by REBECCA FELTON

THE RIVERFRONT WRITING TEAM

REBECCA FELTON
Senior Market Strategist

ROB GLOWNIA, CFA, CFP
Senior Portfolio Manager |
Co-Head of Investment Committee

CHRIS KONSTANTINOS, CFA
Chief Investment Strategist |
Co-Head of Investment Committee

KEVIN NICHOLSON, CFA
Global Fixed Income Co-CIO

DOUG SANDLER, CFA
Head of Global Strategy

ROD SMYTH
Director of Investments

SUMMARY

- Government spending is expected to continue to rise providing a tailwind to the economy.
- However, we believe taxes on companies and top earners are likely to rise.
- On balance, we believe that the economic benefit of higher government spending will outweigh higher taxes, especially in 2021.

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Changes in Washington – What it Means for Taxes and Spending

A Conversation with Strategas Research Partners

With a new administration in place, we have been getting questions from clients on several policy related topics. We are fortunate to be able to pass these questions along to our partners at Strategas. Recently, we had the opportunity to get some updated insights from Dan Clifton, Managing Director and Head of Policy Research, along with Courtney Rosenberger who is a Director of Policy Research. Their answers to our questions are provided below.

Q. Clients are asking questions about potential tax hikes. On the campaign trail, President Joe Biden was vocal as to his intentions to raise taxes. Do you think the infrastructure bill that is expected later this year will bring tax increases with it?

President Biden campaigned on the platform to end the COVID-19 pandemic and stimulate the economy. With passage of the $1.9 trillion American Rescue Plan in the first quarter, Biden believes the resources are in place to achieve both of those goals. Attention will now turn towards a larger, more structural type reform focused on infrastructure and climate change spending but will also likely be coupled with tax increases.

As a candidate Biden proposed $4 trillion of tax increases, far larger than previous Democratic candidates for president. Our sense is that not all of these tax increases will be passed into law, but investors should start preparing for some tax increases. The purpose of these tax increases is twofold. First, to pay for more infrastructure spending and second, to offset income inequality by raising taxes on corporations and high-income individuals. This involves raising the income, capital gains, dividend, and corporate tax rates.

We want to be clear that we do not believe that Democrats are going to pass tax increases as a standalone bill. In our opinion, legislation that just raises taxes is unlikely to pass in a divided Congress. Rather, we believe these tax increases would be coupled with new government spending. A good way to think about how spending and tax increases interact is by thinking about spending as candy and tax increases as spinach. The more candy (spending) that can be passed into law, the easier it will be to digest the spinach (tax increases).

In 2017, former President Donald Trump passed tax legislation that lowered the US corporate tax rate from 35% to 21% and allowed US multinational companies to repatriate their foreign profits back to the US. Nearly every Democrat believes the US corporate tax at 21% is too low and should be higher. Our base case is that the corporate tax rate will be increased to 25% starting in 2022. Additionally, most Democrats believe that the current international tax system of the US is leading to an outsourcing of jobs. We would not be surprised if Democrats seek to increase the current tax on US multinationals' intellectual property overseas to about 15% from roughly 10.5%. Democrats need to be careful not to go too far on corporate tax changes that could lead to more US companies leaving the country.

All of this is predicated on some infrastructure bill passing in 2021. The American Rescue Plan passed under an expedited budget process called 'budget reconciliation', only requiring a simple majority in the Senate. An infrastructure bill will be more complicated since many of the provisions would not technically qualify for the 'reconciliation' process and would thus require bipartisan agreement. Therefore, it could turn out that the package will be smaller than the consensus expects and that may also lead to fewer tax increases than we outlined above. The process is just starting, and we have a long way to go before any bill becomes law this year.

Q: Your view on the macroeconomic impact of the infrastructure bill that could come later this year is somewhat contrarian. Can you tell us why?

Investors are quite excited about the possibility of an infrastructure bill and the price tag on the surface looks to be quite large. For example, there is talk about $2-$4 trillion of more infrastructure spending. But the trillions being discussed in an infrastructure package are very different than the trillions of dollars in a COVID-19 package. The American Rescue Plan is transfer payments that go directly to US consumers and governments. The money is front loaded and can be spent quickly.

That is not true of infrastructure spending which has a long lag time before the money is actually spent. When you hear $1 trillion, divide that by 10 years for a rough estimate. Hence $1 trillion of spending over 10 years is the equivalent of $100 billion per year, or roughly 0.45% of GDP.

Once we get past the timing issue, then we need to get to the capacity issue. Incremental infrastructure spending of $100 billion per year would require a near doubling of current US infrastructure spending. We believe this is unlikely to happen. The first two years of former President Obama's 'Build America' infrastructure bill amounted to an incremental $19 billion. These seemed like very large increases, but disappointed investors who thought hundreds of billions of dollars were coming.

As we look ahead, the key for investors will be the incremental dollar amount. Less than half of the funds authorized to be spent in the House infrastructure plan gets spent in the first 10 years. At its peak, it is slightly more than $50 billion annually. This moves the needle for infrastructure levered stocks, but is not much of a macro driver, in our opinion.

