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# New Tax Regime: Bigger Threat Than Coronavirus?

*How to position your equity investments*

**Favorable drivers for the market remain in place…** The S&P 500 topped 4,000 before the Good Friday holiday, marking a new all-time high and representing a 7% YTD gain. We attribute this performance to four factors. One, the innovative nature of U.S. corporations and their inherent ability to grow (without which the other stuff wouldn't matter much). Two, ultra-low interest rates and the promise that rates will remain low. Three, government stimulus. And four, momentum.

**…Notice that we did not cite expectations for the economy to "reopen" among our list of favorable market factors.** The media and analysts continue to talk about economic recovery as a positive driver for many businesses, the stock market, and the economy overall. It is a positive. However, in our opinion, this was fully reflected in professional investor expectations months ago. If you are buying stocks today because Covid19 is going away, you're too late.

**…but if we're looking forward, we see a cause for concern.** Government spending is a stimulus to economic activity. Biden's $2 Trillion infrastructure plan, unveiled last week, promises to be a boon to select companies, their employees and the economy in general. Unfortunately, the dark side of the plan is that it will be paid for by raising tax rates on corporations.

## Why Higher Tax Rates on Corporations Matter

This is very simple. Higher tax rates mean lower earnings. Higher tax rates also reduce a company's economic return. A business' economic return (how much value it creates for shareholders) determines in part what multiple it should trade relative to earnings. A lower return equals a lower multiple. Thus, higher tax rates for corporations will result in lower earnings (the "E") and also justify a lower earnings multiple (how you get to the "P" in the price to earnings ratio ("P/E")). All else being equal, it seems clear that raising corporate tax rates would imply lower stock prices.

## Unfortunately, Higher Tax Rates for Individuals are Also on Tap

You might believe that a lower stock market is not that relevant to the overall economy. Therefore, higher corporate tax rates and lower equity prices might not seem like something to worry about. You might also believe that funneling the tax proceeds into a much-needed infrastructure plan is a favorable offset. We agree that this spending will serve as an offset and a is positive for economic activity. The trick is in quantifying this benefit relative to the negative of higher taxes.

Regardless of the net impact, following the $2 trillion infrastructure tax-and-spend plan is likely to be a change to the individual income tax brackets. Specifics are not available but we believe it's safe to assume that rates will be going up. This could include higher federal tax rates, higher rates on capital gains or investment income, reduced deductions, and various higher transfer taxes on estates.

## Why Higher Tax Rates on Individuals Matter

Think of higher taxes as the opposite of stimulus. If sending money to individuals boosts economic activity (the data over the past year with three cash distributions clearly shows this to be the case) then taking money away via higher tax rates will have the oppositive impact. Progressives might argue that the lower income families getting the stimulus payments had a very high propensity to spend. On the other hand, taking money away from higher income families that might otherwise save the funds will hurt the economy to a lesser degree. There is some truth to this, but it does not remove the reality that higher taxes on individuals equals lower spending.

## The Double Whammy of Lower Equity Prices and Higher Tax Rates

Consumer spending is 2/3 of U.S. economic activity. It is difficult for the economy to grow if consumer spending contracts. The single most important factor in determining consumer spending is employment and wages. Consequently, "closing" the economy due to Covid19, which threw millions out of work, plunged the U.S. directly into economic contraction and recession.

Subsequently, both administrations have followed the same strategy which essentially amounted to throwing money at the consumer and economy while playing for time for a vaccine. This has worked. Things are looking much better and the crisis is fading into the past. Unfortunately, the new proposals being considered would essentially reverse a key component of the previous strategy by effectively reducing spending power and taking money away from consumers. What will be the positive offsets?

