FIRST Forward™
Investment Insights

August Commentary

What Now? What's Next? What If?

For some odd reason, it feels as if, with everything going on in the world, the global news cycle almost seems to have hit a pause button. The Ukraine and Russia conflict rages on in the Kursk region, as does the conflict in the Middle East. However, the upcoming U.S. election has and will continue to take center stage for the next couple of months. It appears the outcome is anything but straightforward, especially given Kamala Harris's ascension to the top of the blue ticket. It appears the Democratic party platform and strategy have not changed all that much—but the party has been re-energized by the new Harris-Walz alliance while former President Trump's core base of support remains unwavering.

As for policy, well, that depends on who you ask. Corporate tax rates, estate tax laws, and the personal exemption, taxing unrealized capital gains, and doing away with the step-up in cost basis upon death are trial balloons being floated around pre-election. These are financial issues that people who do what I do for a living must regularly contemplate. Arcane topics and questions like these don't usually make for a very engaging dinner conversation in many households. Admittedly, these issues often do not directly apply to the lunch pail crowd or the everyday citizen. Why should they care about taxation policies purported to be geared at the wealthy? Or the tax policies being bantered about for corporate America?

I would ask you to stick with me a little longer, and let's tackle one policy issue where there is a vast political divide that I believe could impact the economy and market dynamics—the policy issue: corporate taxes. Currently, the nominal federal corporate tax rate is a flat 21%. One party has said it wants to cut it to as low as 15%, and the other wants to increase it to 28%. At face value, to Johnny Sixpack, that probably seems like much to do about nothing. However, this "so what" issue could bring a very hefty price tag if you dive into the numbers. Let's take the plunge and analyze a scenario and the potential results.

Starting with increasing the corporate tax rate from 21% to 28%:

- Suppose Company XYZ generates $10 billion annually in revenue, has a 15% pre-tax profit margin, and has 1 billion common shares outstanding. That means XYZ makes $1.5 billion pre-tax and, assuming no other taxes or extraordinary items, would have a $315 million tax bill at the current 21% rate and $420 million at the new proposed 28%.

So, doing the math, this is a difference of $105 million in taxes due, which is peanuts to massive corporations, right?

- Let us further assume investors put a 25x price/earnings multiple on XYZ's stock (meaning investors are willing to pay $25 for every $1 of earnings). If so, what is the difference in the company's market capitalization due to the increase in the corporate tax rate from 21% to 28%?

This example's math is easy due to the round numbers and base assumptions. It is the difference in the tax bill ($105 million) multiplied by 25. This figure equates to a whopping $2.625 billion decrease in market capitalization and represents a nearly 9% decline in the original value of XYZ. Of course, real life isn't always as buttoned-up as this example.

OK, now that was just one company, a whole lot of numbers, and way too much math. But what if this scenario plays out and the entire U.S. stock market fell the same 9% due to changes in this one tax policy? Well, as of September 9, 2024, the S&P 500, the most widely recognized U.S. market index, had a combined market capitalization of just under $46 trillion, meaning a 9% decline would be over a $4.1 trillion erosion in market/societal wealth (this link will show a different value every day). So, even if you aren't Warren Buffett or Gordon Gekko, if you have a 401(k) plan, an IRA, 403(b), or participate in a pension plan of some sort, that is important. Will it happen? I hope not, but the proposed policy could have legs if one party wins and can garner enough congressional support.

On the contrary, if we project the same mathematical principles used above across all of corporate America, a proposed reduction in the corporate tax rate to 15% from the current 21% would generate an increase of over $3.6 trillion in the market capitalization of the S&P 500. Therefore, the difference in stock market capitalization between cutting the rate to 15% and raising it to 28% is around $7.7 trillion. This figure is greater than the gross domestic product (goods and services produced in one year) of every country except the U.S. and China. The same holds about this proposed policy for a corporate tax cut, which would need support and approval from Congress.

No company will sit idly by and watch higher taxes eat into their earnings. No CEO or CFO will throw up their hands and say: "OK, guys, you win. Our investors and stockholders will have to be happy with less." There is no chance in Hades that this will happen. These corporate leaders will need to figure out how to sell more widgets or slash costs and hope revenue stays the same. Most would probably do a combination of the two, but cutting expenses is the more effective and quickest way to make an impact rather than hoping to increase the top line. So, let us suppose a company decides to cut costs by $75 million and work like the dickens to maintain net profit margins after the tax increase—what can they do, you ask? Well, if the average associate at the company makes $55,000/year, it could start by letting go 1,363 workers. How does that sound? Or it can fire half that number and make up the rest by slashing other costs. That may not be good for folks like you and me. And, of course, those savings will come with a price to vendors, suppliers, etc., and could have a significant ripple effect throughout the economy. Make no bones about it: Someone, somewhere and somehow, will have to make up the difference in corporate America's tax bill if the corporate tax rate increases. It is not a question of whether someone will get the short end of the stick. It is a question of who.

