A Look Ahead

November 30, 2020

After a tough start to this year with the Coronavirus affecting just about all aspects of the economy and our personal lives and related plunge in the stock market, equities have recovered beyond expectations with all three "major" averages, the DJIA, the S&P 500 and the NASDAQ Composite rising to all-time highs last week before closing slightly off these record highs. Of greater significance to Main Street is that the Dow eclipsed 30,000 -- a major milestone. We remember when the Dow was bobbing around 900 and a big day was a move of 10 points! We have come a long way. As we pointed out last week, both small and mid-capitalization value stocks have also joined the rally after being down as much as 38%+. The government bond market lagged and is beginning to reflect the possibility of an increase in interest rates as the recovery gains steam.

The surprising rally has been sustained by an aggressive combination of government stimulative monetary and fiscal policies. The early surge in consumer savings provided the wherewithal for many individuals to spend money online for discretionary items. Another offshoot of the stay-at-home order was a proliferation of stock traders who had nothing better to do than sit in front of their computer trading stocks all day. With the abolition of brokerage commissions, there was no cost involved in this activity resulting in increased volatility in daily price fluctuations. One could assume that the combination of easy money through record low interest rates, a buildup in savings from various government programs and the ability for the stock market to act like a computer game gave the overall markets a lift that pushed indices to record levels.

When asked about where the stock market is likely to go in 2021 we tend to lean on the metrics related to corporate profits, the successful distribution of a vaccine and therapeutics and the continuation of government policies that provide the stimulus needed to keep the economy on a growth track. So, what could go wrong with this positive outlook?

A slower roll-out of a vaccine, and a Georgia result in early January that would lead to aggressive tax hikes are the two biggest concerns. Back in the 1980s, Tom wrote for the firm A.B. Laffer Associates where he learned the importance of setting tax rates -- especially from understanding the famous Laffer Curve that demonstrates the importance of the timing of a change in tax rates. Announcing a future increase in tax rates will likely have a positive effect on the current economy but a negative effect after the tax increase has been implemented. Similarly, announcing a future tax rate cut will postpone economic activity to the future and penalize the current economy. Imagine a car dealer announcing a big sale next month. How many cars do you think will be sold this month?

This issue could become a problem some time in next year. The new administration has proclaimed a series of tax increases to be implemented next year. The size and shape of those tax increases will have a bearing on both the economy and the stock market and history tells us that after the implementation of a tax increase, there could be an interruption in economic growth and subsequently in the stock market advance. To complicate matters, such a tax rate increase could be made retroactive to the beginning of the year.

There are alternative investment strategies that may accompany changes in tax laws and keeping a close eye on how those changes could affect portfolios can be an important aspect of portfolio management. We will remain vigilant to potential fiscal tightening and the impact on financial markets.