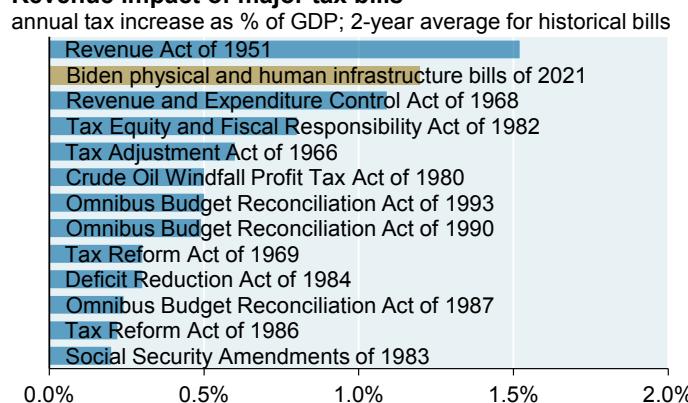


## The Smalligarchy: how the narrowest political margins in decades could deliver one of the biggest taxation and spending increases in the post-war era; the US economy approaches lift off; *Morone saxatilis*

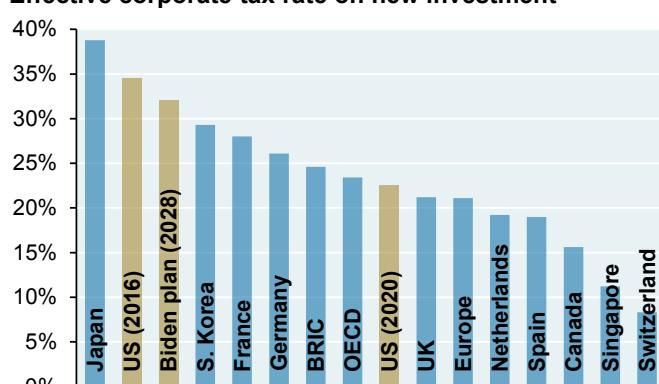
While Trump's margin of victory in 2016 was narrow, Biden's was even narrower. Less than 25,000 votes (i.e., 0.01% of the voting age population) could have changed the 2020 Presidential outcome, and less than 8,000 votes in one of the November 3<sup>rd</sup> Georgia Senate races could have changed the Senate outcome as well. In a large country with intense partisan divides, the **Smalligarchy** refers to the very small number of voters in swing counties that can effectively determine major policy outcomes. This is now on full display with the rollout of Biden's "physical" and "human" infrastructure proposals which, if enacted, would rank among the most comprehensive changes in decades<sup>1</sup>. The first chart compares Biden's tax proposals to post-WWII tax increases.

### Revenue impact of major tax bills



Source: Treasury, CBO, Cornerstone. March 2021.

### Effective corporate tax rate on new investment



Source: Mintz and Bazel (University of Calgary). March 2021.

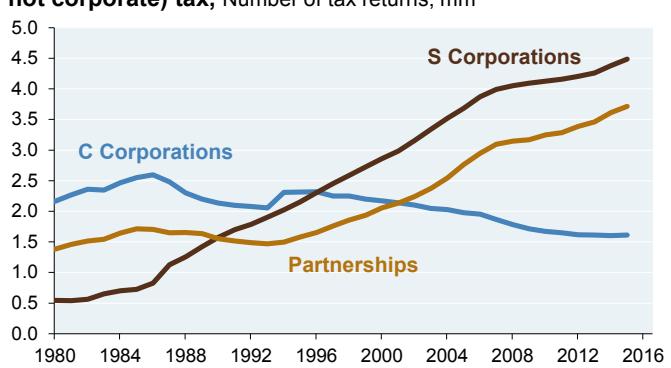
Biden's proposed tax increases to partially fund both infrastructure bills are split roughly 2/3 on corporations and 1/3 on high income individuals. As investors, we're more focused on corporate tax increases given their potential impact on markets. There are a lot of ways to look at corporate taxes. My preferred approach: **marginal effective corporate tax rates on new investment**, which allow for comparisons over time and across countries. This is how tax academics look at it since it smooths out idiosyncratic noise in company-specific data. As you can see above (right), Biden proposals would almost entirely reverse the 2017 corporate tax cut<sup>2</sup>.

