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Should Investors Fear The Blue Wave?

Joe Biden is going to be the next President of the United States, and it appears that the Democrats will also win both the House and Senate. How will this "blue wave" impact investors, and what can they do to prepare for this sea change?

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Recent Interview

I was interviewed by the advisory team this week to talk markets and answer tough questions. We transcribed the conversation.

It looks like the Democrats will control the Senate. If so, how does a blue wave affect taxes in 2021?

Most tax policy gets through the Senate through a process called "budget reconciliation." It's a fast-track process for consideration of bills. Instead of the 60-vote minimum, a reconciliation bill only needs a simple majority. If the Democrats take both seats in Georgia, then the senate is tied 50 – 50 with Kamala Harris as the tie breaker.

Many of Biden's major tax initiatives would qualify for reconciliation. But Democrats will still need to agree on policy changes, and this might not be as easy as it sounds for a couple reasons. First, there are several moderate Democrats in the Senate who might balk at anything too progressive. All it takes is one or two dissenters.

Second, look what happened in the House of Representatives back in November. The Democrats kept a majority but lost a lot of seats. I think this really spooked the Left and they interpreted it as a sign that the country is more moderate than expected.

Just look at who Biden has already selected to fill his cabinet. They are all moderate Democrats. Nobody too far left. At least not yet. That tells me there is a good chance that we won't see anything too progressive.

Are you saying taxes won't go up?

Um no. Taxes are going up. The top income tax bracket will go back to 39.5% for earners above $400,000, but that's relatively benign to the economy. Besides, this is where the rate was under Clinton and Obama's second term, and no recession happened in either period. I can't see any reason this time would be different.

Corporate taxes will also rise. Biden campaigned on an increase to 28%. If so, corporate earnings would take a hit, but the U.S. hasn't seen corporate taxes this low since the 1930s. It's hard to make the case that investors are owning stocks based on the assumption that the corporate tax rate would stay this low forever.

Those are the two big ones that I see passing. The rest of his campaigned tax plan is just too controversial. For example, I don't see how eliminating the step-up basis and/or taxing capital gains as income even make it to the floor for a vote. Imagine going back to constituents and asking for their vote during 2022 midterm elections after eviscerating their retirement nest egg. Politicians are just like you and me. They don't want to lose their jobs.

It sounds like you are saying that taxes aren't a big deal to the economy.

Almost 70% of U.S. economic activity comes from consumer spending. Add in business spending, and these two represent 88% of the $21 trillion economy. When money is taken out of the pockets of consumers and corporations, it's cash that won't get spent in the economy. Therefore, higher taxes slow economic growth, but they don't stop it. If I'm right and nothing too progressive gets through Congress, then these tax hikes should be relatively benign.

What about regulation?

Regulation also slows economic growth, but increased regulation on the energy industry, for example, won't do much to the broader economy. Besides, Obama tried that and got nowhere. The U.S. is the largest energy producer in the world despite his administration's attempts to curtail it. I don't see how Biden can do much worse.

That being said, the one notable risk to the economy is increased regulation on banks. Since 88% of our economy is spending, banks are the gatekeepers to economic growth because most large purchases are done on credit. When people buy a house, most get a mortgage. Same thing with a car. If the Democrats do what they did after the financial crisis, then it could attach an anchor to the economic recovery.

I don't have a crystal ball here, but I'd wager the banks get a hall pass simply because the sector is healthy but also not printing money either. Besides, it seems that the Democrats have their attention focused elsewhere at the moment.

What about the technology sector? There is a lot of talk in the media about regulation coming their way.

There was a great movie maybe 15 years ago called *Thank You For Smoking*, about a lobbyist for big tobacco. In one scene, the main character's son is working on a project for school, and he asks his dad why the American government is the best government. He answered, "Because of our endless appeals system."

That's pretty funny but it's also kind of true. Even if the government can somehow prove that big tech are not just monopolies but also hurting consumers, this will still live in the courts for a really long time. I'm no lawyer but I'd guess at least 5-7 years. Maybe even a decade or longer if the intent is to break them up.

If so, these companies will continue to earn massive amounts of cash along the way. Now, there could be increased regulation on privacy and security. This would lower earnings, but these companies have more money than most countries. It's unlikely that it will move the needle all that much.

But what if I'm wrong and they somehow break up tech monopolies this year. Is that actually a bad outcome for investors? These companies are massive. Imagine how much unlocked value exists inside them. Google owns YouTube. Amazon owns Amazon Web Services. Facebook has Instagram and WhatsApp. These are all viable companies on their own and may do way better for investors if they operated independently.

How?

There's this idea in finance called the "conglomerate discount." This happens when markets value a diversified group of businesses at less than the sum of its parts.

It's pretty common in industrials and other sectors that are dominated by massive holding companies like big tech. Two common causes are underperforming divisions dragging down the valuation of the entire company and outperforming divisions not getting the credit they deserve. In regard to big tech, there could be a lot of upside if they were forced to split up.

