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INSIGHTS

THREE MAJOR ISSUES

When making investment decisions, under normal circumstances investors would assess a company's prospects from a 'bottom-up' perspective. That is, assessing the market for a company's product or service (demand), as well as competition from similar companies (supply) and determining a fair current value for the company's stock based on expected cash flows generated by the business.

However, since the financial crisis in 2008, and the Covid-induced government-mandated economic shutdown in 2020, the normal supply / demand dynamics impacting the corporate operating landscape have been distorted by massive government and Federal Reserve intervention. As a result, investors not only have to assess a company's underlying business fundamentals, but also figure out the impact of fiscal and monetary policy.

Three major issues currently loom large for investors:

Monetary Policy

First, regarding monetary policy - when will the Federal Reserve dial back its quantitative easing (QE) efforts? Recall, since interest rates are near zero, the only way the Federal Reserve can add further monetary stimulus is by buying $80 billion of US Treasuries and $40 billion mortgage-backed securities EVERY MONTH. The Fed has a dual-mandate – price stability (keep inflation and deflation in check) and support full employment.

Since inflation is running above their 2% target, and recent employment numbers show people are going back to work, there is less need for $120bn of monetary stimulus each month. As such, analysts expect the Fed to announce their intention to start tapering these purchases sometime in the fourth quarter of this year, with the actual tapering to start in January 2022 and ending by then end of 2022 (reducing purchases by $10 billion each month for 12 months). Once the tapering is complete, it is expected that the Federal Reserve will want to start hiking interest rates in 2023.

Fiscal Policy

Second, regarding fiscal policy, what will be the final size of the infrastructure bill and how will it be funded? Politicians and the media tout this as $1 trillion that is fully paid for without tax hikes. However, the Congressional Budget Office recently scored it as raising discretionary spending by $415 billion in the next ten years while lifting budget deficits by a total of $256 billion, which means it's not fully paid for.

It seems that consensus among analysts is that late this year a bill (or bills) will get passed, with total extra spending of roughly $2 trillion with some tax hikes. Analysts expect a top tax rate of 39.6% on regular income (currently 37%), a corporate tax of about 25% (currently 21%), and a top capital gains and dividends rate of 24% (currently 20% - well below the 39.6% the Biden Administration proposed). Also, the Biden Administration would like to eliminate the step-up basis at death for capital assets, but most analysts believe that is a bridge too far for Congress.

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Covid

The final question revolves around the potential for another 2020-style Covid shutdown. That seems doubtful. Analysts think a shutdown would be perceived by the country as a step backward against the virus at a time when Democrats are in control of the White House, the House, and the Senate, while the party is trying to pass key legislation.

If a shutdown results in a Republican victory in the Virginia governor's race in November 2021 that would make it even harder for moderate congressional Democrats to vote with the Biden Administration on taxes and spending. Expect more mask mandates and limited vaccine mandates, but not shutdowns.

Hopefully, in the years ahead, investors can get back to focusing on good old supply and demand in evaluating investments instead of having to guess what deals politicians can strike around government policy.

Matt Jones, JD, CFP
President

LEGACY CAPITAL

David Trent
Managing Principal