TCM INSIGHTS

TOP OF MIND: THE ELECTION

With just a few days until the election, polls and prediction markets suggest that the Democrats will control the White House, Senate, and House of Representatives. Former Vice President Biden's lead in national polls has risen from +7 to +8 during the past month, according to RealClearPolitics. Prediction markets currently give Democrats a 64% likelihood of winning the White House and a 61% likelihood of winning the Senate.

The most direct consequences of a Democratic sweep on S&P 500 profits are corporate tax reform and fiscal spending. Analysts expect a Democratic sweep will have only a modest net impact on the medium-term path of S&P 500 earnings. It is expected that the combined effects of higher corporate tax rates, more fiscal spending, and lower tariffs under the proposed Biden-Harris policy agenda will result in annualized S&P 500 earnings growth of 13% through 2024. Under the pared-down agenda that economists believe is a more likely outcome, where Democrats control the House and hold a small majority in the Senate, estimates show a slightly higher EPS (14% compound annual growth rate).

The timing of a potential capital gains tax rate hike has been a key focus for many investors. Long-term capital gains and qualified dividends are currently taxed at a maximum rate of 20%, along with a separate 3.8% tax on investment income. Vice President Biden has proposed taxing these as ordinary income for **filers with over $1 million in annual income.** This would roughly double the tax rate on capital gains and dividend income from 23.8% to 43.4%.

Past capital gains tax hikes have been associated with declines in stock prices and in total household stock allocations. Using Federal Reserve data, it is estimated that the wealthiest 1% of households now hold around $1 trillion in unrealized equity capital gains. However, the trend of net equity selling and falling stock prices around capital gain rate changes has usually been short-lived and reversed during subsequent quarters. As an example, in 2013, although the wealthiest households sold 1% of their assets prior to the capital gains tax hike, they bought 4% of starting equity assets in the quarter after the change and therefore **only temporarily reduced their equity exposures in order to realize gains at the lower rate.**

Analysts expect US household equity allocations will actually rise in 2021 irrespective of the election outcome. Rising economic growth expectations should support higher equity allocations next year. The increase in equity allocations will likely be funded, in part, by a continued rotation away from cash. There is currently $4.35 trillion sitting in cash on the sidelines as investors remain wary of the election and a COVID vaccine. As those two issues get resolved,

continued on page 2

expect cash to move back into the stock market.

Additionally, it is also expected that foreign investors and corporations will also be net buyers of US equities in 2021. A weakening US dollar should support $350 billion of net equity buying by foreign investors. It is also estimated that as corporate balance sheets stabilize, a 15% jump in corporate stock buybacks and a normalization in share issuance will boost net corporate equity demand.

There will be sellers - for the right reasons, however. Mutual funds and pension funds are expected to be net sellers of US equities. Analysts expect the long-term secular shift in AUM from active to passive management should continue to drive mutual fund selling and inflows into ETFs next year. Also, rising bond yields and positive equity market returns will improve funded levels among pension funds, supporting pension fund net selling of equities.

Trent
Capital Management

October 30, 2020n