Q: Over the past few weeks, you have written about one of the aspects of the stimulus bill that has not gotten as much attention - an expansion of the Affordable Care Act. Can you tell us more about that and why you believe it presents opportunities?

We believe most of investors' attention has been focused on the consumer and government aid in the stimulus package. However, underneath the surface is a major expansion of the Affordable Care Act, in our opinion. This is achieved by expanding the dollar amount of a tax credit someone can receive to purchase health insurance. Slightly less than 10 million Americans purchase health insurance on the ACA exchanges and nearly every person does so because they receive a subsidy from the government. Without the subsidy, the purchase of health insurance on the exchanges is too cost-prohibitive. The new law expands the level of subsidies for individuals and makes health insurance more affordable.

In 2020, in the United States, the poverty threshold for a single person under 65 was an annual income of $12,760; the threshold for a family group of four, including two children, was $26,200. Under the current law, someone making 150% of the poverty level ($19,140 individual/ 39,300 family) pays roughly 4% of their income toward an insurance premium with the government subsidy paying the remainder. Under the new proposal, that individual would pay zero towards their health insurance premium for 2021 and 2022. By lowering the percentage of income someone needs to pay for insurance premiums the subsidy amount effectively increases. Another major change is individuals and/or families making more than 400% of the poverty line ($51,040 individual and $104,800 family) now qualify for subsidies. Not surprisingly, managed care companies, which benefit from more people participating in the ACA exchanges, have been outperforming the S&P 500 since February as the odds of the full $1.9 trillion package being enacted were increasing.

Q. Prior to the election, you had expressed your belief that a Biden administration would take a tougher stance than President Trump on antitrust and big tech. Do you still believe that and is the technology sector still a target?

President Biden has been making aggressive antitrust personnel moves recently, and we believe that signals a much tougher antitrust policy than previous administrations. Recent news that Biden is likely to select antitrust advocate Lina Khan to the Federal Trade Commission comes on the heels of news that Tim Wu will join the White House staff tasked with competition

policy. While most of this discussion is focused on the tech platforms, the shift could have a larger impact around antitrust policy generally. The full scope of Biden's antitrust approach will not be known until Biden's selection for the Antitrust Division of the Department of Justice is made. There is a possibility that Biden assigns more aggressive appointments to the White House and Federal Trade Commission and then appoints more moderate members to DOJ and for the remaining FTC appointments. It is also important to remember that antitrust is based on existing law, and changing those rules is not easy to do in Congress. Companies have recourse if antitrust officials go too far outside the law.

Q: One of the portfolios you manage is constructed based on corporate lobbying activity. What are some of the portfolio implications under the new administration?

Our basic thesis is that companies spend money to lobby Washington, D.C. policymakers with the belief that their lobbying will produce some return on investment, like an R&D (research and development) expenditure. We also find that company pressure campaigns on major macro issues are successful over time and thereby produce an earnings benefit. This view has generally worked under Republican, Democratic, and split government over time. The one rare exception was that company lobbying failed to produce an earnings benefit under former President Trump with respect to trade policy. In our opinion, no amount of lobbying was going to change his views on tariffs even though many companies tried. With a new administration in place, we do not expect to see immediate tariff reductions, but we also do not expect the same headwinds on trade policy. Their focus is now on stimulus, and with the newly passed $1.9 trillion spending package, we are already seeing companies lobbying for a portion of the health care and education money. Moreover, many consumer-based companies benefit from the massive amount of consumer relief set to be provided. Post stimulus, attention will turn to infrastructure spending but also the tax increases that would be attached to the measure. More granularly we anticipate fierce lobbying battles over defense and drug pricing measures as we move later into the year.

Our Takeaways from this Interview:

RiverFront broadly agrees with Strategas' outlook recognizing that the 'devil is in the details'. We think investors should expect more spending, stiffer regulations, and higher taxes, but the exact details remain unclear. We believe that the 'gives' from the Biden administration (stimulus, infrastructure spending, etc.) should outweigh the 'takes' (higher taxes and stiffer regulations) in the near-term and thus should not derail the stock market's ability to rise from here over the remainder of 2021. We continue to monitor these developments closely and will adapt our portfolio positioning if necessary.

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Dan Clifton is the Managing Director and Head of Policy Research for Strategas. He serves as Partner and Portfolio Manager for Strategas Asset Management. Courtney Rosenberger is the Director of Policy Research at Strategas Asset Management. The views expressed are Dan Clifton's and Courtney Rosenberger's and not necessarily those of RiverFront Investment Group.

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In a rising interest rate environment, the value of fixed-income securities generally declines.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be

influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Lobbying "intensity" is defined by large-cap U.S. companies with the highest lobbying strength based on (1) the aggregate amount of dollars spent on lobbying activities by that company relative to (2) the size of the company measured by reference to several fundamental factors (reported in quarterly corporate filings) and market factors (market capitalization, liquidity).

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Index Definitions:

Standard & Poor's (S&P) 500 Index TR USD (Large Cap) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

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