On The Mark

RIVERSTONE WEALTH MANAGEMENT

History of tax hikes and market impact

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Key Takeaways

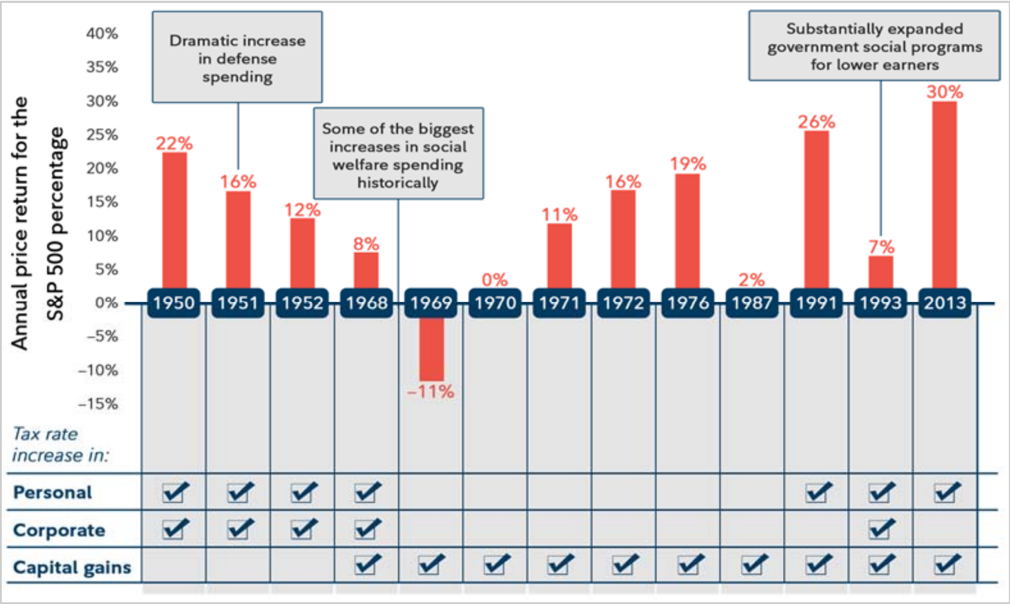
- Despite the assumption many have that increasing tax rates would sink stocks, historically, markets have generated positive returns in the wake of tax increases.
- Other economic factors, such as ongoing stimulus and an accommodative Fed, can counterbalance the influence of higher taxes. In short, taxes matter, but not necessarily for their forecasting ability.

Last year, we visited the topic of higher taxes and the impact on markets during the election season. In 2021, with various proposed tax increases to fund the American Jobs Act and the American Families Plan, we thought it might be a good time to revisit what we know so far and how markets have historically behaved after tax hikes.

Among the proposed taxes increases, are three key areas—corporate, personal and capital gains—have received the most attention. The first proposal is to raise the corporate income tax rate from 21 percent to 28 percent. The second proposal is to raise the top marginal tax rate to 39.6 percent on individuals earning $400,000 or more. Lastly, there is a proposal to apply ordinary income tax rates, including the proposed 39.6 percent rate, to the capital gains of individuals with more than $1 million in taxable income[1].

This by no means is the full set of comprehensive tax proposals but highlights some of the key issues the markets have focused on recently. While the exact fate of each of these tax increases remains open to debate in Congress, as investors it may be worth taking a look at how past tax hikes have impacted markets.

The below chart by Fidelity looked at tax increases across corporate, personal, and capital gains, and the impact on the stock market as measured by the S&P 500 index since 1950[2]. The data analyzed by Fidelity looked at the calendar year of the tax changes, plus the year prior and the year after. Historically, large changes in the tax landscape have been rare, occuring only 10% of the time over the last 70 years. The last time there was an increase in the corporate, personal and capital gains tax all in the same year way in 1993 and yet the S&P 500 gained 7% that year. Another example is looking at the capital



Source: Fidelity

gains which went up 9% in 2013 and yet stocks rose 30% that year[3]. The study also highlights that stocks rose 100% of the time when corporate taxes were raised. In summary, since 1950, there have been 13 instances of tax increases and the S&P 500 index had positive or flat returns 12 of the 13 times despite tax the increase.

If this has left you scratching your head, the answer lies in understanding the bigger picture. Tax hikes don't happen in a vacuum. These observations of the past are not meant to draw a conclusion that tax policies can't have an impact on the market in the short term. They certainly can, but there are many other factors to consider as well. Tax increases are often accompanied with additional stimulus such as increased defense spending and expanded government social programs as shown in the chart. These examples have acted as a counterbalance, making it difficult to predict the direction of stock markets. In 2021, there appears no shortage of stimulus from low interest rates set by the Federal Reserve, additional government spending for individuals, and potential future spending on infrastructure. In short, taxes matter, but not necessarily for their forecasting ability.

[1] https://taxfoundation.org/biden-first-100-days-taxes/
[2] https://www.fidelity.com/learning-center/trading-investing/tax-hikes-history
[3] https://www.ubs.com/global/en/wealth-management/chief-investment-office/market-insights/house-view/daily/2021/latest-23042021.html

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