of $)	S&P 500 Performance (1-Month Prior)	S&P 500 Performance (1-Week Prior)	S&P 500 Performance (1-Month Later)
April 6, 1993	4,370	225	-1.1	-2.4	0.5
August 10, 1993	4,900	530	0.3	0.0	2.7
March 29, 1996	5,500	600	0.8	-0.8	1.3
August 5, 1997	5,950	450	3.9	1.1	-2.4
June 28, 2002	6,400	450	-7.9	0.1	-13.8
May 27, 2003	7,384	984	5.9	3.5	2.6
November 19, 2004	8,184	800	6.1	-1.2	2.0
March 20, 2006	8,965	781	1.4	1.6	0.5
September 29, 2007	9,815	850	4.3	0.1	0.9
July 30, 2008	10,615	800	0.3	0.2	-0.1
October 3, 2008	11,315	700	-13.8	-9.4	-12.1
February 17, 2009	12,104	789	-7.2	-4.6	-1.4
December 28, 2009	12,394	290	3.3	1.2	-3.8
February 12, 2010	14,294	1900	-5.3	0.9	6.9
August 2, 2011	16,394	2100	-6.4	-5.8	-6.4
February 4, 2013	16,699	305	2.0	-0.3	2.0
October 17, 2013	N/A	Suspended	1.7	2.4	3.8
February 15, 2014	17,212	213	-0.5	2.3	0.1
March 16, 2015	18,113	901	-0.8	0.1	1.1
March 16, 2017	19,809	1696	1.5	0.7	-2.2
September 8, 2017	20456	647	-0.5	-0.6	3.6
February 9, 2018	21,988	1532	-4.8	-5.2	6.4
August 2, 2019	N/A	Suspended	-1.4	-3.1	-0.2
July 31, 2021	28,500	6470	2.3	-0.4	3.0
		Maximum:	**6.1%**	**3.5%**	**6.9%**
		Minimum:	**-13.8%**	**-9.4%**	**-13.8%**
		Median:	**0.3%**	**0.1%**	**0.7%**
		Average:	**-0.7%**	**-0.8%**	**-0.2%**

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Will the Federal Government Shutdown Again?

There is a one firm upcoming deadline, which is September 30. That is when Congress will need to pass a bill to fund the government's fiscal year 2022 initiatives. If a funding deal cannot be reached by that deadline, then the Federal government may be forced to shut down non-essential operations.

Past precedent suggests a shutdown may be short-lived, with the average shutdown since 1976 lasting just under 8 days (the longest was 34 days). During those previous shutdowns, the return of the S&P 500 was essentially flat (the worst performance was -4.4% in 1979. **See figure 6**).

Figure 6: Summary of US Stock Market Reaction to Federal Government Shutdowns Since 1976

Year	President	Dates of Federal Government Shutdown	Number of Days	S&P 500 Performance During the Shutdown (%)
1976	Gerald Ford	September 30 to October 11	10	-3.4
1977	Jimmy Carter	September 30 to October 13	12	-3.2
1977	Jimmy Carter	October 31 to November 9	8	0.7
1977	Jimmy Carter	November 30 to December 9	8	-1.2
1978	Jimmy Carter	September 30 to October 18	18	-2.0
1979	Jimmy Carter	September 30 to October 12	11	-4.4
1981	Ronald Reagan	November 20 to November 23	2	-0.1
1982	Ronald Reagan	September 30 to October 2	1	1.3
1982	Ronald Reagan	December 17 to December 21	3	0.8
1983	Ronald Reagan	November 10 to November 14	3	1.3
1984	Ronald Reagan	September 30 to October 3	2	-2.2
1984	Ronald Reagan	October 3 to October 5	1	0.1
1986	Ronald Reagan	October 16 to October 18	1	-0.3
1987	Ronald Reagan	December 18 to December 20	1	0.2
1990	George H.W. Bush	October 5 to October 9	3	-2.1
1995	Bill Clinton	November 14 to November 19	5	1.3
1995-1996	Bill Clinton	December 16, 1995 to January 6, 1996	21	0.1
2013	Barack Obama	October 1 to October 17	16	2.3
2018	Donald Trump	January 20 to January 23	3	1.0
2018	Donald Trump	February 9	1	1.5
2018-2019	Donald Trump	December 22, 2018 to January 25, 2019	34	10.3
		Average:	**7.8 Days**	**+0.1%**

