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Fiscal Policy, Rates, and Inflation: There Is No Desirable Alternative

A look at the spending and tax proposals being vetted by Congress and the White House—and their impact on investor strategies.

In summarizing our views on the US budget, interest rates, and inflation, we selected five themes that we believe merit additional research and potential investment consideration. These include:

1. Higher spending = higher taxes: Investors should consider increasing exposure to tax-advantaged investments. As tax rates rise, the tax base will likely narrow. We see taxes continuing to increase in order to fund more expenditures.
2. An emphasis on "fairness" may provide greater returns to labor than to capital. Businesses will increase their reliance on technology to manage labor costs.
3. Infrastructure spending = increasing commodity prices. This could give rise to co-investment opportunities.
4. Increased spending on "green" initiatives: Consider increasing exposure to sustainable products and services, and consider reducing exposure to issuers with high pre-financial environmental costs.
5. Global minimum tax: A higher tax burden on larger investment-grade companies could create investment opportunities related to onshoring, which would give mid-sized, domestic companies a structural tax advantage. Expect increasing leverage within the technology and pharmaceutical sectors.

At $6 trillion, the Biden Administration's 2022 budget is the largest since World War II. It focuses on infrastructure spending, wealth redistribution and improved revenue collection. To fund this historic level of spending, US taxpayers are facing the biggest tax increase since 1993. Even with the myriad improvements now under consideration, the proposed legislation remains highly complex and uncertain at this point. Although we'll discuss the proposals below, please keep in mind they are an opening bid to Congress and will likely be changed due to the Democrats' slim Congressional majority.

The proposal's overall focus is on increasing tax collection on higher-earning households and on corporate profits. There is a theme of improving the "fairness" of taxation by not only increasing the tax rate on higher earners but also by reducing exemptions and improving efficiencies.

In its current form, a couple of observations stand out. First, the proposals raise the top rate of income tax while narrowing the tax base. One of the more controversial provisions is that while most tax increases would begin to take effect in 2022, the increased tax rate on long-term capital gains and qualified dividends would be retroactive to April 28, 2021. Another controversial proposal is to end the practice of increasing the cost basis of investments at death and to treat gifts

Key Points

- At $6 trillion, the Biden administration's 2022 budget proposal will come at no small cost to taxpayers.
- The Federal Reserve will soon begin reducing its monthly asset purchases. By the end of 2022, an interest-rate hike is possible.
- As the economy transitions back to a new normal, we expect to face higher levels of inflation over the medium term.

Insight from sub-adviser Schroders Investment Management

Lisa Hornby
Head of US Multi-Sector Fixed Income

David Knutson
Head of Fixed Income Product Management

and death as tax-recognition events. From a corporate perspective, the rise in the corporate-tax rate would take the average rate, including state and local levies, to 31%—the third highest among rich countries. For those taxpayers on the coasts, there is talk of lifting the cap on an exemption from federally taxable income used to pay state and local taxes. The cap was introduced in 2017.

Below is a summary of select individual and corporate tax provisions from the US Department of the Treasury May 2021 General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (the Green Book).

A proposal to increase the top marginal income tax rate from 37% to 39.6% will affect only 1% of taxpayers.

The American Families Plan

A cornerstone of the proposal is to increase the top marginal income tax rate from 37% to 39.6% for people earning more than $450,000. It's important to note that this increase will affect only 1% of taxpayers. The tax rate for long-term capital gains (LTCG) and qualified dividends greater than $1 million will be taxed at an ordinary income tax rate of 39.6%, up from the current LTCG rate of 20%. As discussed above, changes affecting capital gains taxes on property transfers would end the basis step-up on securities owned by the deceased estate (IRC section 1014). There would be exemptions and exclusions on transfers to a spouse or charity, a $1 million per-person exclusion on transfers by gift or death, and the current exclusions from a gain on the sale of a principal residence as well as the exclusion on the sale of a small business if a family-owned business continues to be family-owned. As part of the attempt to close loopholes, there's a proposal to limit the deferral of gain from like-kind exchanges and to establish a "self-employment tax" of 3.8% for the self-employed or on business income for partnerships, LLCs and S corporations above $400,000.

Some current provisions would be made permanent, including the excess business-loss provisions of IRC section 461(l) and the expansion of the Earned Income Tax Credit for workers without qualifying children. Certain provisions of the American Rescue Plan Act would also be expanded and extended, including tax credits for children and dependent care.

American Jobs Plan

The stated goal of the plan is to reform corporate taxation—specifically, to increase revenue collection through a fairer tax system while reducing incentives to hide profits and offshoring.

The marquee proposal under the plan would increase the C corporation tax rate to 28% from 21%. It's important to note that several Democratic senators have expressed concerns over a 28% corporate rate and have instead suggested a rate of 25%. The Republicans generally view a modification of the Trump-era Tax Cuts and Jobs Act (TCJA) provisions as a "red line." The topic of a global minimum tax is addressed with a 15% minimum tax on the income of large international corporations with income greater than $2 billion.

From a spending perspective, the budget contains several proposals to support housing and infrastructure, including a low-income housing-tax credit and a Neighborhood Homes Investment Tax Credit, which would support investments in houses in run-down neighborhoods. Despite the absence of a carbon tax, there are also proposals to support and prioritize clean energy with tax credits for electricity transmission and electric trucks.