For example, let's say Amazon were divided into two pieces tomorrow – the ecommerce business and then Amazon Web Services (AWS), which is a cloud computing business. Shareholders would see Amazon stock removed from their accounts and replaced with two new stocks – a high growth ecommerce stock and a cash cow cloud computing stock.

Those investors that want to own the ecommerce business but not a cloud business can now do so, and the same goes for those investors who only want AWS. Those who want both businesses can just own both stocks. The increase in demand for both stocks could boost the combined valuation and be a windfall for existing shareholders.

But just to be clear, I'm not insane enough to say this is going to happen. I learned long ago never to bet on the outcome of a government decision. It's just an example of how a forced breakup may not be the worst outcome for investors.

You are making it sound like this is more of a blue ripple than a blue wave. Will anything change materially?

There is one big change coming and that's spending. The reason spending won't face the same hurdles as raising taxes is because of optics - spending benefits all voters today. Any issues with an increased deficit are decades away, so this "swipe the credit card" mentality can create significant political capital.

Democrats can pretty much spend as much as they want, and every indication leads me to believe they plan to do so. Biden campaigned on $7 trillion in spending over the next decade. I don't know if they will do that much, but it's going to be a big number. I just hope it's spent well.

What would be a good use of spending?

Two buckets. The first is helping those who got hammered last year. The decision to shut down our economy ruined peoples' lives, and they need a lifeline.

The second bucket is targeted stimulus. From a pure economic standpoint, I sound like a broken record here, but infrastructure spending should be top of the list. This would create jobs and increase our country's competitiveness over the next half century. Don't just fix the potholes. Fix the one in three bridges that aren't up to code. Update the software that lands airplanes. Do it all. Our country could earn a massive return on its investment.

Moving on to markets, what does a blue wave mean for stocks in 2021 and beyond?

Stimulus is crack to the stock market, so it's likely that expectations get baked in pretty soon over an increased stimulus package later in the year. That could be a big boost to stock prices. Looking further down the road, I don't think I've been this bullish on equities in a long time for five reasons.

First, the Fed will probably keep rates at zero for at least 3-4 years. Maybe longer. Interest rates are the foundation for all asset prices, so this creates stability for stocks.

Second, inflation is coming. I'd argue it's already here. The money supply rose 25% last year, and supply chain disruptions are everywhere right now due to the pandemic and shutdowns. If I make widgets and my input costs go up, I can raise the price of my widgets to preserve my margin. Hence, stocks can be a hedge against inflation.

Third, the economy is recovering. The pace of improvement is slowing but it's still healing at a faster pace than I had even expected. The right kind of stimulus will only help this go faster.

Fourth, there is nowhere else to go for investors who want real returns and liquidity. Cash loses money safely to inflation, and the bond market isn't much better.

Fifth, entrepreneurship and innovation drive the economy over the long run. These didn't slow down much during the recession last year, and I don't see how they will be impacted going forward.

Think about it this way. There are economic headwinds right now, and a blue wave may create more headwinds. But I believe the tailwinds are stronger and will last longer. This is why I am so bullish.

That sounds identical to your thesis six months ago.

I was interviewed by a reporter the day after Trump won in 2016. She asked what I planned to do after his surprise win. I gave her a one-word answer. Nothing.

She looked at me a little funny until I explained to her that we had no idea what was going to happen next. Sure, the Republicans owned the White House and Congress, but it was going to take months before Trump could set his agenda. Had we started making bets prematurely on policy changes, that could create unnecessary risk. It took two years for Trump to lower corporate taxes and almost six years for Obama to get the first Obamacare plan into the marketplace. Policy takes forever.

It also dies on the vine quite frequently. Let's go back to infrastructure. I feel like every president going back two decades has campaigned on infrastructure spending. But guess what. It's never happened to the scale promised. Jumping the gun on policy decisions set by self-interested politicians is way too risky for my liking.

That's how I see it today. We don't know what is to come just yet, so I'm going to wait until we get more clarity. Once policy begins to take shape, some adjustments here and there will most likely be warranted.

But if you wait until policy is enacted, won't you miss the move in the market?

We might miss part of the move, but that's ok because I don't know many people in this business who have bet on the government and been right consistently. Enacting policy takes a long time, but the impact of policy changes takes a lot longer and is usually way more profitable for patient investors. If we miss that initial pop, c'est la vie. We aren't gamblers.

But aren't there some obvious moves today? For example, it's safe to say that Democrats will champion clean energy. Why not pivot now before it's too late?

The only obvious moves in investing are the ones in hindsight. It may feel obvious to buy solar and sell oil, but how will a blue wave bring new customers to solar? Sure, government-sponsored investments into solar technology could be a game changer, but when? Free market capitalism isn't an allegory for *Field of Dreams*. If they build it, that doesn't mean customers will come. If they don't, investors could be left holding stocks with higher valuations but no future earnings to support them. That's not a compelling opportunity to me.

And I'm not slamming solar either. I'm just saying that big moves in the stock market after an election tend to drive multiples, but policy and fundamentals drive earnings. I'm far more interested in the latter, but as we've discussed, those take time.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

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