STOCK MARKET LOOKING THROUGH ECONOMIC DETERIORATION

With the Democratic sweep of the Senate seats in Georgia, they effectively control the U.S. government and are in a very strong position to implement their agenda, says Brent Puff, vice-president and senior portfolio manager, global growth, at American Century Investments..

In a conversation with Bernard Chua, vice-president and senior client portfolio manager, global growth, in the *Benefits and Pensions Monitor* 'Elections, Vaccines and the Implications on Global Equity Markets' webinar, he said under that scenario, it's very reasonable to assume that the Democrats and President Joe Biden will move swiftly to raise corporate taxes.

Bernard Chua: What sort of tax changes can we expect under a Biden administration and how will that, more importantly, impact earnings?

Brent Puff: If you look at the tax plan that Biden ran on during the election, there are three core elements.

First, he wants to basically unwind the Trump tax cut, effectively raising the statutory tax rate from 21 per cent to 28 per cent.

He also talked about doubling the minimum tax rate on foreign subsidiaries to approximately 21 per cent. That change is effectively targeted towards technology and healthcare companies that do an above average job of sheltering their earnings in lower tax jurisdictions around the world.

The third element is to institute a minimum 15 per cent tax rate on reported book income.

What that means to corporate earnings is it will shave about seven per cent of S&P500 earnings right off the table. From a sector perspective, the technology, healthcare, and communications services sectors are probably going to be the hardest hit.

Chua: Where are we in regards to the COVID-19 health crisis and its impact on the economy?

Puff: Unfortunately, COVID and these headwinds to the economy are going to persist for a little longer and continue to be highly problematic for certain parts of the economy. The economic improvement we saw over the summer and into the fall is almost certainly going to moderate.

The huge positive is the available vaccines appear to be very well tolerated by patients and highly effective. So, the stock market – even though it very clearly understands that the near term picture is muddy – is looking right through the deterioration because in stock market time, the second and third quarters are right around the corner.

Chua: What investment opportunities do you see?

Puff: For probably the last six months, we've been taking profits in some parts of our portfolio that have done exceptionally well through the pandemic and invested those proceeds into businesses that have suffered. We view COVID, to some extent, as a natural disaster – albeit one that has greater persistence than an earthquake or hurricane. There are lots and lots of businesses that have really suffered because of COVID. But as the economy normalizes as the population becomes vaccinated, some of those businesses that have suffered are likely to bounce back dramatically.

Chua: What do you see as the largest risk to the market heading into 2021?

Puff: There are several risks that are going to have a pretty big influence on outcomes over the next 12 to 18 months.

My starting point would be COVID. At this point, if vaccine production and distribution happens relatively rapidly, the world will be way well on its way to normalization as we enter the second half of this year. But any COVID related development that runs counter to that is going to represent a tangible threat to markets.

Another threat is interest rates. The 10-year U.S. bond yield exiting 2019 was hovering somewhere a little bit below two per cent. Today, it's a little bit below one per cent. So basically, the long bond yield has been cut in half over the last year.

What I struggle with is why interest rate expectations continue to be anchored at such low levels. One reason may be the communication from the U.S. Federal Reserve and most central banks around the world that they are not raising rates for a year or two and are going to continue to support financial markets via various QE policies. This has helped anchor interest rate expectations at low levels.

However, central banks can change tack relatively quickly if we get a really robust recovery so it's going to be harder for interest rate expectations to remain as subdued as they currently are. With a really robust recovery, I will be surprised if the 10-year yield isn't meaningfully higher than where it sits today. **BPM**

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