# U.S. LEGISLATIVE AGENDA MARKET IMPLICATIONS

## *Key Takeaways:*

1. Additional fiscal stimulus could lead to faster growth, tighter labor markets, and hotter inflation.

2. Open calls like our REITs tilt, our structured credit tilt, and our emerging market equities tilt should position us to benefit from a sustained rotation into reflation beneficiaries.

3. We're maintaining our constructive market outlook. While Biden's proposed tax hikes could represent a moderate headwind for U.S. equities if passed, we don't believe they will derail broader favorable trends across risk assets.

## *Summary*

Since the beginning of the COVID-19 crisis, Congress has provided for more than $5 trillion in incremental spending and tax relief. That represents more aid than we saw over the last five U.S. recessions combined. Moreover, recent Biden administration proposals suggest we could see additional stimulus later this year:

- On March 31, Biden proposed a $2.25 trillion American Jobs Plan (AJP). That AJP proposal included funding for physical infrastructure such as transportation and water systems alongside support for healthcare and workforce training, and offsetting corporate tax hikes.
- On April 28, Biden proposed a $1.8 trillion American Families Plan (AFP). That AFP proposal includes provisions for investing in social programs and human capital, alongside offsetting individual tax hikes.

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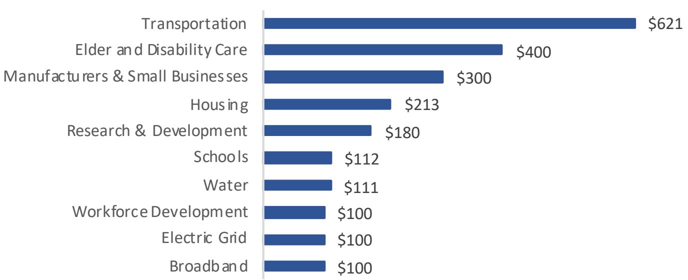
Although we're not attempting to handicap the odds of Biden's AJP and AFP proposals making it through Congress, we do think the proposals carry implications for capital markets. Specifically, we believe the AJP could further fuel the ongoing reflation rotations across equities, rates, and real assets. Additionally, the capital gains tax hikes in the AFP could create short-term selling pressure across equities.

We are not recommending shifting portfolios in response to these plans. However, we believe open calls like our REITs tilt, our structured credit tilt, and our emerging markets tilt should put us on the right side of these trends. We review the potential market implications of those proposals in more detail below.

## *American Jobs Plan Proposal*

The American Jobs Plan focuses on developing U.S. infrastructure. While the plan is broad-based, the majority of its $2.25T budget would go to transportation, elder and disability care, manufacturers, and small business:

AJP Cumulative 10-Year Budgets (Billions)




*Source: White House AJP Fact Sheet*

The bulk of the $2.25 trillion in spending would occur over the next eight years. Although infrastructure spending could take a few years to ramp up due to the limited number of shovel-ready projects, the package could still generate $300 billion in incremental spending as soon as 2022.

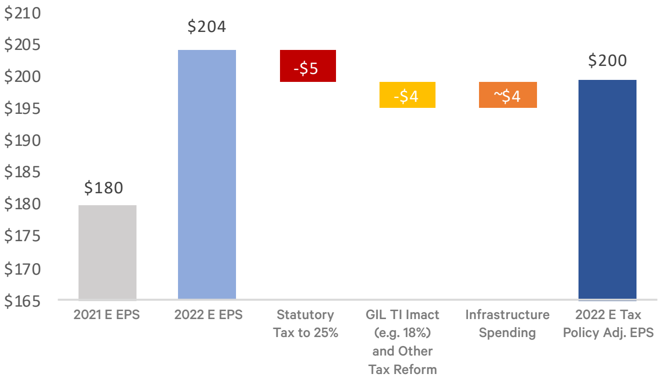
## *Made in America Tax Plan Impact*

The AJP is accompanied by a partially offsetting Made in America Tax Plan. Key provisions of the tax plan include:

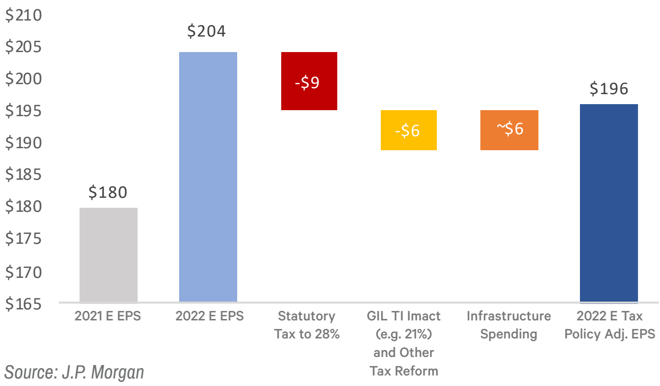
1. Increasing the U.S. corporate tax rate from 21% to 28%. This could be negotiated down to ~25%.
2. Establishing measures to disincentivize offshoring and prevent corporations from taking advantage of tax loopholes, including a 21% minimum global tax rate on the profits of U.S. multinational corporations and a 15% minimum tax rate for all U.S. corporations.

If passed, these tax hikes could take a bite out of 2022 S&P earnings. Specifically, they could represent a ~$15 hit to S&P earnings under a severe scenario and a ~$9 hit to earnings in a moderate scenario. However, infrastructure spending could drive offsetting earnings growth. Taking these numbers into consideration, the J.P. Morgan team has modeled the net impact of Biden's AJP proposal as a 2%-4% EPS hit in '22:

Infrastructure and Tax Proposal Impact
Estimated 2022 EPS Impact Moderate Scenario




Infrastructure and Tax Proposal Impact
Estimated 2022 EPS Impact Worst Scenario

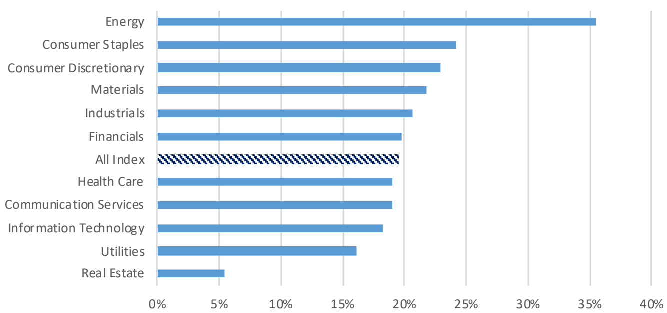



*Source: J.P. Morgan*

We'd advise assuming large error bars around these initial 2022 earnings estimates.

Taking a more granular view, proposed fiscal spending could favor procyclical energy, industrials, and financials names by driving growth and inflation higher. The tax proposals included in the AJP could also disproportionately affect low effective tax rate sectors such as technology and healthcare:

S&P 500 2020 Effective Tax Rates by GICS Sector




*Source: Bloomberg, Average S&P 500 Effective 2020 Tax Rate grouped by GICS sector*

The same companies significantly affected by tax hikes will also likely see limited upside from stronger U.S. economic growth. Meanwhile, more cyclical, U.S.-focused stocks in the industrials and financials sectors could see more muted tax headwinds and more upside from a stronger economy and rising rates. So, while the AJP could moderately hurt aggregate S&P earnings, it could have a bigger impact on market internals by fueling the ongoing rotation into cyclicals.

## *Market Impact:*

If passed, the American Jobs Plan could reward some of our cross-asset calls, including our constructive views around REITs, emerging market equities, and structured credit.

Our call to overweight emerging markets relative to developed markets could benefit from the American Jobs Plan, given:

- Tilting away from the U.S. should insulate us from corporate tax hike headwinds.
- Infrastructure investment could be positive for commodity prices, contributing to emerging market returns.

An overweight to REITs relative to TIPS may be rewarded as:

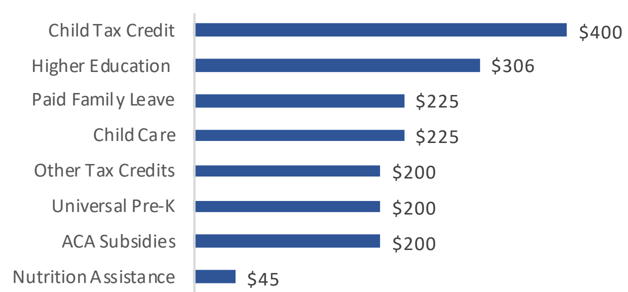
- REITs don't pay corporate taxes. So, they could face limited headwinds if corporate tax rates rise, offering better relative value than the broader U.S. equity market.
- If significant fiscal stimulus continues to propel inflation higher, real assets like REITs could benefit.

