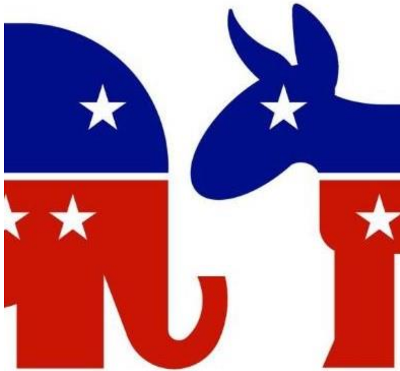
Volume 130

THE PER STIRLING
CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

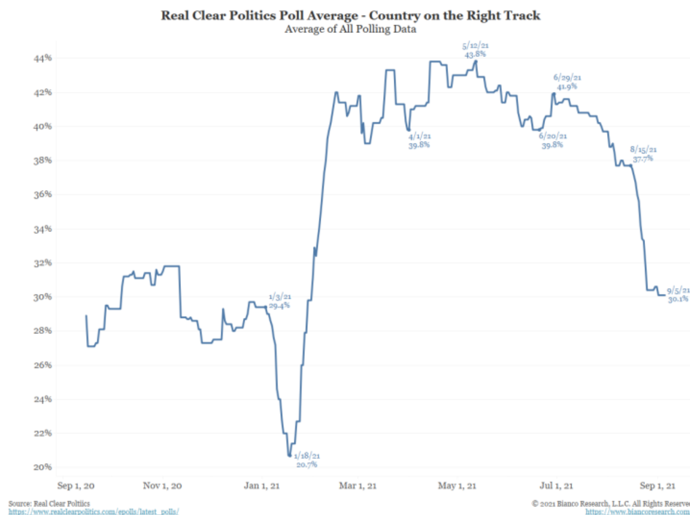
September 2021

According to Winston Churchill, "A politician needs the ability to foretell what is going to happen tomorrow, next week, next month, and next year. And to have the ability afterwards to explain why it didn't happen".



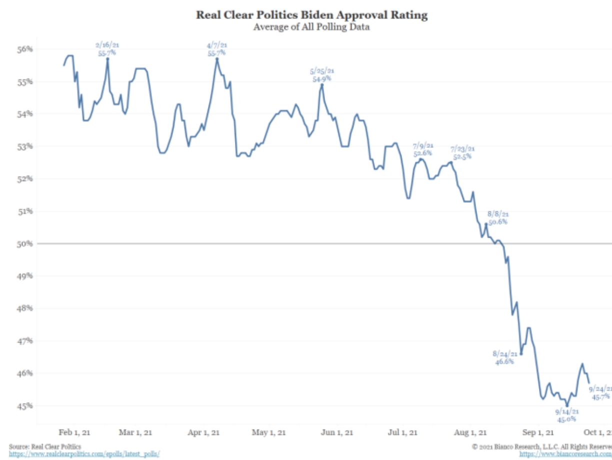
With the mid-term elections over a year away and the next presidential election more than three years away, this may seem like a somewhat unusual time to dedicate a commentary to national politics and the goings-on in Washington, D.C. That said, it is hard to remember a time when Washington and Wall Street were so interconnected, and when there were so many things going on in Washington that could have a significant and long-lasting impact on the capital markets, many of which will become quite acute between now and early next year.

On the table are proposed tax increases, record deficits and fiscal spending, a potential change at the head of the Federal Reserve, estate tax changes, a potential government shutdown, an unlikely but threatened default on federal debt, and a variety of other initiatives that could not only impact the investment markets, but ultimately slant the deck towards one party or the other when voters return to the polls in about thirteen months. One can only imagine how contentious and controversial that is going to be even under the best of circumstances. As was noted by political satirist Steve Bhaerman, "We have a deeply divided body politic. Half of our population believes our elections are broken; the other half believes they are fixed".



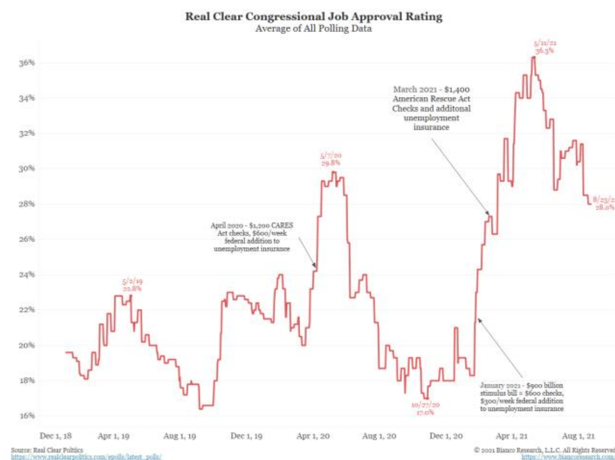
This example of political pith is probably more relevant than ever before, with a recent CNN/SSRS poll showing that 78% of Republicans believe that Biden's presidency is illegitimate and that he stole the election from former-President Trump. Meanwhile, polls suggest that many Americans are disappointed that the moderate president that they thought they had voted for has moved notably to the left, while the progressive wing of the Democratic Party is disappointed that Biden's positions are still not liberal enough. Throw in the bungled withdrawal of U.S. troops from Afghanistan, high inflation, a slowing economy and an ongoing pandemic, and President Biden's favorability numbers have fallen even further and faster than did those of former-President Trump in the weeks after the January 6th attack on the Capital by Trump supporters. What a sign of the times that is!

