Uncommon Sense

Read My Lips: Higher Taxes Are Unavoidable

"Dear IRS, I am writing to you to cancel my subscription. Please remove my name from your mailing list."

— Snoopy

Michael Arone, CFA
Chief Investment Strategist, State Street Global Advisors

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Print

The dog days of summer are an unusual time to be writing about taxes. So, why am I interrupting your summer BBQ or beach holiday with commentary on taxes? Given that the political environment has never felt more divisive than it does right now, I tried to select a topic for this month that has nationwide agreement. Americans hate paying taxes. Sure, some folks take pride in paying their taxes for government services rendered. Sort of a taxes as a necessary evil philosophy. And, of course, there are raging debates about who actually pays or should pay their fair share of taxes and which types of taxes are most tolerable (e.g., income, payroll, capital gains, estate, property, sales, value added tax, corporate, etc.). However, when all is said and done, nobody, and I mean nobody, likes paying taxes.

While taxes are generally a mid-April matter, there are many reasons why taxes should be top-of-mind for investors this summer.

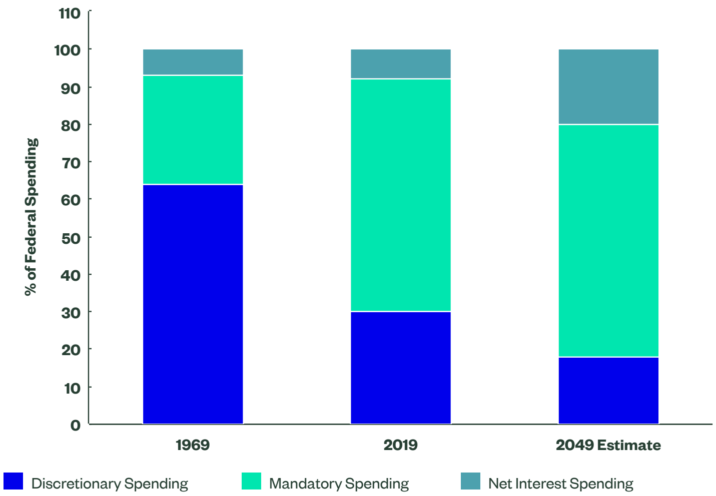
It's a Smile, It's a Kiss, It's a Sip of Wine…It's Tax Time?
On July 4, Americans will celebrate Independence Day. And oppressive taxes, such as the Tea Tax and Stamp Act imposed on the colonists by Great Britain, were a main catalyst for the American Revolution. In some ways, the July 4th holiday is an annual reminder that Americans' extreme dislike of unjust taxes traces its roots all the way back to the birth of our nation.

Also this year, in response to the COVID-19 pandemic, the traditional US tax day of April 15 has been extended three months, to July 15. Therefore, in the next few weeks many Americans will be gathering their tax-prep documents and firing up the TurboTax® Deluxe software to see where they stand with Uncle Sam.

Finally, the US election is just four months away on November 3 -- and both the Democratic and Republican National Conventions are scheduled to be held in late August in Milwaukee and Charlotte, respectively. That means how to pay for the massive fiscal and monetary policy responses to the COVID-19 pandemic will be part of this summer's political debates.

Some estimates of the US budget deficit now exceed $4 trillion in 2020. Congress has already passed four separate pieces of legislation totaling $2.4 trillion and a fifth stimulus package with a $1.5 trillion price tag is expected to pass this summer. The Federal Reserve has pitched in too, expanding its balance sheet by more than 70% this year to $7 trillion as of June 22. Finally, the US national debt stands at $26.3 trillion, rapidly on its way to an embarrassing $30 trillion burden for future generations.

Figure 1: Changes in Federal Budget Spending Over Time



Source: Peter G. Peterson Foundation. Office of Management and Budget, Historical Tables, Budget of the US Government: Fiscal Year 2021, February 2020; and Congressional Budget Office, The 2019 Long-Term Budget Outlook, June 2019. Note: Mandatory Programs include Social Security, the major federal health programs, and other entitlement programs, and offsetting receipts.

