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SUMMARY

- We believe investors should be focusing on higher corporate tax rates for the second half of 2021.
- Inflation worries could impact infrastructure legislation and Federal spending, in our view.
- The Biden administration's anti-trust focus has extended beyond the technology sector.
- We believe the US/China 'Cold War' is broadening to include the capital markets.

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Washington 'Insiders' View on Taxes, Infrastructure, Anti-Trust, and China

Second Half Outlook from Strategas' Policy Research Team

In a news conference in April of 2020, Federal Reserve Chairman Jerome Powell addressed the gravity of the economic situation being created by the pandemic and urged Congress to "use the great fiscal power of the United States to do what we can to support the economy and try to get through this with as little damage to the longer-run productive capacity of the economy as possible". He also noted that the types of policies needed would carry a hefty price tag. The US government responded with massive stimulus and now debates are ongoing as to how to pay the bill for the stimulus.

We reached out to our partners at Strategas with questions regarding the ongoing policy debates in Washington D.C. as well as changes ongoing in the Biden administration. Dan Clifton, Partner and Head of Policy Research, and Courtney Rosenberger, Director of Policy Research share their opinions on our questions below.

Q. In your last RiverFront Strategas Policy Opportunities portfolio rebalance comments, you noted that tax policy had become one of the biggest themes for companies in the S&P 500. Yet, despite more money being spent on lobbying around tax policy by S&P 500 companies, there seems to be little concern amongst investors regarding changes to the US corporate tax structure. Do you see this as a headwind for US equities?

We believe tax policy will be a bigger issue in the final four months of the year for investors. We believe companies understand the risks and opportunities Washington, D.C poses to their businesses faster than investors do. We believe companies see risk building as evident by their current lobbying effort to water down proposed tax increases on corporate income. In the first quarter of 2021, over 40% of S&P 500 companies were lobbying on components of the Biden tax plan and that was even before President Joe Biden released his proposal. With his proposal released, we expect that this number climbed significantly higher in Q2. If these proposed tax changes were not meaningful for the companies, we would not see this type of lobbying activity.

How significant will the changes be? Take a look at S&P 500 consensus earnings for 2022. According to FactSet, earnings for 2022 are forecast to grow by 9.5% when compared to 2021. Under our compromise scenario of a 25% corporate tax rate and 18% tax on US multinational income, we see the Biden tax plan as reducing the year over year growth from 9.5% to just 3%. Now this could change, particularly if earnings expectations accelerate for 2022, but the impact is substantial in our view, all else being equal.

So why have investors not focused on this? **We think we are probably still months away from the final legislation passing into law and the range of outcomes are still quite wide.** It feels a lot like 2017 to us when the equity market was ignoring the possibility of large tax cuts on corporate income during the summer. However, as soon as the legislation was introduced, equities responded.

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The sell side earnings estimates, however, did not get lifted until the bills passed in December. Our experience is to focus on these changes now so that we are ready and ahead of the market when that time comes.

Q. There are more and more reports of fractures inside both the Democratic and Republican parties which could be an impediment to progress on the infrastructure legislation. Do you believe any opposition that is brewing underneath the surface will impact the passage of fiscal legislation? And how will 2021 elections impact the voting equation on new fiscal measures?

The Democratic Party has lots of divergent views and reaching policy agreements is not easy. Additionally, there is little wiggle room in both the House and Senate with such narrow majorities. But investors need to pay attention to the fundamentals. Moderate Democrats are getting a shot at delivering a bipartisan infrastructure package which has more than enough votes to pass the House and Senate. These same members would like to see a more generous state and local tax deduction which means they would have to support a larger, $3.5 trillion spending package that passes under budget reconciliation. The key point here is that the Democratic Party is not having a debate about "whether" to pass more spending and tax increases. They are having a debate about the level of spending and tax increases. **This makes it likely that President Biden will get about $2.5 trillion of new spending between the two packages and $1.5 trillion of tax increases by the end of this year.** Likely does not mean guaranteed and there could be external factors that shape the direction of the package.