The tangible implication of this dramatic drop in popularity and confidence is that President Biden has lost much of the "political capital" than he may ultimately need to "spend" in order to push through his agenda, as he did last March with the "American Rescue Act".



Historically, there is relatively little political risk associated with bucking the will of an, at least temporarily, unpopular president, and this is manifesting itself not only on the Republican side of the aisle, where Republicans have stated that they would rather risk a default on U.S. debt than raise the debt ceiling, but also on the Democratic side of the aisle, where more moderate Democratic Senators like Joe Manchin of West Virginia and Kyrsten Sinema of Arizona are essentially blocking the bulk of the Biden administration's ambitious agenda by refusing to vote for the profligate spending contained in the proposed $3.5 trillion "human infrastructure" package.

As Senator Manchin recently noted in a Wall Street Journal editorial, "I, for one, won't support a $3.5 trillion bill, or anywhere near that level of additional spending, without greater clarity about why Congress chooses to ignore the serious effects inflation and debt have on existing government programs." When recently pressed on the issue, Manchin replied, "It's going to be $1, $1.5 [trillion]." He has also stated that he will not vote for tax increases as high as those proposed by either President Biden or the House Ways and Means Committee.

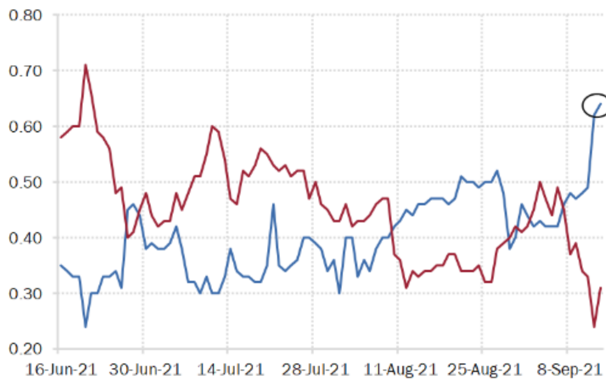


Arguably Manchin and Sinema may be the most powerful members of Congress at present, as Biden's proposals are not garnering any support from Republicans, which means that every single Democratic vote will be required to pass legislation through the Senate.

Of note, Manchin and Sinema's peers in Congress probably have even less political capital with which to pressure these more moderate senators into compliance than does the White House, as Congress' approval rating of only 28% is even worse than the 46% approval rating assigned to President Biden.

One can argue that this political dynamic is already having a significant impact on the legislative outlook, as the proposals that are coming out of the democratically-controlled Congress are much less draconian than anticipated, with lower-than-expected increases in both corporate taxes and capital gains taxes (each of which are of great importance to investors). Moreover, congressional proposals to-date have included neither a step-up in basis, in regard to estate taxes, nor the removal of carried-interest. Changes to each were proposed by President Biden, and widely expected to become law.

That said, the proposal from the House Ways and Means Committee does raise taxes on 500,000 more people than does the Biden proposal. In general, the proposals coming out of the House are considerably less progressive than are the White House proposals, whereas the proposals coming out of the Senate are even more progressive than are the proposals from the Biden administration. In a September 24th press conference, President Biden described the current situation as a "stalemate".



This political dynamic is likely to have both short and intermediate-term implications for the economy and the markets, the most immediate of which likely relates to the raising of the debt ceiling, which will be necessary if the U.S. is to avoid defaulting on some of its debt payments, which would have potentially calamitous implications. This procedure used to be a non-partisan and largely inconsequential event, at least from an investor's perspective. However, that all changed when Newt Gingrich was the Speaker of the House, and he decided to use the debt ceiling as leverage, in his efforts to force the Clinton administration to cut some of the perceived "fat" from the federal budget. Ever since that time, the raising of the debt ceiling has been used as a political football.

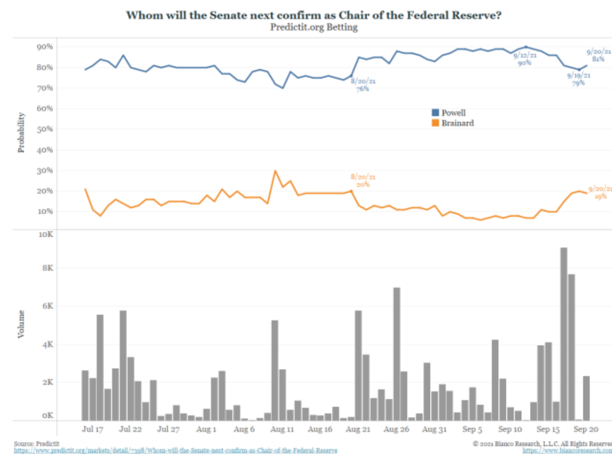
While we believe that the likelihood of the U.S. government actually missing an interest payment on its debt is quite remote, what is not remote is the likelihood that this congressional "game of chicken" will roil the markets, as it has done on numerous occasions, including in 2011, when the debt ceiling crisis resulted in a S&P downgrade of the U.S. credit rating from AAA to AA+, drove the 10-year Treasury note yield down by a full percentage point, and catalyzed a 17% decline in the S&P 500 Index.

