MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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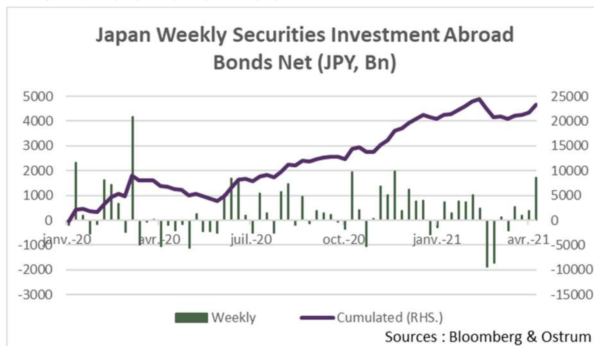
Topic of the week: The Biden Tax Revolution

- **The Biden administration's proposal to impose a corporate tax of at least 21% would completely change the logic of tax optimization for many businesses.**
- **Economically, beyond the trivial implications for tax optimization, the reform could have an indirect impact on international flows and external imbalances.**
- **Finally, the market balance would be disrupted: Treasury demand, pressure on the dollar and complex sectoral rotations.**

Market review: Complacency risk

- **Equities up strongly again amid low volumes**
- **Yields dip in the US despite data strength**
- **Powell hints at tapering for the first time**
- **Busy primary markets in sovereign space ahead of EU borrowing**

Chart of the week



While economic data are very strong, both in terms of activity and price pressure, US rates have fallen since the beginning of the month.

One explanation is the return of Japanese investors who bought the market. The available statistics show that Japanese purchases have indeed accelerated considerably recently. Even if the available statistics are aggregated and do not allow to say to which regions these flows have gone to.

The monthly data, published later, will allow to validate the idea that a significant part actually went to the United States.

Figure of the week

9.8

Source : Ostrum AM

9.8% is the month-over-month increase in retail sales in March. This places the level of consumption far above its pre-crisis trend.
The effect of the Biden's plan is already being felt.

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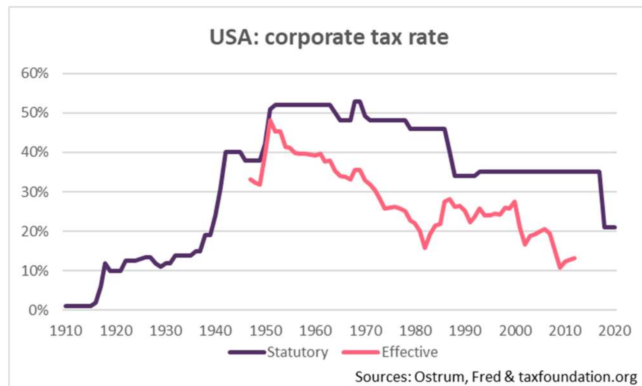
● Topic of the week

The Biden Tax Revolution

The proposal of the Biden administration to impose a minimum corporate tax of 21% would completely change the logic of tax optimization of many companies. Competition for the best tax among countries would also largely lapse, putting an end to a trend of the past forty years. The overall impact would be a change in the tax strategy of the states but also in terms of international trade or purchases of Treasury by foreigners. If the average effective tax rate is close to 21% for shares listed in the United States, the sectoral impact would be very diverse.

The statutory corporate tax rate is currently 21%, it was lowered to this level in 2018 by the Trump administration and was 35% until then. Biden's proposal is twofold. On the one hand, raise the tax rate to 28%, which would remain the lowest level in the post-war period, if we exclude the last three years, following the Trump reform.

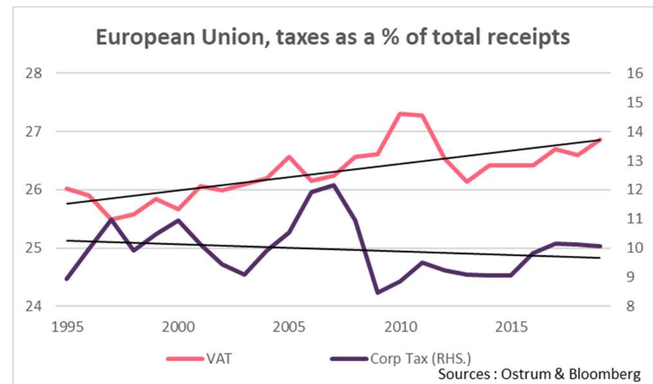


Second reform, which concerns us on this article, a minimum tax rate of 21% on global profits. In the event of an effective overall tax rate below this level, the US tax authorities may therefore tax the supplement. Taxation will be based on the share of turnover made in the country, which reduces the incentives for tax optimizations.

Where are we on the corporate taxes?