### On corporate tax rates

Marginal effective corporate tax rates assess the impact of statutory tax rates, credits and deductions firms get for new investment. METRs are not all-inclusive; for example, they do not incorporate minimum taxes on foreign income. But they are the best way we have to assess corporate tax burdens and competitiveness.

Measures of corporate taxes to GDP over time in the US, and when compared to other countries, are **muddled by US adoption of pass through tax rules** in the 1980s which resulted in many corporate taxpayers becoming personal taxpayers instead.

### The rise of pass-through entities subject to personal (and not corporate) tax, Number of tax returns, mm



Source: IRS. 2015.

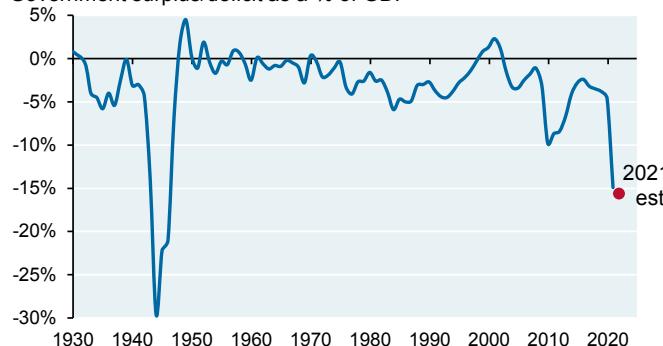
<sup>1</sup> **Biden proposal assumptions.** **Physical** infrastructure (transport, broadband, clean energy, housing, schools) \$1.6 trillion in new taxes, \$2.3 trillion in spending. **Human** infrastructure (paid leave, child tax credit, universal pre-K, free community college) \$1.0 trillion in new taxes, \$1.5 trillion in new spending. [Cornerstone Research]

<sup>2</sup> **A different approach gets to the same place:** Trump corporate tax cuts excluding one-time items and assuming extension of full expensing and interest deduction limitations (0.4% of GDP) are smaller than Biden corporate tax hikes of 0.5%-0.6% of GDP.

Given only partial funding of the bills, \$1.2 trillion would be added to the deficit using our assumptions. US deficit and debt levels are, as we all know, already elevated. **It could take months for Democrats to get enough support for both bills**, even when using a reconciliation process that requires no participation from the GOP. The final bills may look very different than our assumptions once Congress starts drafting and negotiating.

#### US fiscal deficit

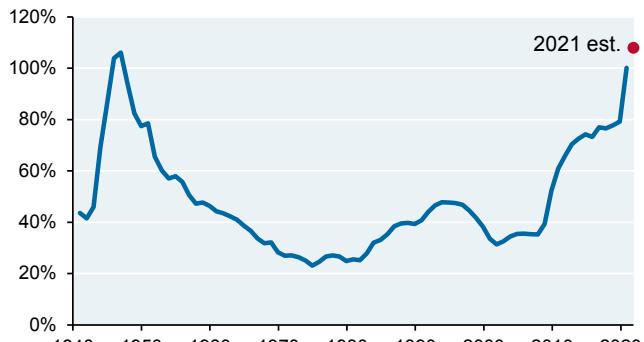
Government surplus/deficit as a % of GDP



Source: OMB, CBO, CRFB. March 2021. Includes virus bill; excludes infra. bill.

#### Gross federal debt held by the public

% of US GDP



Source: CBO, CRFB. March 2021. Includes virus bill; excludes infra. bill.

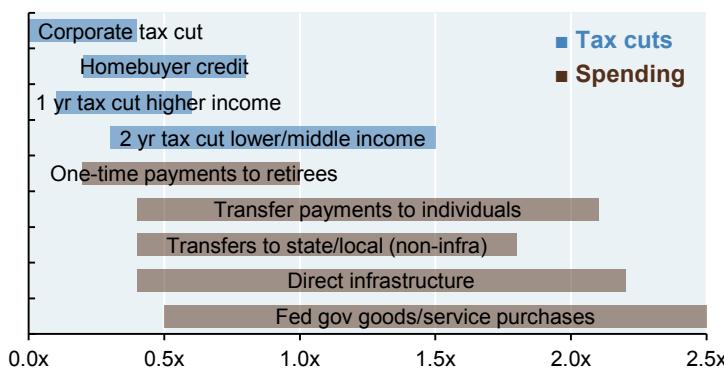
#### Market impact of higher taxes and higher spending

Most analyses we've seen of Biden's corporate tax plan are "static": they apply new rules to 2022 projected S&P 500 earnings per share and compute the decline in EPS. The major components (higher statutory rate, minimum tax rate on worldwide income, minimum rate on large companies, social security payroll tax hike) **could on a static basis reduce S&P 500 EPS by 8%-9%**. As the largest beneficiaries of the 2017 tax cuts, Tech, Healthcare and Communications sectors would experience larger effective tax rate increases.

