The Damped Spring Report

"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

4/23/2021

We exited our max long positions in QQQ, US Long Bonds, and Gold last Friday at the peak of the equity market for various reasons described in an email sent to clients. We have no strong views, at the moment, and will deliver a playbook for the 5/3 Treasury Announcement toward the end of the month. However, last night the equity market fell on the announcement of a increase in capital gain taxes. We have some thoughts but at the high level the worst case hit for stocks should be about 2.5% and probably much less. We are trimming our immediate SPX target from 4350 to 4300 reflecting the impact of the cap gains tax increase.

Thoughts

Taxes matter. Let's work backward. First let's assume that the 20% increase in cap gains taxes was a complete surprise. Before we drop into the weeds on this, for this analysis we will assume the tax is retroactive. Of course, that isn't known and as the final legislation is drafted there will be a one time tax gain harvesting flow that will be interesting but will not occur until year end.

If the increase in cap gains was a complete surprise a holder of assets going forward will have a lower after-tax return in holding these assets. While dividend or interest income is not expected to change, price gains are now worth less.

Let's ignore dividend income for the moment. If you own the SPX today at 4131 our estimate of your long term expected return (based on 30 year rf interest rates and a risk premium) is 4.25% per year pre tax

Yesterday your after tax expected return was (1-TR)* 4.25% or 3.4%

Today, in order to receive the same after tax return you would need 3.4/(1-TRnew) or 5.667%

Increasing the pre-tax return would require prices to fall. **Prices would have to fall 25% for investors to have the same-after tax expected return.**

Seems like a lot. The reason why it wont fall like that or anything close to that is because most assets are not held by taxable accounts exposed to this increase AND after tax dividend income is not impacted AND it was neither a surprise nor likely to be as big as proposed.

Stocks are owned by

1. Taxable accounts who are exposed to the increase
2. Taxable long-term investors not exposed to the increase

3. Non-taxable accounts (retirement accounts of all types, etc)
4. Foreign nationals
5. Short term traders who are already paying high short term capital gains

If we assume a 10% of the owners of stocks now value stocks 25% less the impact on stocks would be 2.5%

We believe the impacted holders of assets own much less of the equity market than 10%. Also, we believe that the market had priced in a significant increase in capital gains already. **For those reasons we are lowering our target on SPX by a small 1.2% from 4350 to 4300.**