Despite both political parties' apparent eagerness to spend our country's way to prosperity, not surprisingly, the Democrats' soon-to-be presidential nominee, Joe Biden, and the Republican incumbent President, Donald Trump, have polar-opposite tax plans.

Neither candidate should underestimate the impact the tax debate could have on the election. A campaign tax blunder likely cost at least one former US president his re-election bid. In accepting his party's nomination, on his way to the presidency, George H.W. Bush famously said, "Read my lips, no new taxes" at the 1988 Republican National Convention. Four years later, in the 1992 election, President Bush's broken promise came back to haunt him. He eventually lost his re-election campaign to then national newcomer and rising Democratic star, Bill Clinton.

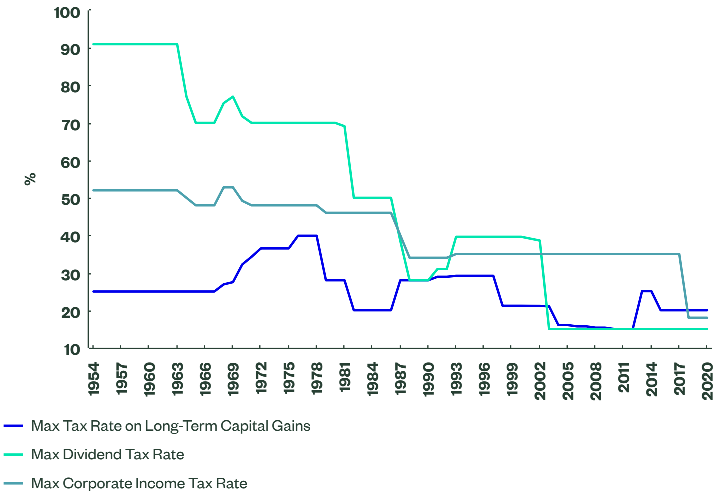
From my perspective, regardless of your political affiliation, it's not about if taxes will increase in the future, it's more a matter of when will they increase, by how much, and who ultimately will pay them.

The Summer Wind Came Blowin' In

While Independence Day, the extended July 15 tax deadline and the run-up to the election are all likely to ensure that taxes remain a hot topic this summer, investors should be alarmed that the threat of higher future tax rates could depress the outlook for stocks.

According to Empirical Research Partners, all of the margin improvement experienced by S&P 500 companies since 2015 has been attributable to lower tax rates. In fact, stable and/or falling capital gains, dividend, individual and corporate tax rates for much of the last two decades have been an under-appreciated boost to stock prices. This tax tailwind shifting to a headwind could complicate the outlook for future stock returns.

Figure 2: Tax Rates Have Fallen Historically



Source: https://www.taxpolicycenter.org, IRS, 12/31/1954 - 12/31/2019

Please, let me be clear. I'm not making a political judgement whether higher tax rates are good or bad. I am simply suggesting that as policymakers attempt to rein in yawning debt and deficits an important tailwind for historical stock returns probably will become less positive. Higher taxes will likely curtail growth and lower returns at some point in the future. In the midst of the COVID-19 pandemic, it is too soon to act on the possible consequences of these probable tax hikes. However, investors probably will have to consider the impact of higher tax rates in the not-too-distant future.

It seems reasonable that a change in US leadership will likely lead to higher corporate and capital gains tax rates as early as 2021. As a result, many investors are grappling with the impact a reversal of the 2018 corporate tax cut would have on profit margins and the stock market. It's difficult to determine the effects of a rise in corporate tax rates on stocks because it happens so rarely, just twice in the past 80 years. It's mainly been a global race to the bottom, with India and the US seeing the largest declines in corporate tax rates. By some estimates, a reversal of the 2018 corporate tax rate could reduce S&P 500 earnings by 7-8%. Market multiples would also likely contract because going forward companies will be compounding at a lower level of margins. Empirical Research Partners suggests that the market's multiple could decline by about half a point. They acknowledge that the reduction could be larger because companies paying low tax rates in the technology and healthcare sectors have gained a greater share of the earnings pie.