In the end, a surprisingly sluggish news cycle, sans the continuous election coverage, has led to this narrative about how increased corporate taxes could have significant negative consequences for the economy and the markets. Sure, there is no denying my point of view is painted with brushstrokes from a guy who lives and breathes all things economic and market-related every day. It's funny how things color your perspective and view when you do them for a living. However, my reasoning is some not-so-complicated math and a basic understanding of market dynamics.

Congratulations if you made it this far. Let us turn back to the question I posed early on: What about the U.S. elections? During every presidential election cycle, we hear claims of it being "the most monumental election of all time." This statement is partially true because every election is significant and impacts policies affecting Americans. But is the upcoming November 8, 2024, election truly the most monumental ever? I guess it depends if you are more concerned with economic, social, or the combination of all proposed policies in their totality. It's like believing every college football game is "the most important game" of the season. Don't make that argument with Michigan vs. Ohio State, Alabama vs. Auburn, or Florida vs. Florida State fans, or any number of fan bases around the college football landscape. I have no doubt there are hardcore fans who would be willing to lose every game of the year as long as they were

victorious in their annual rivalry game. Sometimes, folks just want to win no matter the cost or carnage left in the wake of victory.

We will likely continue to see volatility until the election, as with any event carrying uncertainty; however, risks will get priced into the market, solutions or workarounds will be found, and ultimately, equity prices will grind higher over the long term. When looking at historical returns, the scenario yielding the most robust returns is a divided Congress, regardless of which party controls the White House. So, in essence, the stock market prefers political gridlock. Equities perform best when Congress has trouble passing new laws and companies are left to their own devices to do what they do best— business without having to navigate the blustering of politicians.

Here are a few of the major economic policy issues comparing newly appointed Democratic nominee Harris and former President Trump:

Policy	Harris	Trump
The 2017 tax cuts for individuals, which expire at the end of 2025	Supports the Biden plan to allow all tax cuts to expire except for households earning less than $400,000	Extend or make permanent all the 2017 tax cuts
Corporate taxes	Raise the corporate tax rate from 21% to 28%	Lower the corporate tax rate from 21% to as low as 15%
Other taxes	Eliminate federal income tax on tips; impose new tax on wealth above $100 million	Eliminate federal income tax on tips and on Social Security income
Trade	Continue to restrict high-technology exports to China and sustain 100% tariffs on Chinese electric vehicles	Impose a 10% to 20% tariff on most imports and a 60% tariff on imports from China
Healthcare	Extend or make permanent temporary subsidies for higher-income Americans to buy insurance through the Affordable Care Act; forgive some medical debt	Repeal Affordable Care Act or reduce subsidies
Housing	Enact a $25,000 subsidy for first-time home buyers; establish incentives and reforms to help build 3 million additional homes	Pressure the Federal Reserve to support lower interest rates, ease regulations, open federal land to development
Russia’s war in Ukraine	Continue military aid to Ukraine	Seek a settlement with Russia and end or restrict U.S. military aid to Ukraine

Regulation	Raise federal minimum wage to $15, expand student debt relief, ban price gouging in grocery industry	Cut regulations substantially across the board, eliminate regulations targeting appliances and products, reduce/rollback on consumer fees, categorize more civil workers as political appointees rather than employees, reduce barriers for mergers/acquisitions
Energy	Extend electric vehicle incentives to commercial transportation, expand carbon capture credits	Offer tax credits for oil and gas drilling, eliminate the electric vehicle tax credit, expand carbon capture credits
Immigration	Implement enhanced border enforcement on asylum seekers	Implement substantially more restrictive immigration rules, restore funding for the border wall, increase deportation on undocumented individuals

The reality: Right or left, red or blue—it doesn't matter who is in the Oval Office concerning market performance—some things are within the scope of presidential powers, and some are not. Many variables and market forces affect asset prices. The best strategy continues to be investing for the long term and ignoring short-term political changes because the president cannot directly control the stock market. That, in and of itself, is a good thing. Let's hope this continues.

For more information, follow this link to our previously published Election 2024 piece.

Until next month—

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