Source: Citi Global Wealth Investments as of June 2021. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Final Impacts: There is No Such Thing as a Free Infrastructure Bill

As we discussed in previous bulletins (please see CIO Bulletin: Driving Under the Influence), increases in government spending that are tax financed, are quite different from the deficit financed (and monetized) emergency spending boosts of 2020-2021. When the economy is not deeply depressed, the effect is largely redistributive rather than stimulative. However, the positive impacts of larger investments in US infrastructure and support for labor force participation through enhanced child-care services **(see Figures 7-8)** are likely to be material.

Figure 7: Growth of US Infrastructure: Roads, Bridges and Powe Grid

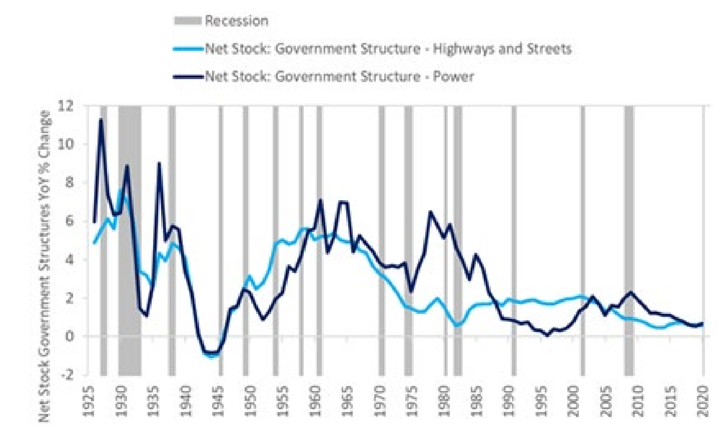
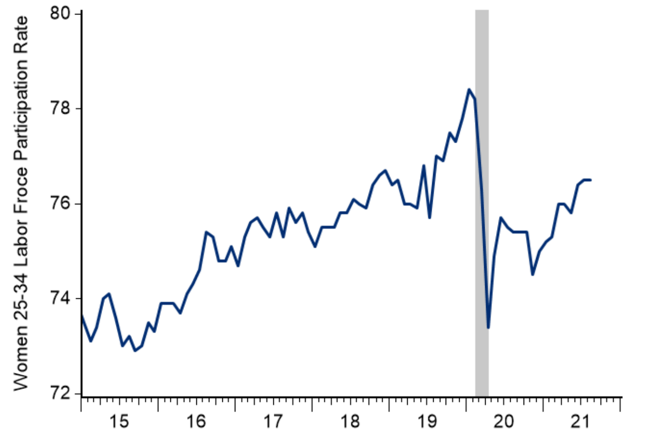


Figure 8: US Labor Force Participation: Women Aged 25-34



Source: Haver as of September 11, 2021. Grey areas are recessions.

Conclusion: Stay Tilted Toward Equities

As markets now expect more modest tax increases, we are not altering our equity and bond allocations based on US tax issues alone. That said, we will watch keenly for further clarity on potential winners and losers from resulting from legislation and other important market drivers.

Of course, government support for the economy will not come "cost free" for investors. Certain industries will see outsized benefits and costs from the redistribution of resources. While the spending proposal is not very large as a share of the US economy, depending on timing it will annualize at 1%-2% of US GDP, this can be concentrated in a small group of industries. Higher spending on US infrastructure and alternative energy may reinvigorate the performance of related shares **(see Figures 9-10)**.

Just as we noted above regarding tax increases and tax cuts at a macro level, government support for particular industries doesn't occur in isolation. Traditional infrastructure shares seem likely to outperform consumer goods producers in the period ahead given fiscal support. However, like most cyclicals, they have already enjoyed a strong year.