In recent years, technology and healthcare have been the market's leading growth sectors. Coincidentally, they pay the lowest effective tax rates and generate the highest profit margins. Declining taxes have been a key component to their growth equation. Exploding debt and deficits from around the world may result in desperate attempts to increase tax rates on these growth sectors, eventually hurting margins.

Changes to capital gains tax rates occur more frequently, including once in the 2010s, but the impact on markets and multiples is much more difficult to determine. Some research indicates that high beta, high multiple stocks are most negatively impacted by rising capital gains taxes. This also might suggest that some of the high-flyers in recent years would be hurt by an increase in capital gains tax rates.

The bottom line is that rising corporate and capital gains tax rates have the potential to slash growth rates, reduce profit margins and contract multiples for some of the sectors that have led the market in recent years.

Table 1: Historical Inflation, Valuation, Yields, Tax Rates & Growth

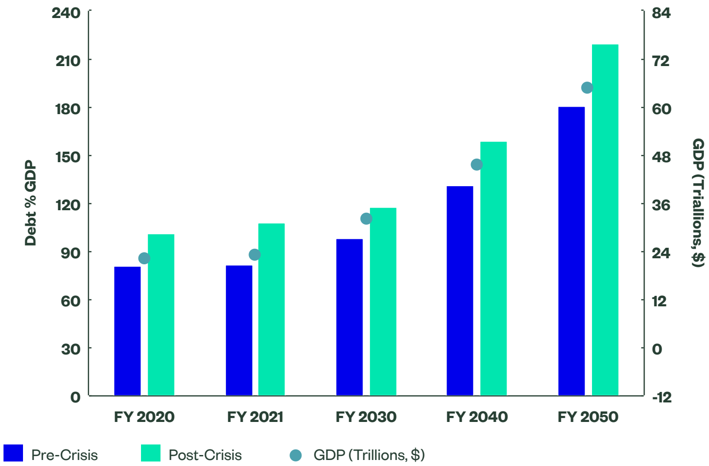
	CPI Y/Y % Change	S&P 500 Operating P/E	10 Year Treasury Yield (%)	Dividend Tax Rate (%0	Capital Gains Tax Rate (%)	Nominal GDP (Y/Y % Change)
1950s	2.1	12.6	3	91	25	7.1
1960s	2.3	18.1	4.7	80.3	25.4	7
1970s	7.1	12.5	7.5	70.2	36	10.2
1980s	5.6	11.7	10.6	48.4	23.6	7.8
1990s	3	19.5	6.7	37	26	5.6
2000s	2.6	20.1	4.5	23.4	16.8	4
2010s	1.8	17.7	2.4	21.2	21.2	4.1
Average	**3.5**	**16**	**5.6**	**53.1**	**24.9**	**6.6**
Current	**2.3**	**19.6**	**0.7**	**15**	**20**	**2.1**

Source: Historical Data Sourced from Strategas Research Partners as of January 27, 2020. Current Data Sourced from Factset and Bloomberg as of 6/24/2020.

Those Days Are Gone Forever. I Should Just Let Them Go

The gigantic fiscal and monetary policies in response to the COVID-19 pandemic have built an important bridge from economic recession to recovery. However, the mounting debt and deficits will need to be addressed in the future. And there are no good options. Policymakers will need to raise taxes, slash spending or monetize the debt. Maybe all three. None of these options are particularly good for future economic growth, inflation or stock returns.

Figure 3: Pre- and Post COVID-19 Crisis Debt Projections (% of GDP)



Source: CRFB as of 6/24/2020. GDP and Pre-crisis projections are based on data from the Congressional Budget Office's March 2020 budget projections. Post-crisis projections are based on the Congressional Budget Office's April 2020 near-term budget projections and its May 2020 Interim Economic Projections

The probability of a change in US leadership has been climbing in recent months. And with that change, investors may see a shift in corporate and capital gains tax rates. Stable and/or falling tax rates have been a somewhat unnoticed aid to stock returns over the past couple of decades. If taxes increase, investors may need to recalibrate their expectations for future returns, growth rates, profit margins and market multiples -- especially for some of sectors that have led the market in recent years.

Higher tax rates are inevitable, but their impact on future stock returns remains unclear. It just doesn't feel like it will be very good.

Glossary

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