Interest Rates and Inflation

What We Know

The Federal Reserve (Fed) will **slowly** reduce purchases of Treasuries and agency mortgage-backed securities in November. An interest-rate hike is possible by the end of 2022. Although **US real rates are negative**, this needs to be compared to the global market in which roughly **20% of all global investment-grade (IG) bonds have a nominal negative yield**. A yield around 2% for US corporate credit is outstanding when compared with what is available abroad. Despite the low-rate environment in the US, we believe yields on IG corporates are the most attractive they have been in years for non-US investors on a currency-adjusted basis.

In addition, while forecasts are estimating that we'll see nearly $1.3 trillion in IG corporate supply in 2021 (the third highest on record), we believe much of this supply was front-loaded. Companies still carry sizable cash war chests and the mergers-and-acquisitions pipeline with issuance implications is relatively low. All these factors point to a strong technical picture for US IG corporate bonds despite low yield levels.

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What to Watch

- Leadership at the central bank: Fed Chair Jerome Powell's term expires next year and the decision to reappoint him is complicated by two factors: Sen. Elizabeth Warren's opposition to the Fed's deregulation during Powell's term and an ethics scandal in which two regional Fed presidents traded for their own profit in assets that the Fed's actions could have influenced. In addition to one governor's term ending early next year, the scandal prompted both men to resign. We expect the White House to announce President Biden's choice of whom to lead the Fed in the coming weeks.
- Consumer sentiment surveys: The University of Michigan survey decreased, which could imply this is a good time to make major purchases. Inflation is outpacing wages, cutting into real purchasing power and dragging on demand.

And the 2021 Word of the Year: Transitory or Bottleneck?

Our economists published a baseline scenario that sees global growth increasing to 5.9% in 2021 and inflation rising to 2.9%. We expect that some of the latest spike in the US Consumer Price Index[1] will turn out to be transitory and for prices to gradually fall in the following months. However, we expect that inflation over the next several years will run at a higher rate than it has for the last several years.

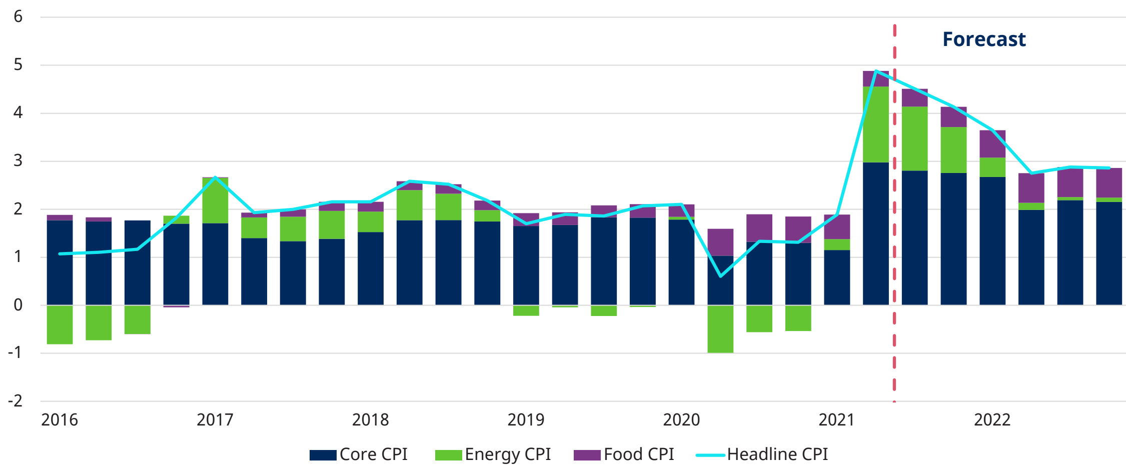
We have run scenarios on the path of inflation: while the baseline scenario is relatively benign to risk assets,[2] there's a risk that our inflation forecast could be wrong, and the price increases we have witnessed become a more permanent feature. To this end, we have modelled two cases that we think are relevant: a "Boom and Bust" scenario and a "Supply Side Inflation" scenario. Both have higher baseline inflation with different levels of growth.

As the economy transitions back to a new normal, we expect to face higher levels of inflation over the medium term—driven by the Fed average inflation-targeting policies and remaining supply bottlenecks for goods and labor. These factors account for much of the increase in our forecast for US inflation, which we now expect to come in at 3.8% this year and 3% next (increases of 0.5% and 0.7% respectively).

We continue to expect inflation to ease in the coming months as base effects pass through and the recovery pushes down unit-wage costs. Core inflation (excluding food and energy) is also expected to ease as the jump in prices that has accompanied re-opening fades. However, by the second half of next year, the closing of the output gap means that underlying inflation picks up again and core inflation rises more broadly.

FIGURE 1

US Inflation *Somewhat* Transitory, but Likely to Remain Above Pre-Pandemic Levels



Past performance does not guarantee future results. Includes some forward-looking views. There is no guarantee that any forecasts or opinions will be realized. Source: Refinitiv, Schroders Economics Group, as of 8/26/21.

Talk to your financial professional for help staying abreast of federal policy changes that can impact your portfolio.

[1] The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

[2] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

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