"Green energy" shares include a wide range of technologies, some likely to be favored by different regional governments. For example, hydrogen deployment is a much stronger priority in Europe than in the US. After a booming 2020, most alternative energy shares have corrected significantly lower in 2021. As highly-valued long-term potential growth opportunities, such shares are somewhat sensitive to movements in interest rates.

The period ahead is unlikely to see either falling market interest rates or another cyclical surge (the first came from COVID reopening). Nonetheless, the long-term potential opportunity seems great for the premier "green tech" firms. Over the shorter-run, increased fiscal spending on infrastructure may help generate outperformance for the shares most linked to large scale engineering and construction projects in the US.

Figure 9: US Infrastructure-Related Shares vs Global Equities

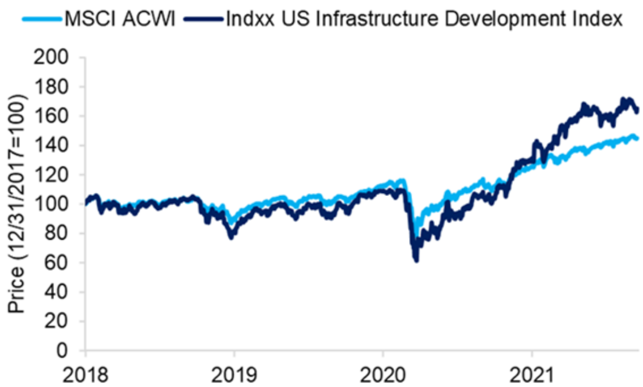
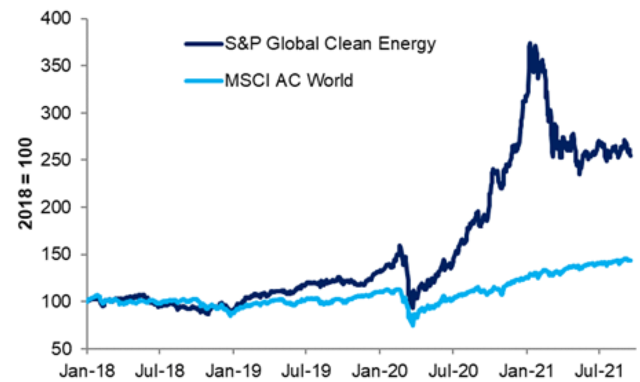


Figure 10: Alternative Energy Shares vs Global Equities



Source: Haver Analtyics as of September 11, 2021. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Appendix: Tax Proposal Details

Tax Code Item	Current Law (If Applicable)	Proposed Tax Code Change
Corporations and businesses		
Corporate tax rate	21% flat rate	18% on income up to $400M 21% on income up to $5MM 26.5% on income above $5MM
Corporate interest deduction limitation		New section limits interest deduction of certain domestic corporations to an allowable 110% of net interest expense Applies only to domestic corporations where average excess interest expense over interest includible over three-year period exceeds $12MM
GILTI (Global Intangible Low-Taxed Income) and FDII (Foreign-Derived Intangible Income)		Reduce FDII to 20.7% Reduce GILTI to 16.5625%
Carried interest and capital gains	Three-year holding period	Extend to five-year holding period to qualify for long-term capital gain treatment Three-year holding period retained for real property trades or businesses/taxpayers with an adjusted gross income less than $400M
Individuals		
Individual tax rate	37% top marginal tax rate	39.6% top marginal individual tax rate Lower threshold for applying top rate.
Capital gains tax rate	20%	25% flat rate, applied to gains recognized on or after September 15th Current 20% rate would apply to gains/losses for portion of tax year prior to the date of introduction, and for gains resulting from transactions entered into before September 15th
High-income surcharge		Impose a tax equal to 3% of a taxpayer's modified adjusted gross income (AGI) in excess of $5MM (or in excess of $2.5MM for a married individual filing separately)
Unified credit		Revert unified credit against estate and gift taxes to $5MM per taxpayer, adjusted for inflation

Source: Bloomberg as of September 18, 2021.


Client calls & events