For example, the recall election of Governor Newsom in California and the Virginia gubernatorial election could scare moderate Democrats from voting to raise taxes should the Republicans win in both cases. Public polling is showing that voters are more worried about inflation than employment with voters blaming higher government spending. We believe sustained increases of inflation could impact the fiscal legislation.

Q. Many of President Biden's Cabinet and other appointees are characterized as anti-trust advocates, how could that change the landscape for lobby spending?

We recently authored a client note titled "Arbageddon" because the merger arbitrage traders are getting crushed by the uptick in antitrust actions from the Biden administration. Spreads on merger deals that would have been approved by Republican and Democratic administrations over the past 40 years are now under attack, despite the law permitting these mergers to go through. The thesis here is "Big is Bad" as nearly all the regulatory action has come in mergers greater than $10 billion or more. We believe it is unlikely that Congress will change antitrust law. As such, Biden is putting companies on notice that if they have a large merger, his administration will use every tool available to delay, challenge, and raise the cost of those mergers so that companies reevaluate whether the merger is worthwhile.

The irony is that when antitrust is spoken about, investors immediately think about Google, Facebook, and Amazon. But where the antitrust stress has been, is in more traditional industries. For example, the AON/Willis Insurance merger was rejected by the Biden administration despite winning the more onerous European Union approval. News reports recently suggested the Biden administration will challenge the United Health/Change Healthcare merger, which is a vertical merger (a vertical merger is between companies that do not directly compete with one another). The US has challenged only one vertical merger over the past forty years, AT&T/Time Warner, and lost in court.

Biden is also looking to use government agencies of regulated industries to stop mergers such as the Surface Transportation Board which needs to approve the Kansas City Southern merger or the Department of Defense which reviews the Lockheed Martin/Aerojet deal. The Federal Trade Commission is now likely to make life difficult for US tech companies. The Department of Justice is likely to continue its challenge of Google. For those companies, these issues will take years to resolve. The biggest risk to these companies is that they spend so much time fending off the government they lose the focus on their business. However, we believe the more immediate threat is on merger approvals and we expect the pressure to continue on large mergers.

Q. Recently, there was a bipartisan legislative proposal called The Taiwan Partnership Act. As President Biden and his administration have continued to express concerns about human rights, cyberattacks, and economic pressure on our allies; does this legislation complicate future relations with China?

Something interesting happened after Biden took office: **Investors realized there is little difference between Biden and Trump's policies on China** (for more on RiverFront's views of the US's current China policy, see our Weekly View from 8/2/21). President Donald Trump's policies are becoming the official policy of the US government and investors are adjusting. China is also adjusting. While Trump was the aggressor for the past four years, China's President Xi is now the aggressor. He sees Biden making progress in rallying US allies against China. There is some belief that Biden allowed the Nord Stream 2 pipeline to go through in Europe in exchange for Germany's support with getting tough on China. As such, Xi needs to get his house in order in anticipation of growing pressure from the West. When Congress imposed new restrictions on Chinese companies listing in the US last year, China was not pleased. Now China is saying they do not want Chinese companies listing in the US. We were already in a cyberwar and the restrictions on US listings from China is a sign that a capital war is developing. This is all part of the de-coupling process. Our sense is that there could be proposals to limit US residents from investing in Chinese companies.

Much of this is posturing until after the 2022 Winter Olympics in China. We get the sense that China is just identifying the red lines right now with no major moves expected before the Olympics. China is concerned that big moves ahead of the Olympics could force boycotts and the China plans on introducing the digital yuan at the Olympics in a bid to compete with the US Dollar for the reserve currency.

As such, US policymakers believe after the Olympics, Taiwan will be a bigger focus. The net result of this is likely less globalization which we believe can result in more inflation. If you look back to the Cold War, we had higher interest rates, higher inflation, and lower earnings multiples on stocks. But once the Berlin Wall went down, the world globalized, and the supply of labor increased. Inflation came down, interest rates came down, and the price to earnings ratio on the S&P 500 went from 14 to 18. Our sense is that some of these gains post Berlin Wall could reverse as the US and China decouple.

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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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