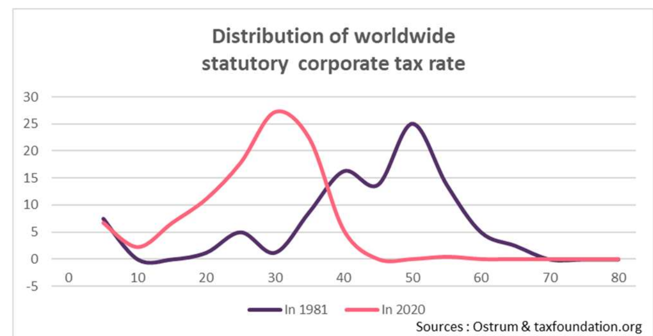
We need to start with some economic theory. One of the recurring results in the tax literature is, at the risk of oversimplifying: tax what doesn't move, don't tax what moves. The intuition is simple. Imagine that the VAT on coffee doubles, you will not go to Bratislava or Porto to take your espresso in order to escape this increase. On the other hand, if the corporate tax doubles, companies will tend to relocate to optimize their taxation. Globalization, by facilitating trade, has obviously made these arguments even more powerful, with in particular the tendency to reduce the tax burden on companies.

The textbook case to illustrate our point is the European Union, an integrated area without tax cooperation. It can be seen that VAT receipts have indeed increased steadily over the past quarter century. Conversely, corporate income tax revenues have tended to decline despite profits surging faster than the GDP.



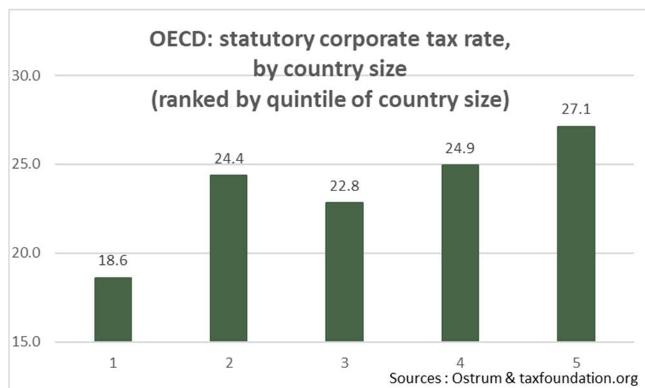
This has contributed to advance inequalities. VAT is a decreasing tax: the poor spend more of their income on consumption and therefore pay a higher VAT in relation to their income. Since capital income is less taxed, this benefits the most favored. As one economist said, "it's expensive to be poor", unfortunately, and that's one more example.

The distortion of the tax structure is obviously much more global. Each country wants to attract capital and reduce its tax rate. This is the "parrot scale" effect: a state will lower its tax rate below the level of its neighbor, so the latter will in turn lower its tax rate below the new level. The evolution over the last forty years has been gradual but uninterrupted and above all global. Whereas in 1981 the distribution of the statutory corporate tax rates was scattered around 40-50%, in 2020 we see a group shooting around 20%, with almost no countries above 40%.



The last point to mention is that this "do not tax what moves" logic is all the more valid when the country is small. It is hard to imagine some sectors leaving Germany or the United States altogether. On the other hand, snubbing a small

country is easier. In this logic, the ability to tax is all the lower because the country is small. Intuition validated by the data. In the next chart, among the OECD countries, it is indeed the smallest which have the lowest tax rate and the largest that can afford somehow higher rates.



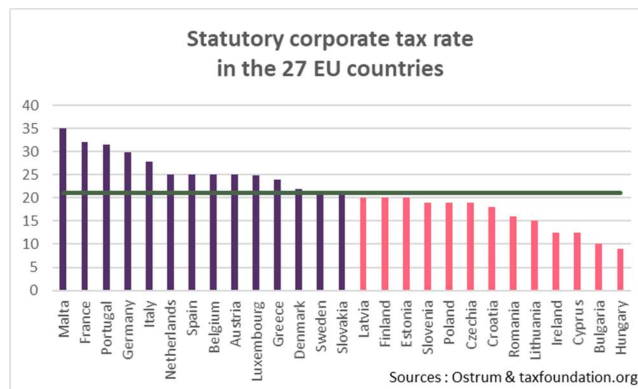
What are the implications?

Tax arbitrage

Biden's decision, if implemented, would completely change this logic. The tax arbitrage that U.S. companies are engaged in would be doubtful. In a recent blog, Philippe Waechter, our chief economist, writes "The US is putting pressure on all developed countries. Europe will be deeply affected by these disruptions. This could limit tax havens and lead to a more coherent tax framework within European countries."[1]

Indeed, of the countries in the European Union, 14 have a level of statutory corporate tax rate higher or equal to 21%, the level targeted by the Biden administration. The other 13 are on a level that de facto implies that American companies will have to pay a supplement of taxes at home. De facto, Hungary, Bulgaria, or Ireland, to name but a few, by keeping their tax rate below 21%, are setting up a tax transfer to the US Treasury. It is very nice of them, but we can also guess that these countries will be reconsidering their position.

Another consequence is the United Kingdom, where some dreamed of a "Singapore on Thames", and which will have to find a better idea to revive its economy. More generally, tax havens are seeing their competitive advantage significantly diminished.



