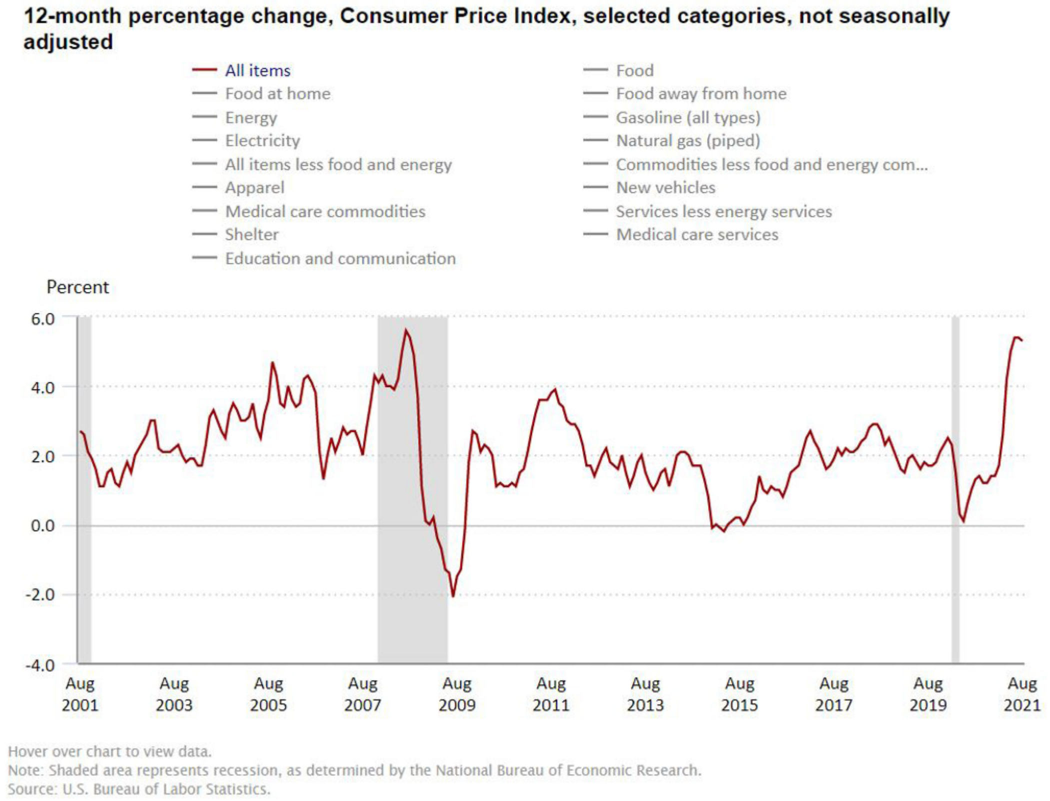
Week in Review

Friday, September 17th, 2021

1. Latest Consumer Price Index Suggests Inflation Rate Has Peaked or At Least Paused

This week saw the release of the Consumer Price Index (CPI) for August. On a month-over-month basis, the August headline CPI came in at 0.3%, below consensus of 0.4%, and down from July's print of 0.5%. On a year-over-year basis, the CPI is still running historically high at 5.3%, but down from 5.4% in July. Gasoline, food, and shelter were among the components rising, while used cars and airline travel were areas with price declines.



Source: U.S. Bureau of Labor Statistics

The Federal Reserve has been watching inflation closely but has downplayed the large increases this year as being largely temporary and focused instead on employment recovery as the key metric for changing accommodative monetary policy. This week's data can be seen as providing incremental support for the Fed's patience in moving forward with tapering.

On the other hand, the COVID resurgence during the summer is likely having an impact on the index to some extent. The potential for a COVID decline in the coming weeks could be a catalyst for CPI to reaccelerate at the margin later in the year. The burst in the index seen earlier in the year with the reopening of the economy is unlikely to be repeated, but an abatement from the above historical trend is not a given either.

2. Initial House Tax Proposal Released

The House Ways and Means Committee released an initial proposal for tax changes to be incorporated in the budget reconciliation bill. The proposal would raise taxes for individuals and corporations as well as other changes to the Internal Revenue Code.

Proposal highlights for individual taxes include the marginal income tax rate and capital gains rate. For the marginal income tax rate, the proposal would increase the top rate to 39.6% from the current 37%, so back to the pre-2017 levels. This marginal rate would apply to married individuals filing jointly with taxable income over $450,000, to unmarried individuals with taxable income over $400,000, to married individuals filing separate returns with taxable income over $225,000, and to estates and trusts with taxable income over $12,500. In addition, the proposal includes a 3% surcharge on household adjusted gross income of more than $5 million a year.

For capital gains, rates would increase from 20% to 25% on long-term capital gains for individuals earning over $400,000 and married couples over $450,000. A transition rule would provide that the current statutory rate of 20% would apply to gains and losses for the portion of the tax year prior to September 13, 2021. Individuals earning less income would not be affected.

Overall, the proposed individual tax changes are less than previously discussed plans, particularly with respect to long-term capital gains. In addition, the proposal makes no mention of changing the status quo for assessing capital gains at death. Existing law lets heirs receive an asset at its current value, erasing any potential paper gain and thereby reducing their future tax bill if they sell.

The proposed changes to the corporate tax rate are also less than had been initially sought. The top corporate tax rate would be raised from the current rate of 21% to 26.5%, with a graduated rate for small businesses. While higher, this rate is well below the pre-2017 corporate rate of 35% and is targeted at garnering support from moderates, while likely earning the ire of both conservatives and progressives.

At the proposed level, the higher corporate tax rate will be a short time headwind for corporate earnings growth in 2022. The plan released this week is still just a proposal and final legislation could ultimately change.

Thinking Ahead

Market volatility has increased in September as incremental data on inflation, taxes, COVID and corporate outlooks are digested. While overall economic indicators remain strong, the pace of the economic recovery will likely slow, and the opportunity for corporate earnings surprise will be lower than earlier in the year. Proposed government stimulus and tax packages will be closely scrutinized by the market.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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