Indeed, according to Ironsides Macroeconomics, this political gamesmanship has historically produced, on average, a 4% decline in the S&P 500 Index. While these declines have historically proven to be great buying opportunities for equity investors, it is at least noteworthy that, according to Cornerstone Macro, "The risks of a default [today] are higher than at any time since 2011." This risk is being partially reflected in the *PredictIt* prediction market, which is pricing in only a 39% likelihood that the debit ceiling will be raised (which will be necessary to avoid a default on U.S. government debt) by October 15th. Of note, Treasury Secretary Yellen has announced that the government will effectively run out of money in October, but has not yet specified on what day of the month. A September 24th report from the Bipartisan Policy Center estimated that the federal government's funds will be exhausted sometime between October 15th and November 4th.

While we are quite confident that the U.S. will ultimately avoid any kind of debt default, we maintain that the debt ceiling issue is unlikely to be resolved until the "11th hour", and that equity and debt markets are each likely to grow more and more nervous, and therefore more volatile, as the deadline approaches (which has historically catalyzed political compromise).

It is important to keep in mind that, while the Democrats do not want to pass a debt ceiling increase without Republican support, as it would allow Republicans to paint them as fiscally irresponsible, they do ultimately have the power to avoid a damaging debt default and/or a government shutdown, even without any Republican votes. If push comes to shove, we believe that the Democrats will act unilaterally, as they must understand that being viewed as profligate spenders is far less politically damaging than being viewed as the party that caused America to default on its debts, shut down non-essential government services, and furloughed millions of federal employees.

In terms of the market impact of the current political environment, the most obvious beneficiary may be the tax-free, municipal bond market which, according to Barron's, has benefitted from a surge in investor interest ever since the Democrats won the two Georgia runoff elections, effectively giving them control of all three branches of the federal government, thus raising significantly the prospects for higher taxes. Barron's reports that "estimated net cash flows into municipal bond mutual funds and exchange-traded funds reached US$79.25 billion through the end of August this year compared with US$15.73 billion in the same period a year ago [which represents] the largest inflow totals for municipal bonds on record".



Another significant consideration for the markets is the expiration of Jay Powell's term as Chairman of the Federal Reserve, which takes place in February. By almost all accounts, Powell has done a very good job as Chairman. Moreover, markets tend to strongly prefer continuity and certainty over change and uncertainty, which suggests that investors would strongly prefer that Powell be reappointed. However, the progressive wing of the Democratic Party is pushing hard for him to be replaced by Fed Governor Lael Brainard, who is much more pro-regulation, and is a Democrat. Powell is a Republican, who was appointed by former-President Trump.

We opened with a quote from Winston Churchill about the unpredictability of future events in general, and future political events in particular, as it sets the stage for what will almost certainly be an upcoming period of great uncertainty and political angst. As was recently noted by political analyst Matt Glassman "The reason legislative politics are often so hard to decipher is because it's very hard to tell the difference between true party disarray and the normal course of last-minute negotiations where most people are bluffing and someone will blink and the deal gets cut."

History teaches us that investors hate uncertainty more than almost anything else, normally even preferring "bad news" over uncertainty. That said, while we believe that this is a very strong bull market in equities, we suspect that its strength will be tested by policy uncertainty and political brinksmanship over the coming weeks and months.

Disclosures:

Advisory services offered through Per Stirling Capital Management, LLC. Brokerage services and securities offered through B. B. Graham & Co. Inc., member of FINRA/SIPC. Per Stirling Capital Management and B. B. Graham & Co. Inc. are separate and otherwise unrelated companies.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance, or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor.

Nothing contained herein is to be considered a solicitation, research material, an investment recommendation or advice of any kind. The information contained herein may contain information that is subject to change without notice. Any investments or strategies referenced herein do not take into account the investment objectives, financial situation or particular needs of any specific person. Product suitability must be independently determined for each individual investor.

This document may contain forward-looking statements based on Per Stirling Capital Management's expectations and projections about the methods by which it expects to invest. Those statements are sometimes indicated by words such as "expects," "believes," "will" and similar expressions. In addition, any statements that refer to expectations, projections or characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Such statements are not guarantying future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual returns could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors. The views and opinions expressed in this article are those of the authors and do not necessarily reflect the views of Per Stirling Capital Management's independent advisors.

Neither Asset Allocation nor Diversification guarantee a profit or protect against a loss in a declining market. They are methods used to help manage investment risk.

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted.