THEMATIC GLOBAL VIEWS

What if the Democrats succeed in passing the capital gains tax?

Since Joe Biden's elections, most observers have been surprised by how Democrats managed to pass significant fiscal policies despite their thin majority. We believe the capital gains tax hike could go ahead regardless of the Republicans opposition. The impact of previous tax hikes on markets over the short and long run is not clear. However combined with slowing economic momentum and fears around Fed tightening, this might be a short-term headwind for US equities in Q4 2021.

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Democrats are not looking for a compromise with the Republicans

When Joe Biden was elected last November, the Democrats did not have a majority in the Senate. The consensus then was that the new administration would seek a compromise with the Republicans on fiscal policy. Gaining a majority in the Senate in early January did not change the conviction of observers. The Democratic majority was seen as too narrow to pass all the electoral promises. This is all the more true since some centrist Democratic lawmakers openly opposed some promises.

It was therefore not without surprise that the Biden administration managed to pass a $1.9 trillion stimulus package without compromise, when most observers expected a $1.1 trillion to $1.3 trillion package. The only thing the Democrats had to give up was a measure to raise the federal minimum wage, because the reconciliation procedure could not be used to pass a measure that did not directly affect the budget.

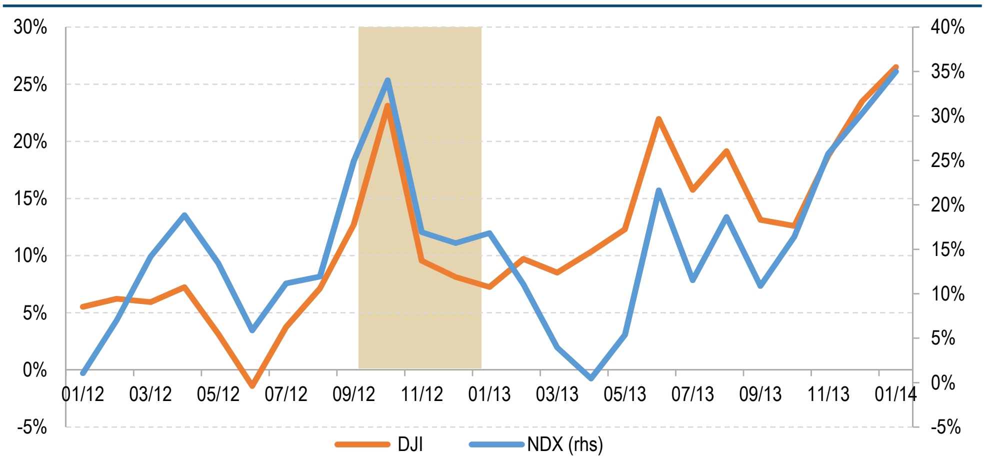
Shortly afterwards, Joe Biden presented his infrastructure investment plan ("American Jobs Plan"), which includes many of his presidential campaign commitments. Amounting to nearly $2,250bn over 8 years, this plan would be financed by an increase in corporate taxes of an equivalent amount but over a period of 15 years. Joe Biden then presented the second part of his recovery plan, with $1,800bn in new social spending over 10 years, financed by tax increases on the wealthiest households. At the same time, the administration wants to eliminate tax breaks for private equity fund managers[1]. Finally, Joe Biden signed an executive order to increase the minimum hourly wage from $10.95 to $15.00 in companies with federal government contracts.

As a matter of fact, the Democrats are not concerned about finding a compromise with the Republicans, who are naturally very much opposed to all these projects, especially those on taxation.

The results of the latest census show that political power is shifting from the Midwest and Northeast to the South and West. The new state population figures will be used to reallocate seats in Congress and the Electoral College. We think this will strengthen the Democrats in their strategy. According to our calculations, Democratic-dominated states will lose three seats in the House of Representatives in 2022, while Republican-dominated states will

[1] *In addition to wages, these managers rely mainly on a share of asset appreciation (known as carried interest). These profits are currently taxed as capital gains, at a rate well below the top marginal income tax rate applied to wages. The Biden plan would remove this tax break.*

1/ **Dow Jones Industrial (DJI) and Nasdaq100 (NDX) performance (YoY %, monthly, Jan 12 to Jan 14)**



Source: Amundi Research - Data as of 25 May 2021

THEMATIC
GLOBAL VIEWS

The census show that political power is shifting

The capital gains tax could negatively impact stocks with a strong price momentum

gain three. This means that the Democrats could loose control of the House with this new split in November 2022. This is a real wake-up call for Democrats.

The census should therefore encourage them to keep their electoral promises in order to consolidate their electoral base. One of the most emblematic measures **is the increase in the capital gains tax**, which has strong distributional effects. Against this backdrop, we believe, unlike most observers, that this measure is likely to be passed by the end of the year.

Could the capital gains tax hurt the US stock market?