A "dynamic" analysis **incorporates revenue benefits** from trillions in new spending. Physical infrastructure takes time to roll out and may be narrowly distributed, while the corporate tax increase would affect all companies immediately. If that's the case, a dynamic analysis wouldn't be that different from the static one. If the "human" infrastructure bill passes as well, the spending impact could be sooner and broader in which case revenue growth could offset part of the corporate tax increase. The more you believe in growth multipliers, the smaller the hit to corporate profits. For what it's worth, **a 2015 CBO report showed the highest growth multipliers for the kind of direct Federal gov't purchases of goods & services found in Biden's physical infrastructure bill**.

#### What helps GDP growth the most?

Estimated fiscal multiplier range

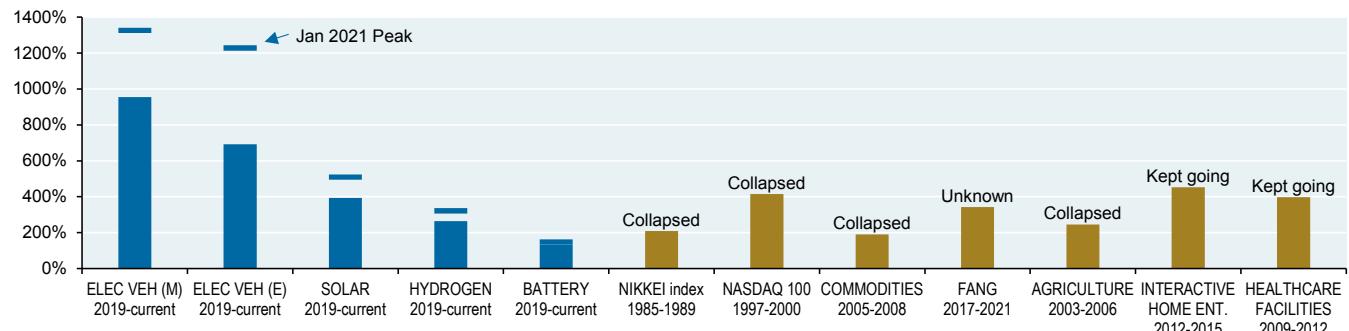


Source: Congressional Budget Office. February 2015.

An infrastructure bill has been broadly signaled by Biden and has been priced in for some time. Industrials have outperformed the S&P 500 by 10% since the election, and the PAVE ETF of heavy equipment, raw materials and construction outperformed the S&P 500 by 24%. Valuations of infrastructure and broadband/digital stocks based on the ratio of enterprise value to sales are in line with recent 5 year averages. As for clean energy, even after the selloff from January highs, the net run-up in the last three years is very large compared to the history of short term surges in sector valuations. The usual suspects (closed and open ended infrastructure funds, including those focused on digital infrastructure as well as roads, bridges and highways) are the most straightforward ways to position for continued public works spending.

#### Renewable stock price surge (2019-2021) vs prior sector/country stock price gains of 200%+ in 3 years or less

Labels indicate what happened 3 years after the stock price surge



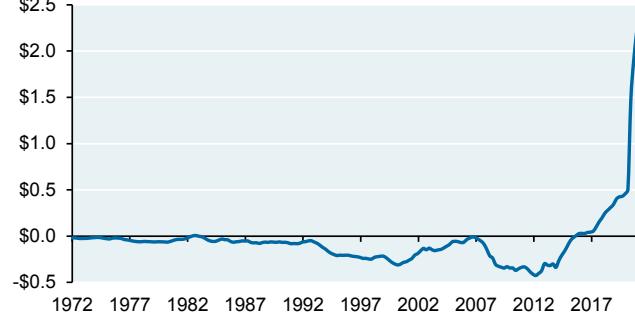
Source: Bloomberg, JPMAM. March 31, 2021. EV companies presented both market-cap (M) and equal (E) weighted given Tesla's outsized impact on the former.