Our underweight to core fixed income in favor of structured credit may also be additive. Structured credit has limited duration. That tilt could drive outperformance if the AJP leads to rising interest rates by accelerating the return to full employment, contributing to inflation risk, and forcing the Fed to hike interest rates sooner.

## *American Families Plan Proposal*

Biden introduced the American Families Plan proposal on April 28. The American Families Plan proposal involves spending ~$1.8 trillion on the following priorities over the next 10 years:

AFP Cumulative 10-Year Budgets (Billions)




*Source: White House AFP Fact Sheet*

The AFP also includes tax code changes such as:

- Increasing the top federal ordinary income tax rate from ~37% to 39.6%, effectively reversing the 2017 cuts to the top bracket.
- Nearly doubling the marginal long-term capital gains rate from 23.8% to 39.6% for people with an income greater than $1 million.

While it is fairly easy to identify the top-line costs of the American Families Plan, its economic impact is not as cut and dry. Investments in human capital and early education may be additive over the long-term, but economists aren't equipped to estimate those impacts.

## *Market Impact:*

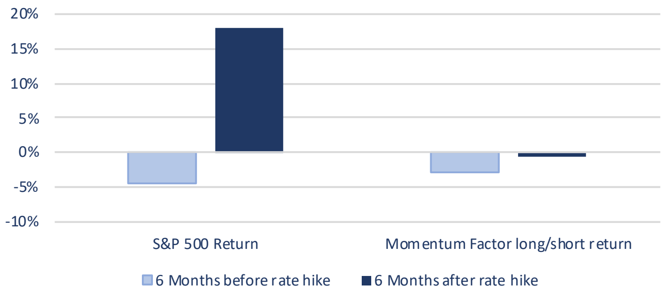
Most research around the market impact of the American Families Plan proposal is centered around its capital gains tax hike provisions. Capital gains tax hikes incentivize taxable investors to sell appreciated positions before tax code changes take effect.

The Biden administration is pushing for a retroactive tax hike date of April 2021. If that provision is passed, investors have already missed the opportunity to realize gains at a lower tax rate. However, the likelihood of retroactive tax hikes winning congressional approval seems low.

In the event that Congress approves a capital gains rate increase, we could see selling pressure across equities. That could have an outsized impact on long-term winners like Facebook, Apple, Google, and other large growth names due to investors' significant embedded gains in those outperformers.

Those forces played out during the last three U.S. capital gains tax hikes, in 1987, 1988, and 2013:

Trends Around Historical U.S. Capital Gains Tax Rate Hikes
1987, 1988 & 2013




*Sources: FactSet, eVestment, AQR Database*

Market performance around those tax code changes shows rising capital gains rates were a short-lived headwind for equities as investors who sold appreciated positions to realize gains tended to buy back into the markets shortly after at higher basis. However, they created more sustained headwinds for momentum stocks.

That momentum index performance figure captures the relative performance of recent winners. Momentum stocks tend to have larger embedded gains, as they represent top performers over a trailing 12-month period excluding the previous month. Thus, momentum index performance is a decent proxy for high embedded gain stocks' relative performance. Today, most momentum indices are heavily tilted toward growth stocks and tech stocks.

In light of this, we view the AFP as marginally negative for U.S. equities and especially negative for growthier strategies and long-term winners within U.S. equities.

Meanwhile, capital gains tax hikes could be marginally positive for REITs. Today, taxable investors' REIT dividends are taxed at the ordinary income rate. By equalizing high earners' qualifying dividend tax rates with their ordinary income tax rates, the AFP could put REIT dividends on an even footing with other listed equity dividends, improving their relative value.

## *Conclusions:*

Ultimately, we're not confident the AFP and AJP proposals will make it through Congress at the levels the Biden administration initially proposed. The two parties remain divided with negotiations requiring considerable compromises thus far. While a tentative agreement on a reduced AFP proposal appears to have been reached, there is still much work to be done to ensure passage through the full Senate. Democrats' narrow control of Congress along with tax hike misgivings from moderate Democrats could create a challenging path forward for these pieces of legislation. Moreover, we're not comfortable making developments in Washington a big part of our investment process. However, we are monitoring the progress of those plans. We believe open calls like our REITs overweight, our structured credit tilt, and our emerging markets equities overweight should put us on the right side of those proposals.

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