There have been four capital gains tax increases in the US in recent history: 1969, 1976, 1987 and 2013. The 1976 hike was limited to less than 4% whereas the other three were close to 9%, i.e. comparable to the current hike being discussed by the Democrats. 1969 was more than 50 years ago, a time when the US household savings rate was nearly 10% compared with 2.5% today and US equities were in a bear market. Therefore, the comparison with today's situation might not be so relevant. But we can still use 1987 and 2013 as reference points.

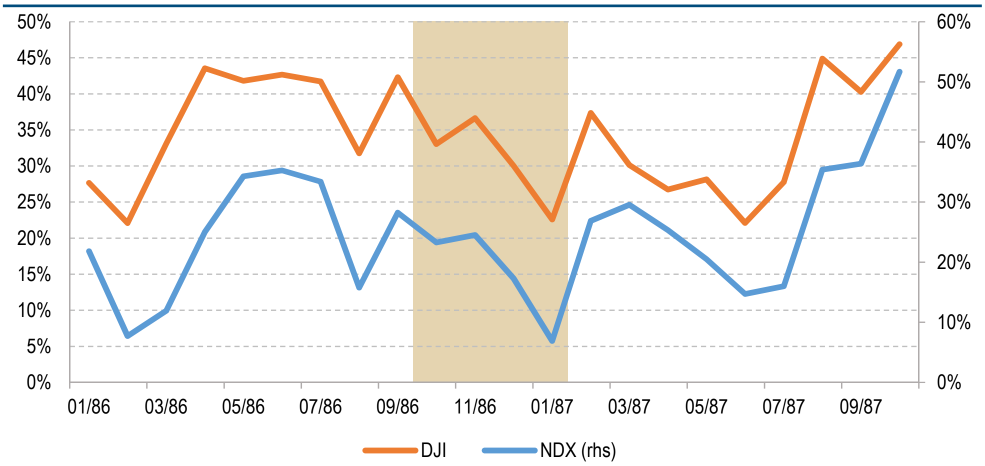
When looking at the performance of the Dow Jones Industrial Average (DJI) and the Nasdaq100 (NDX), we can see an inflexion point three months before the capital gains tax implementation date, which could be linked (among other factors) to investors taking profits before the introduction of the new tax rate. The NDX lost 5% in the last three months of 2012 and the DJI lost 2%. A similar situation happened prior to the 1987 capital gains tax hike, where the NDX and the DJI both lost their positive price momentum in the last three months of 1986, although they maintained a small positive return. Yet, in 2013 and 1987, both indices recovered quickly and showed positive performances in the first half of the year. Therefore, assuming the tax hike was the main factor behind these performance changes, it was only a one-off with short-term effects.

Assuming that the same profit-taking behaviour will apply again this time if the new hike is implemented on 1 January 2022, the US equity market could face headwinds from October to December 2021. Private investors might then rebuild their positions over the first quarter. Going forward, we should assume the impact will be marginal. Indeed, three years after the 1987 and 2013 hikes, the DJI and NDX were both up by between 30% and 76%. Therefore, we cannot conclude that the tax hike had a big impact on that measure alone. However, when combined with slowing economic momentum and fears around Fed tightening, it may be the case.

An analysis of single stock performance around the 2013 capital gains tax hike (using the constituents of the Dow Jones industrial Index) shows that some of the outperformers in 2012 registered a pull-back from October until the year-end. However, there are several counter examples. Looking at stock returns over 1, 3, 5 and 10 years prior to the event, out of the 17 stocks that had a positive performance across all time horizons i.e. stocks with the highest probability of large cumulative gains, only nine had a negative performance in the last 3 months of the year. This includes names like Apple, McDonalds, Wall Mart and Disney, with no specific sector bias. 50% is not enough to formulate a rule, yet it is worth noting that most stocks showing a poor performance prior to the tax hike outperformed the index during the three-month period. We shall therefore assume there is some impact.

An increase in the capital gains tax may have an impact on stocks or sectors of the US market that have had very strong

2/ **Dow Jones Industrial (DJI) and Nasdaq100 (NDX) performance (YoY%, weekly, Jan 86 to Oct 87)**



Source: Amundi Research - Data as of 25 May 2021

THEMATIC
GLOBAL VIEWS

performances in recent years. The effect could be more significant at the individual stock level than at the index level. Names like Tesla or Apple, for instance, could suffer, but the impact should be limited and short-lived. If history repeats itself, there is no evidence that the hike could have a long-term negative impact on the US stock market.

A problem might actually occur elsewhere. The capital gains tax will be limited to those earning income above $1 million a year, i.e. 0.7% of US households. These investors have access to the stock market of course but also to a broad range of investment products, such as private equity and alternative investment funds. The strong performance of sovereign bonds and credit might also be part of the equation and the capital gains tax could trigger outflows from the equity markets.

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