MAY 11, 2021

On the Radar

FAQS ON THE MARKETS AND ECONOMY

Are higher taxes a threat to the equity market?

The Biden administration has proposed a range of personal and corporate tax increases to pay for roughly $4 trillion in new spending plans. While higher taxes ahead appear inevitable, we expect changes to some of these proposals as they move through the legislative process. For instance, instead of raising the corporate tax rate to 28% from 21%, Congress will likely settle on a more modest increase.

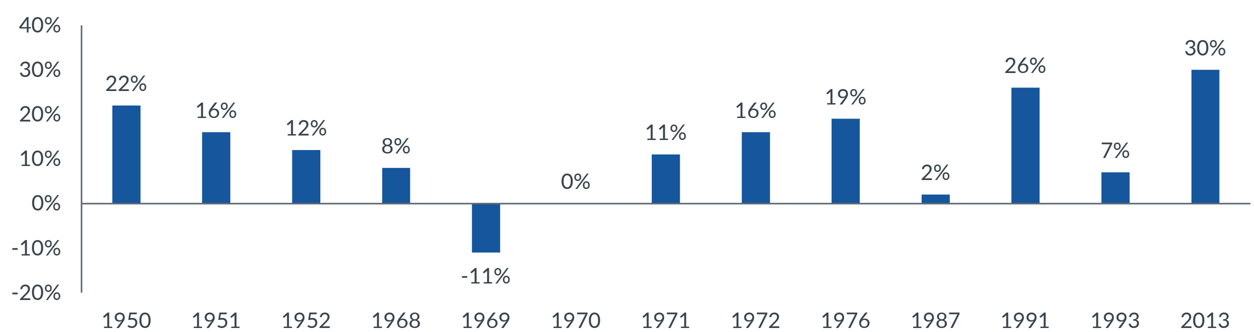
Higher taxes by themselves are certainly a negative headwind for stocks, and they will take a bite out of corporate profits. However, taxes are only one factor behind earnings growth and equity returns, with the macroeconomic backdrop being a bigger overall driving force.

Indeed, the stock market has historically performed well under a variety of different tax increases. This reflects the fact that tax hikes are typically accompanied by higher federal spending and that they tend to take place when the economic fundamentals are positive and the economy is able to absorb higher levels of taxation without significantly slowing growth.

Earnings growth has been robust this year on the back of a strong recovery and is expected to continue to be in 2022, despite the hit to profits from a higher corporate tax rate. Given this, it's not surprising that investors have so far largely taken potential tax increases in stride, with the S&P 500 trading near record highs.

Still, in a market in which expectations are optimistic, the potential for tax hikes could be a source of volatility for stock prices in the months ahead, and investors should also begin reviewing their tax budgets with an eye on changes to come.

S&P 500 Performance in Years of Tax Increases



	1950	1951	1952	1968	1969	1970	1971	1972	1976	1987	1991	1993	2013
Personal	X	X	X	X							X	X	X
Capital Gains				X	X	X	X	X	X	X	X	X	X
Corporate	X	X	X	X								X	

Source: FactSet, U.S. Treasury Department.

KEY QUESTIONS

How strong was Q1 GDP?

The manufacturing report declined in April. Is the manufacturing sector weakening?

Is the slowdown in job growth a concern?

How strong was Q1 GDP?

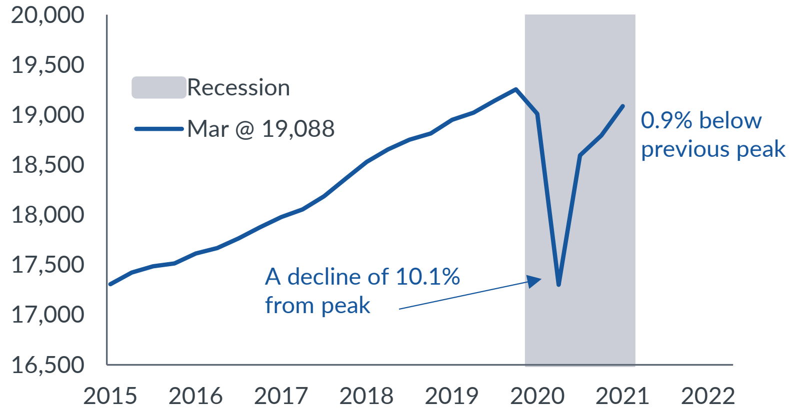
GDP was quite strong, growing 6.4%, which is twice the long-term average growth rate. As a result, the economy now stands less than 1% below the previous peak of Q4 2019. Next quarter, economic output is expected to surpass the previous high, moving the economy from the recovery phase into the expansion phase.

This is a consumer-led recovery. Armed with two stimulus checks, more people receiving the vaccine, and lifting business restrictions, consumers went out and spent money. The pace of spending was a solid 10.7%, the second-fastest rate since the 1960s. Durable goods rose 41.4%. Non-durable goods were up 14.4%, and services were up just 4.6% due to it being disproportionately impacted by COVID.

Looking forward, growth in Q2 and Q3 is forecast to grow even faster than Q1 (chart), driven by strong personal consumption. Households are estimated to be sitting on more than $2.0 trillion in "extra" savings, which give them plenty of resources to spend.

