Investment Commentary: 5/2021

Picking up where the first quarter left off, global stocks started the second quarter strong. Fiscal and monetary support, upbeat corporate earnings, and improving economic outlooks supported the global equity backdrop. Developed markets generally outperformed emerging market stocks, and bonds had positive returns as US Treasury yields declined in April.

> *"Against a backdrop of robust economic data… US stocks outperformed foreign developed and emerging market stocks."*

- While re-openings and stronger economic growth-- particularly in the US- helped fuel market optimism, rising COVID-19 cases elsewhere threatened the global recovery. Despite these competing dynamics, optimism prevailed, boosted by solid corporate earnings.
- The S&P 500 rallied to another record high and had its best one-month percentage gain since November. Against a backdrop of robust economic data, including a 21% surge in US household income in March, US stocks outperformed foreign developed and emerging market stocks.
- US economic data released in April showed the first-quarter GDP expanded at a 6.4% annualized pace, slightly better than expectations of 6.1%.
- US Treasury yields retreated modestly, even as headline inflation exceeded 2%. The broad US bond market advanced in April, but US bonds underperformed global bonds.
- As we discussed in our April commentary, we expected inflation to pick up in the near term. Recent data showed the consumer price index (CPI) surging to a 4.2% annualized rate. It's important to note that most of this increase is due to the reopening of the economy and quirks in some of the CPI measurements. At this time we do not expect the fears of runaway inflation to be realized.

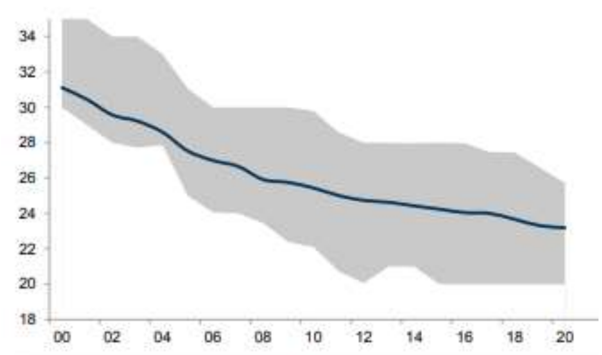
This month we take a look at the prospect for higher corporate tax rates and the implications for stocks and sectors.

Implications of Higher Taxes

Corporate tax rates in the US have trended down for decades, however, that trend is set to reverse in the coming years. Our focus is to objectively understand what is likely to happen to tax rates and the implications for our investors, no matter the direction. For perspective, the chart to the right illustrates how the effective tax rate for global companies has been trending down since 2000. The result of lower rates can be summed as providing higher profit margins for companies and lower revenues for governments. The chart on the next page compares the current effective tax rate in the US to other developed countries and shows the US has has one of the lowest effective corporate tax rates in the world.

Exhibit 1: Tax rates have trended down

Average global statutory corporate income tax rate (94 jurisdictions; excluding zero-rate jurisdictions). Shaded area: Top/Bottom tercile



Source: OECD, Haver Analytics, Goldman Sachs Global Investment Research

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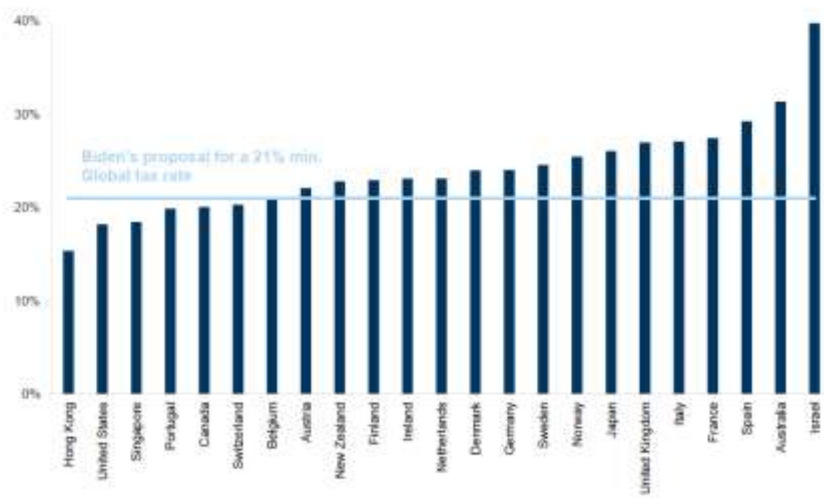
The current environment has prompted a lot of debate about the appropriate level of corporate taxation, due to:

- The rise in debt and government deficits, exacerbated by the costs of the pandemic.
- Whether technology companies with very high profits (and little taxes) are paying their fair share
- Cutting corporate taxes in recent years has not led to more investments by corporations—in fact, the opposite has happened, with much of the increase in profits going to buybacks not investment.
- The growing emphasis on social responsibility and the role of corporations.

Exhibit 12: The US stands out as having a low effective tax rate

2019 Effective tax rate. FF Adj figures for companies with a positive tax rate below 100%. Based on MXWO ex Energy, Real Estate, Investment Trusts and Diversified Financial Services



Source: FactSet, Datastream, Worldscope, Goldman Sachs Global Investment Research

The election win for President Biden and the narrow voting majority for the Democrats in the Senate, make it very likely that corporate taxes will increase. The Biden administration has proposed raising the US corporate tax rate to 28%, up from the current 21%. Most economists we follow believe there is likely to be a compromise at 25%, and ultimately a global minimum tax rate of 21%. The global minimum tax rate is designed to keep corporations from 'shifting' to low or no tax-havens. Based on a study by Goldman Sachs, the implications of a change in corporate tax rates are likely to be:

- US corporate rates are likely to converge with higher rates around the world, prompting a large shift up in global taxes.
- An increase to 28% would reduce S&P 500 earnings by 9% in 2022; while an increase to 25% would reduce earnings by 3%.
- Globally the tech sector accounts for close to 20% of world profits, but only pays 10% of global taxes, we think this is a major target of proposed higher taxes.
- Low tax sectors (technology, biotech, etc.) have outperformed in the low tax environment, going forward they will have greater headwinds.
- Tax changes may favor regional diversification away from concentrated US tech sectors.
- Many value sectors already have higher tax rates and have fewer intangible assets and should benefit relative to growth stocks. Therefore, a tax increase may impact them less than growth stocks.
- Infrastructure stocks should do well as governments spend more, as well as commodity sectors.

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Closing Thoughts

Recent inflation indicators came in hot and triggered a pullback in the stock market, based on fears of a change in Federal Reserve policy (higher rates!). However, it is important to note the inflation data was heavily influenced by some quirks and the reopening of the economy, mainly in the auto-sector and tourism sectors. We believe the Fed remains focused on the labor market and the recent data will not change their view that any increase in inflation is likely to be transitory and can be weathered by consumers. In general, we have added positions to portfolios that will benefit should inflation continue to trend higher.

We have discussed many times that stock market valuations are high and a correction could happen anytime and would be normal. That being said, the optimistic case for the markets seems to remain in place- vaccine distribution reopens the economy, fiscal support has improved household balance sheets to their best levels in history, and monetary is supportive of risk assets.

If you have any questions on this commentary or would like to discuss your investment strategy give us a call.

- AWM Investments (May 2021)