Ropes Wealth Contemplates the Election & Your Portfolio

WAITING ON WASHINGTON

In these wild weeks leading up to the election, you are going to hear lots of dire predictions about what will happen if Joe Biden is elected or if President Donald Trump is re-elected. We urge you not to fret if your favorite candidate doesn't get elected in November. The U.S. economy and stock market have generally marched higher through Democrat and Republican administrations alike. Dramatic events such as 9/11, the global financial crisis and the COVID-19 pandemic have been the cause of sharp and unpredictable market selloffs—but our economy and stock market have historically been resilient even to these types of shocks. While many of us are passionate about politics, at the end of the day, remember that you are invested in companies or pools of companies through our selected funds that have enduring business models led by strong management teams that simply want clarity on what to expect over the next four years.

But won't Joe's income tax hikes crash the market?

Biden has committed to rolling back Trump's tax cuts, including reverting the top individual income tax rate for taxable incomes above $400,000 from 37% to the pre-Tax Cuts and Jobs Act level of 39.6%. In addition, he is suggesting imposing a 12.4% payroll tax on income earned above $400,000, split between employees and employers. In addition, there would be caps and eliminations on itemized deductions for high-income earners. But perhaps the most dramatic difference between the Biden and Trump tax proposals centers on long-term capital gains. The Trump administration would like to lower the upper 20% long-term capital gains rate to 15%, while Biden has proposed increasing it to 39.6% for those earning more than $1 million. This would raise an estimated $800 billion for the federal government to put toward Biden's planned changes for health care, education, infrastructure and climate. In classic campaign strategy, Trump is promising to expand his 2017 tax breaks, while the Biden camp believes the breaks benefit only a few.

We are always cognizant of tax implications when considering investments for clients, so any potential changes to capital gains or investment income taxes could have a meaningful impact on future recommendations and potential after-tax returns. The last time capital gains were taxed as ordinary wages was some 32 years ago, between 1988 and 1990, during the Reagan administration. To date, this marks the only time in U.S. history both were taxed at the same rate. While more clarity is needed on these proposals—and on what Congress may ultimately pass into law—a potential bump in capital gains rates could warrant realizing more gains in 2020 to take advantage of the lower rate. Furthermore, Biden has proposed the elimination of the cost-basis step-up upon death. This would raise an estimated $440 billion. Under the proposal, capital gains taxes would apply at death as if the assets were sold. Both potential changes are equally important in how we may think about managing assets going forward. The potential elimination of the step-up would alter strategies around retaining low-basis positions in the later stages of life.

That said, keep in mind that policy changes take time and—with the backdrop of the pandemic—may by implemented in phases. Furthermore, the pandemic remains the main impediment to near-term economic growth and, quite likely, will remain the focus at the start of the next administration. So while his proposed tax policy may be perceived as unfavorable in the short term, Biden's calls for a much stronger federal role in promoting and financing social distancing, contact tracing and quarantines may be repositioning the country for improved growth prospects.

What about companies?

On the corporate side, Biden is proposing changes that would have a material impact on most company earnings. On the table is increasing the corporate tax rate from 21% to 28% (estimated $730 billion), implementing a minimum 15% corporate tax rate ($400 billion) and doubling the Global Intangible Low-Tax Income (GILTI) tax rate ($340 billion). For reference, GILTI is the income earned by foreign affiliates of U.S. companies from intangible assets such as patents, trademarks and copyrights. We have taken a look at how these changes might impact the different sectors of the U.S. economy and the businesses we invest in. The higher overall rate and GILTI tax of foreign profits

MAIL-IN BALLOT TIMELINES IN KEY BATTLEGROUND STATES

	PROCESSING BEGINS	COUNTING BEGINS	BALLOTS DUE BY
NC	35 Days Before	14 Days Before	3 Days After
FL	22 Days Before	22 Days Before	Election Day
AZ	14 Days Before	Election Day	10 Days After
PA	Election Day	Election Day	3 Days After
WI	Election Day	Election Day	6 Days After
NV	Upon Receipt	Election Day	7 Days After
MI	Election Day	Election Day	14 Days After

combine for a nearly 12% estimated reduction in earnings, and, not surprisingly, technology companies—those that have led asset prices higher during the rebound—are the most affected at an estimated 17-18% hit to profits. For the S&P 500 as a whole, the estimated hit to earnings is about 12%. As stocks trade generally on a multiple of forward earnings, one can see the potential impact this would have on returns as we enter 2021.