While markets are pricing benefits of increased infrastructure spending, markets are not pricing in much of an impact from corporate tax bills, maybe since there are still so many unknowns. Evidence: the stocks that outperformed after 2017 since they benefitted most from lower rates have not underperformed (yet).

What are US equity markets focused on instead? Lift-off. US spending potential that was accumulated by year end is starting to get deployed, amplified by an explosion in the money supply.

#### Excess spending potential piled up by year end

\$tn, rolling 4-quarter spending potential in excess of consumption



Source: Fed, BEA, JPMAM. Q4 2020. Spending potential: 65% of taxable income, 100% of transfer pmts, 10% of housing wealth and 1.5% of fin. wealth.

#### Faster growth in the money supply this time around

M2 money supply + institutional money market fund balances, index



Source: St Louis Fed, ICI, J.P. Morgan Asset Management. Feb 2021.

Here's what liftoff looks like in the US. Note how even pandemic-affected sectors (restaurant spending, lodging, air travel) are picking up sharply as vaccinations approach 30%. Housing is on fire, with a collapse in inventories to all-time lows and surging lumber prices. Interesting side note: while **lumber** prices are rising, **timber** investors have not been reaping the benefits. Sawmills are operating close to capacity and generating profits, but they're paying the **lowest prices in decades for timber** after a glut of tree planting in Texas and the Southeast. It could take years to run down excess timber supply vs demand, even during a housing boom. One of my sons just got his first full time job at a timber management company and is a fount of useful data on such topics.

### Social distancing spending, card present transactions

Spending change vs 2019, 7 day smoothing



Source: Internal Chase data, JPMAM. March 26, 2021. Social distancing: retail, lodging, restaurants, parks, theaters and other recreational services.

### Airline spending, all transactions

Spending change vs 2019, 7 day smoothing



Source: Internal Chase data, JPMAM. March 26, 2021.

### Months supply of existing single family homes

Months



Source: National Association of Realtors. February 2021.

### Lodging spending, all transactions

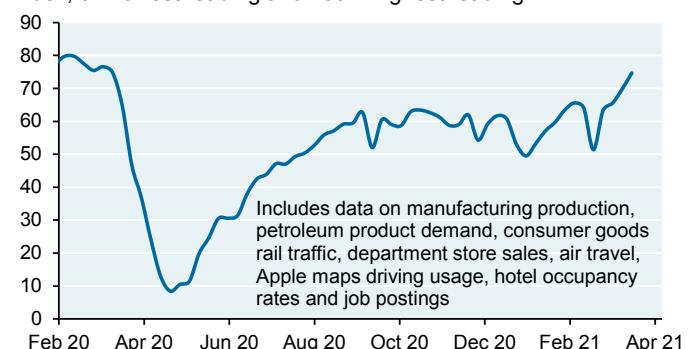
Spending change vs 2019, 7 day smoothing



Source: Internal Chase data, JPMAM. March 26, 2021.

### US activity tracker

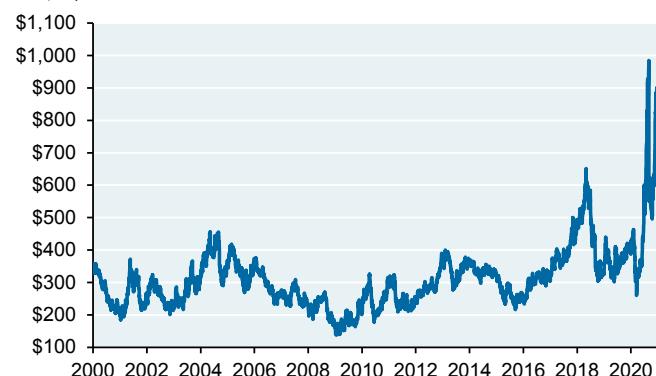
Index, 0 = lowest reading and 100 = highest reading



Source: WWPA, EIA, AISI, EEI, AAR, Redbook, TSA.gov, Apple, Smith Travel, MBA, ThinkNum, JPMAM. March 24, 2021.

