Key Private Bank

Key Questions

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Do Higher Taxes Ensure Lower Stock Prices?

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No, but investors should be discerning and disciplined as they maintain a bias toward risk assets.

“Nothing can be said to be certain, except death and taxes” is a proverb we’ve all heard more times than we can count. While he was not the first to make this observation, Benjamin Franklin is famous for the quote, which he made in a letter to French scientist (and fellow electricity enthusiast) Jean-Baptiste Le Roy in 1789.

Despite the fact that taxes have been close to a near guarantee ever since, markets were seemingly caught by surprise when the Biden administration floated plans last week to raise taxes. Specifically, the White House proposed increasing the capital gains tax rate from 20% to 39.6% for individuals earning more than $1 million annually. Investors really shouldn’t have been completely surprised: The policy is consistent with the views that Biden espoused when he was a candidate for president two years ago.

Reflecting on our views on this issue, we were right in August of last year[1] when we highlighted that tax policy was the starkest difference between the two political parties’ platforms before the election. And we were also correct to suggest that capital gains taxes might be targeted if then-candidate Biden was elected.

That said, immediately following the election, we incorrectly downplayed the likelihood of higher taxes being enacted, citing a weak economy ravaged by COVID-19 and a divided government that we believed rendered substantive policy changes unlikely.[2] Since then, two significant events have transpired.

First, domestic economic activity has sharply rebounded as multiple vaccines have been approved and are being broadly adopted. And second, Democrats captured both US Senate seats in Georgia, affording president Biden with a majority (albeit a narrow one) and emboldening him to pursue more progressive policies.

As a result, investors should now assume that taxes will be raised. The House of Representatives is controlled by Democrats, who would be expected to support and pass tax hikes. In the Senate, most of the changes could be adopted via a process known as budget reconciliation that allows for approval by 50 senators plus the tie-breaking vote by the vice president. While there will likely be considerable debate regarding the details, the likelihood of a bill becoming law by the end of the year appears high, prompting the question: Do higher taxes ensure lower stock prices?

In short, not necessarily. What matters more, in our opinion, is the continued reopening of the economy, which will be influenced by the future trajectory of the pandemic. The following is our rationale supporting these views.

First, despite his bold aspirations to effectively double the capital gains rate, we don’t believe the president will achieve such a feat as not all his Democratic colleagues in Congress agree with such sweeping change. Second, as we noted in previous commentaries, a key pillar of the Biden administration’s platform is increased investment in infrastructure — the main reason why higher taxes are being proposed. Importantly, because much of the spending will occur in the near and intermediate terms and tax increases will be drawn out over time, economic growth will be “net positive.”

We also noted -– and still maintain -– that monetary policy is likely to remain accommodative, meaning that low interest rates will persist and provide additional economic support. And finally, in looking back over several decades of financial history, we observe that the correlation between the tax rates on capital gains and stock prices is very low.

For these reasons, while we may have been wrong to discount the likelihood of higher taxes five months ago, we still conclude that investors should not abandon their long-term commitment to equities and other risk assets. Of course, this assumes the economic picture continues to brighten and the wounds from COVID-19 continue to heal gradually.

Nevertheless, in light of higher taxes becoming more of a certainty, there are other considerations investors should keep in mind. First, according to the Tax Foundation, if all of the president's proposed changes go into effect, that would move the US from the 12th-highest tax-levying country to one of the highest among developed nations. As we noted above, we don't envision that the full scope of the administration's plans will be enacted. Still, at the margin, the overall competitiveness (as measured by tax policy) of the US could decline and make international markets more attractive.

Additionally, while profits as a whole may not suffer with the increased investment in infrastructure, some companies could see their margins come under pressure. This pressure will not be uniform, and therefore we believe that a wider dispersion between perceived winners and losers will result, creating an interesting backdrop for active managers and astute analysts.

All said, taxes may be going up. And while higher taxes may not necessarily result in lower stock prices, investors should be more discerning and disciplined as they maintain a bias toward risk assets overall.

For more information, please contact your Key Private Bank Advisor.

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1 - Key Questions: How Will the Election Affect the Economy? (August 17, 2020)

2 -Key Questions: What Will Joe Do? (November 16, 2020)