Of course, if Biden is elected, his ability to implement changes to tax policy at both the individual and corporate level will depend on the makeup of Congress. He will need both a Democratic Senate and House, and, even with those two, the appetite for change may not be there if the focus remains on the virus, getting more Americans back to work and getting the economy back on track. But, if those conditions are in place, high-income and wealthier households, along with corporations, will pay more in taxes. We are mindful of this fact, as it has the potential to affect after-tax returns and could also weigh on stock prices and the income that companies return to their shareholders in the form of dividends.

Should we expect more volatility?

Even before the COVID-19 outbreak at the White House, the short answer was "yes." Options markets are currently pricing in a fair amount of uncertainty heading into the election, both around the magnitude of potential stock price moves and the timing of election results. There remains a real possibility that on election night the results will be too close to call in many swing counties and states, leading to legal challenges by one or both parties. The 2000 election between Bush and Gore provides historical context. During the 35 days between election night and when Gore finally conceded on December 12, the S&P 500 suffered nearly a 12% decline. In the current scenario, the potential legislative paralysis could become even more damaging to the economy, as additional measures to support the economy during the ongoing pandemic will likely be delayed. Adding to the uncertainty is the recent passing of Justice Ginsburg, leaving many to wonder what might happen if the SCOTUS has to weigh in on a contested election. Whether Mitch McConnell can get President Trump's nominee approved before the election is unclear. If they are unsuccessful, we are likely left with a split SCOTUS, 4-4, and, in such a case, the election would kick back to the House where the vote is not by individual member, but by state delegation. Not surprisingly, the equity market volatility structure is upwards sloping from here to year end, peaking in late 2020, early 2021. This suggests that markets are pricing in risk of a contested election result that might take months to sort out.

Much of the concern is focused on mail-in ballots and how individual states will handle the final tally. As mentioned in last month's newsletter, we also need to consider "what might go right." Yes, Pennsylvania, Wisconsin and Michigan have extended their deadlines, but in other key battleground states like Arizona, Florida and North Carolina, we found it encouraging that mail-in ballot processing begins 14, 22 and 35 days prior to Election Day, respectively. Markets have proven adept at sorting out winners and losers, and we might learn that this election is no different. It is reasonable to assume that the market will have enough information on election night to know who our next president will be with some level of certainty, even if it does take time for a final verdict. We must remember that regardless of who wins the White House, companies across the globe will continue to operate and strong investment opportunities will exist for those able to identify them. For these reasons, we believe a long-term approach remains appropriate for most individuals with the ability to look past this potentially disruptive election period.

GROWTH STOCKS BREAK THEIR STREAK IN SEPTEMBER

After leading the market to new all-time highs, growth stocks finally faced some weakness in September as market participants reconsidered valuations in light of rising virus spread, a stalemate over another round of fiscal stimulus and divisive rhetoric as Election Day approaches. The announcement that the president and much of his inner circle have tested positive for the virus has further added to uncertainty as we head toward November 3. Still, in spite of September's weakness, the market delivered another solid quarter of returns for equity market investors while fixed income markets held steady. Here in the United States, large-cap stocks outperformed small, and growth still outperformed value for the quarter as a whole, mainly due to the outsized leverage to central bank liquidity, secular growth and disruptive theme tailwinds. Sector-wise, consumer discretionary stocks were among the best performers. The S&P 500 posted an 8.93% return while smaller companies, as measured by the Russell 2000, returned 4.93%. Overseas, Asia ex Japan and Emerging Markets were the bright spots, returning 10.24% and 9.56%, respectively, while the broad-based international benchmark, the MSCI All Country World ex. USA, was up 7.93%. As in the United States, growth stocks meaningfully outperformed.

Massive monetary and fiscal stimulus continues to get the credit for higher equity market prices, with some banks, like Bank of America, estimating the support at over $20 trillion. The Federal Reserve made headlines once again, announcing that they expect to hold interest rates near zero through 2023. With that in place, the front end of the yield curve continues to offer little upside for investors who may be looking to ride out a potentially volatile finish to the year. Other positive news for risk markets included hope for a near-term vaccine breakthrough, continued improvement in the labor and housing markets, and company earnings resilience. Year-to-date, investors seem to be brushing aside a number of potential headwinds, including ongoing U.S.-China trade tension, seemingly stretched valuations and concentrated performance in big tech, and high-frequency data suggesting that the recovery is beginning to stall. As we write, partisanship continues to delay additional stimulus, and there is increased talk about "peak Fed," meaning they are low on tools for additional quantitative easing. This highlights the important task for Congress and the White House to achieve some form of fiscal stimulus to bridge the economic gap, as we expect the virus to impede economic growth until an effective vaccine is widely available.

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