### Lumber prices

US\$/1,000 board feet



Source: Bloomberg. March 30, 2021.

**On a global basis, world equity markets are keeping pace with improvements in global business surveys.** In other words, markets are not spending much time right now worrying about COVID variants and rising European infections/lockdowns, and are instead focused on the improving pace of business activity and leading business indicators. The rise in industrial metals prices tell the same story.

### Global Equities vs Global Business Surveys



### Industrial metal prices

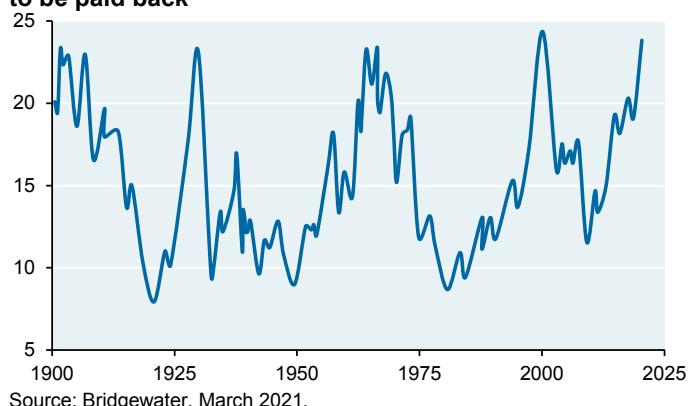


We expect developed world equity markets to maintain their gains as economies gradually reopen (see our [virus portal for details](#)). Vaccinations are finally picking up in Europe (although AstraZeneca is facing new restrictions in Germany, Scandinavia and Canada). While the US lift off is welcome news, I still think that 10% S&P 500 gains for 2021 is the right target. A lot of the good news we're seeing was priced in when the year began and as shown below, the share of the US equity market made up of very high P/E or unprofitable firms has reached a new high. In a similar vein, Bridgewater recently estimated the number of years it would take for US companies to pay back all their debt and equity with internally generated cash flow. This measure reflects both P/E ratios and corporate leverage, and has also reached high levels compared to history.

### Market cap of high P/E (>40x) or unprofitable firms



### Number of years for US corporate debt and equity holders to be paid back



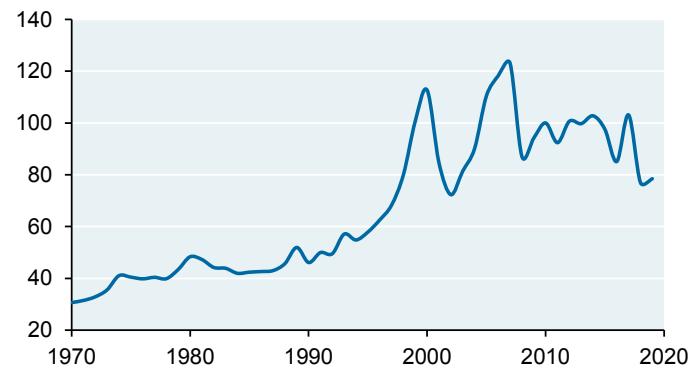
**Other modest headwinds include rising expectations of inflation and a decline in “globalization”,** which we estimate with an index of global trade, portfolio flows and foreign direct investment. While US equity markets have kept pace with improving business activity, they have also kept pace with **rising margin debt** (third chart) which just increased by the largest amount since FINRA data began in 1998. This section concludes with SPACs: after a euphoric January, **over 80% of pre-announcement SPACs now trade below issue price despite the presence of full redemption rights** (a development which I assume is good news for SPAC arbitrage investors).

#### 10-year breakeven inflation rate



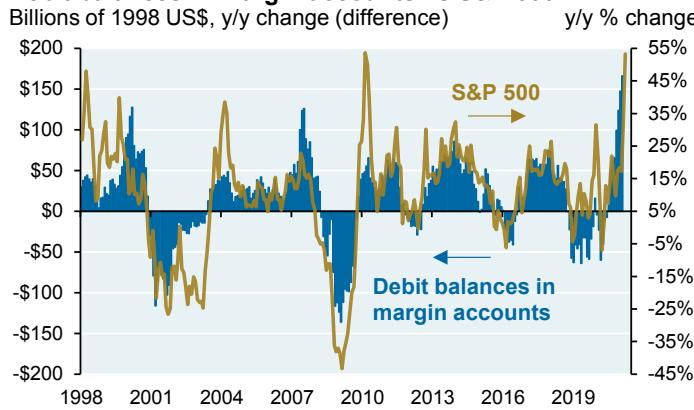
Source: Bloomberg. March 31, 2021.