## The Ironic Beneficiaries of These Policies are…

### *How you should position your equity investments in an environment of higher taxes and lower spending:*

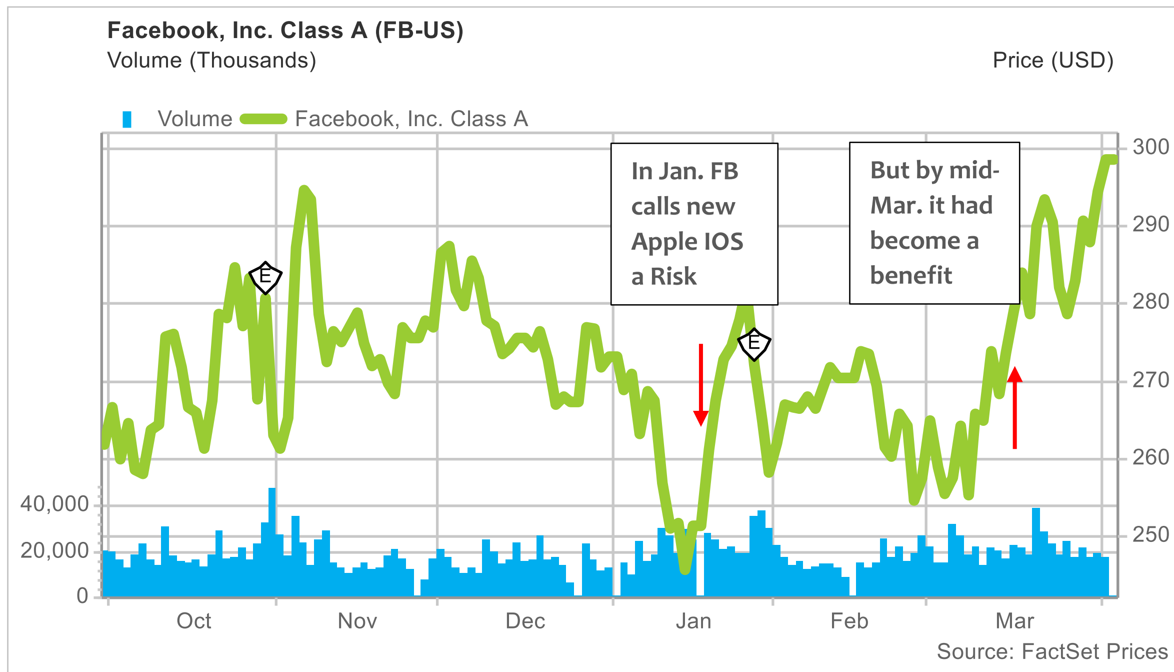
If recent "reopening gains" reverse, spending contracts and economic conditions worsen, the companies that will benefit the most from these challenges are the large established businesses with strong balance sheets that are able to consolidate share. We're talking about Microsoft (MSFT), Amazon (AMZN), Google (GOOGL) and the like. Yes, the same big tech names that are frequently pilloried by politicians and the media. Consequently, we would continue to own this group. There are two other categories of stocks we'd own. The second includes innovative fast-growing companies (if the shares can be bought at reasonable valuations). The third group that we'd find safe to own are companies whose equity is being priced well below the assets and expected future cash flows of the business (value stocks).

**Stocks we'd avoid:** Over the past 9 to 12 months, many of the best performing stocks have been businesses that were threatened with extinction by Covid19 but didn't die. Aside from select companies were able to use Covid19 to transform their business models, these names are now trading at prices that are no longer attractive. We would also continue to avoid slow-growth legacy businesses, smaller companies with no particular competitive advantage and debt on their balance sheets, and unprofitable speculative names. In short, our investment strategy is unchanged whether the economy is off to the races or whether a giant tax-raise-induced recession is looming. When you think about it, this is the best strategy when it is not really possible to predict the future, which it isn't.

## Selection from our Model Portfolio: Facebook (FB) The Master Manipulator

**You generally want to own management teams that understand how equity markets work:** One of our favorite long-term holdings remains Facebook (FB). We see FB's value as primarily stemming from

its trove of user information across its Facebook, Instagram and WhatsApp platforms and its ability to monetize this over time, mostly via advertising. However, not everyone is happy about how FB makes its money. Apple (AAPL), which wants to be perceived as the "good-guy" in the loose confederation of tech conglomerates controlling the digital world, last June announced changes to its operating platform that would give users more control over information shared with app developers, including Facebook. Mark Zuckerberg started whining loudly about this in January, calling it a "risk" to Facebook's business. But was it? Never in our view. Consider: If Apple's changes make it harder for app developers to gather user data, *then the value of user data will increase*. Since Facebook has more data than nearly all other companies (most of it provided willingly by users), Apple's operating system changes can only make FB's cache of information even more valuable while simultaneously hurting the ability of smaller competitors to gather equivalent data. Never mind. The media fell into Zuckerberg's trap, talking up the risk to FB and leading to a few months of underperformance for FB stock (see chart below). This further had the effect of encouraging Apple to proceed. Then, in mid-March, in a "shocking" about-face, Zuckerberg changed his tune and suggested that the new Apple operating system changes would benefit FB. This release of a perceived risk had the effect of shooting FB shares higher. We remain as optimistic as ever on the company's prospects. Well played, Zuck.

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**Yours,**

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

**Hoping you can't catch Covid from a fish.** While the U.S. has been progressively reducing restrictions and allowing life to return to quasi-normal, over here in France, things have been going the opposite direction. Shops remain closed. Restaurants are closed. We're under a curfew and facing travel restrictions inside the country. The French government even reorganized everyone's school holidays at the last minute. Thanks a bunch! Fortunately, I have found important justifications for my travel later this month to Spanish Pyrenees to go on a guided fly fishing trip with a great friend from college. It's needed for my health! If things don't get better in France, I might have to extend my stay…

**Happy Easter and Passover.** I took this photo inside the garden at the Palais Royale in Paris. With all the restaurants closed, eating lunch with this view of the Japanese Cherry trees (I think) blooming was a nice compensation.

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