GDP

$, billions, seasonally adjusted annual rate



Source: Bureau of Economic Analysis as of March 2021.

The manufacturing report declined in April. Is the manufacturing sector weakening?

No, not at all. Manufacturing remains a vibrant part of this strong economy.

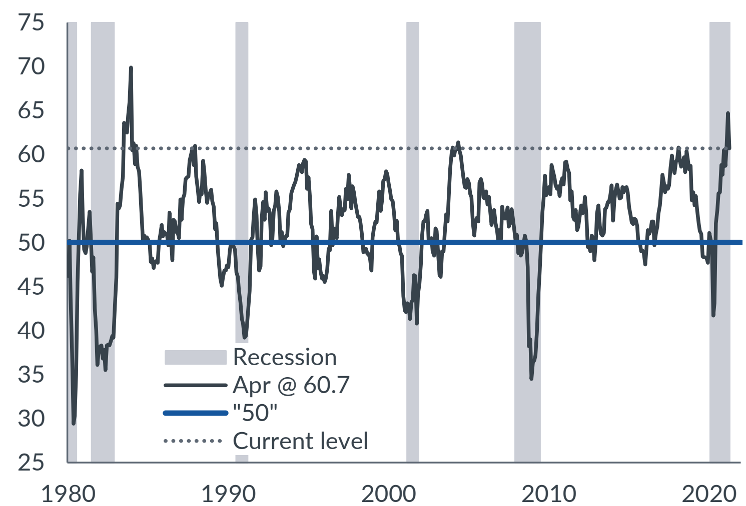
April's ISM manufacturing index, a survey of purchasing managers at more than 300 manufacturing firms, currently stands at 60.7. This is a diffusion index; any number above 50 is expansive; any number above 60 signals a broad and robust expansion.

Manufacturing has been on an upward trend since hitting a low last April (chart). This April's retreat of four points reflects many of the ongoing problems associated with distressed supply chains that have been in place since last summer. Manufacturers have noted continued troubles in the supply of semiconductors, resins, lumber, and industrial commodities, and also interruptions to port activity.

The supply/demand imbalance will probably take several months to work out, but it will. We believe demand for manufactured goods remains very strong as many retailers have to restock inventories.

ISM Manufacturing PMI

Diffusion Index



Source: Institute of Supply Management as of April 2021.

Is the slowdown in job growth a concern?

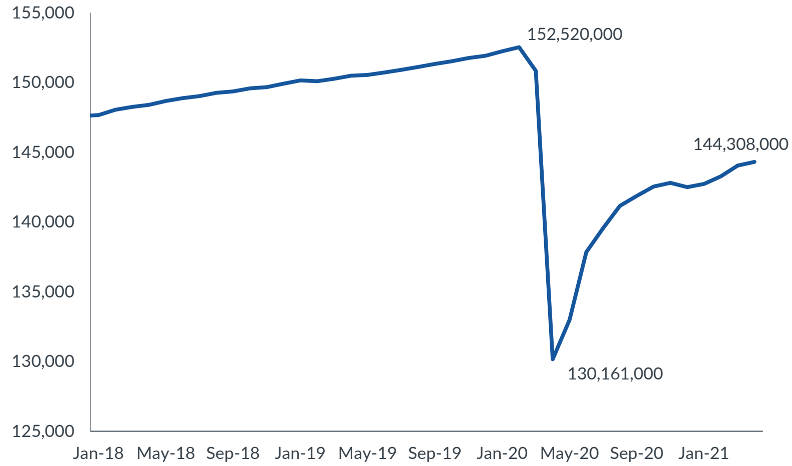
With much of the high-frequency data — including jobless claims — still rapidly improving, it's doubtful that April's disappointing jobs gain of 265,000 signals the recovery is at risk. It could, however, indicate that labor shortages are becoming a significant drag.

As expected, the loosening of restrictions is driving job gains in the worst-affected sectors, with leisure and hospitality employment rising by 331,000 and local government education payrolls increasing by 31,000. But those gains were smaller than anticipated, and they were partly offset by declines in sectors that had seen outsize hiring throughout the worst stages of the pandemic.

The unemployment rate also rose very slightly from 6% to 6.1%, as labor force participation rose more than employment. Given all the recent headlines on labor shortages, it is encouraging to see more people returning to the jobs market. Enhanced unemployment benefits will expire in September, and by then the health crisis should be mostly in the rearview mirror with a large portion of the population vaccinated. This should help to ease some of the potential labor supply issues.

Overall, it is difficult to judge how much weight to put on this report at a time when most of the other evidence suggests economic activity is rebounding quickly, but it is a clear reminder that the recovery in the labor market is lagging the rebound in consumption.

Nonfarm Payroll Employment
millions



Source: St. Louis Fed as of April 2021.

That's a crucial distinction for the Fed. With nonfarm payrolls still 7.3 million below their pre-pandemic level and monthly gains in the hundreds of thousands rather than millions, it could be a long time before officials can claim "substantial further progress" toward the "broad-based and inclusive" full employment goal.

That means any talk of tapering, let alone rate hikes, is likely to be further off than many in the markets seem to believe.

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Index Definitions

S&P 500 Index (S&P500) is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large-cap companies.

The ISM manufacturing index or PMI measures the change in production levels across the U.S. economy from month to month.