#### Globalization index, Index of global trade, portfolio flows and foreign direct investment as % of global GDP, 2010 = 100



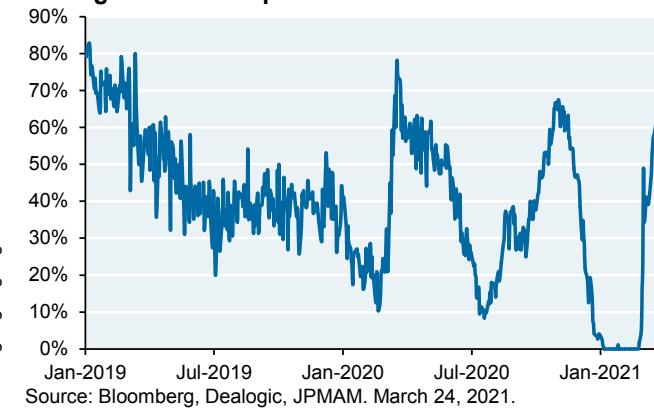
Source: World Bank, IMF. 2019.

#### Debit balances in margin accounts vs S&P 500



Source: FINRA, Bloomberg. March 30, 2021.

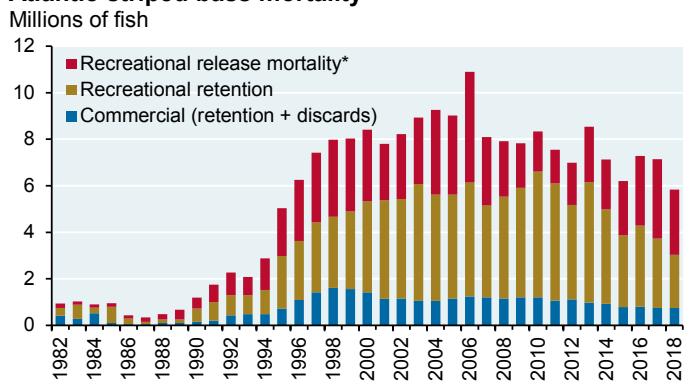
#### Percentage of outstanding pre-announcement SPACs trading below issue price



Source: Bloomberg, Dealogic, JPMAM. March 24, 2021.

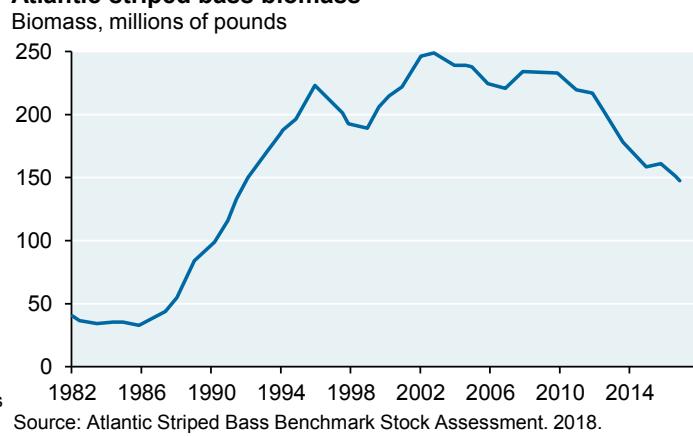
**It's almost fishing season again here**, which is welcome news after a year in quarantine. Striped bass mortality has been declining, but not because people are fishing less or due to stricter retention rules. As shown in the last chart, declining mortality is a reflection of less fish to catch. New slot fish/bag limits and mandated circle hooks are designed to reverse these trends. See my Instagram for fishing pictures and details.

#### Atlantic striped bass mortality



Source: Atlantic Striped Bass Benchmark Stock Assessment. 2018. \*Assumes that 9% of fish released alive die.

#### Atlantic striped bass biomass



Source: Atlantic Striped Bass Benchmark Stock Assessment. 2018.

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