The capital/labor distribution

The direct consequence of this measure is to rebalance the weight of taxation between agents. As we said earlier, the distortion of taxation in favor of indirect taxes, such as VAT, in parallel with the reduction in taxes on profits, has contributed to the increase in inequalities. It has also contributed to the distortion of the division of wealth between capital and labor.
The Biden reform would then be an element that would push for a 180° turn on this trend.

There is an explicit desire for greater equity in the financing of the budget between households and businesses. This is the time to do so, since the budget will be distorted by the increase in social costs related to the aging of the population.

Balance of payments

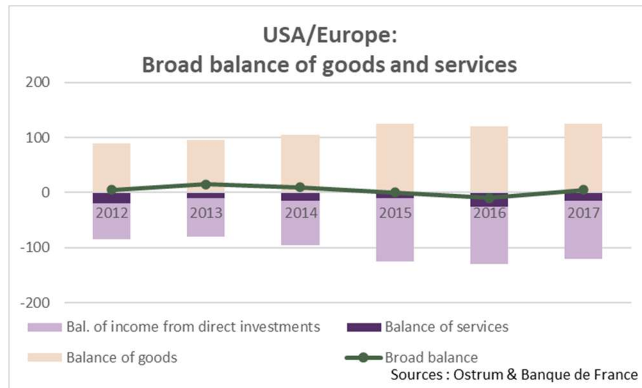
A final impact, much less trivial, is the potential impact on a reorientation of international trade. The effect can be profound.

Let's take an example. Imagine a hypothetical American company exporting mobile phones from the United States to its Irish subsidiary. These phones are sold to the subsidiary at 500 Euros, the cost of production, and therefore the parent company in the United States does not make any profit. The Irish subsidiary sells these telephones for 1,000 Euros and therefore makes a profit of 500 Euros per sale. The advantage of course is that the entire margin is realized by the Irish subsidiary which is taxed much less.
The reality is much more complex, but the logic of optimizing intra-firm "transfer costs" is this.

This means that official export/import data are misleading. In our example, the United States exports 500 Euros to Europe whereas in truth, when the profits made will eventually be repatriated, it is of course 1,000 Euros of exports that will have taken place. In this case, US exports are therefore largely underestimated. And as a consequence, the US deficit vis-à-vis Europe is very much overestimated.
This is a subtlety that the Trump administration had not really

[1] « La révolution fiscale américaine » https://ostrum.philippewaechter.com/2021/04/12/la-revolution-fiscale-americaine/

grasped: by focusing only on the trade balance figures we get a partially misleading view. The Banque de France had also tried to estimate the magnitude of this error in a recent blog[2]. With this conclusion, “After restatement, the balance [between the United States and Europe] of goods and services extended to direct investment income is almost balanced”.



The manipulation of transfer costs is no longer justified after the Biden reform. We could therefore also see American exports become much higher, since they are valued differently, and a US trade deficit could fall substantially.

What it means for markets

Rate: Treasury purchases by foreigners

Last point. Our phone producer, who therefore books a significant part of his profits in Ireland, will tend to invest this cash in dollar assets, to avoid currency risk on his balance sheet, and in low-risk assets. In summary, mainly in Treasury. Ireland is, indeed, the fourth holder of Treasury (313.6 billion USD according to March figures) followed closely by another tax haven, Luxembourg, with 281.4 billion USD. These two countries come after, in this order, Japan, China and the United Kingdom but ahead of OPEC credited with 281 billion.

On the graph above we show the share of Treasury held by foreigners who are booked in tax havens: in order of size, Ireland, Luxembourg, Switzerland, Cayman Islands, Singapore, the Netherlands, and Bermuda. These seven tax havens (smaller ones are missing from the list) totaled $1.369 billion in holdings in March, a fifth of the US debt held by foreigners. To be compared with the biggest holder, Japan with 1.277 Mrds. The accumulation of cash, as we can see, is therefore far from negligible for companies, but also for the financing of the US Treasury.

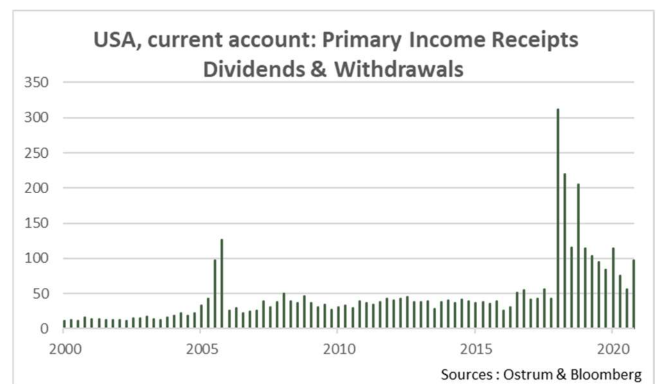
In the event of tax harmonization these treasuries posted abroad would therefore no longer be justified. Paradoxically, we could have a movement similar to what happened when Donald Trump decided to lower the corporate tax rate: repatriation of foreign-held liquidity, and thus sales of Treasury, and dividend distribution or a renewed wave of buyback to use this cash. This has resulted in upward pressure on Treasury rates.

Currency: dollar appreciation

In the same logic it is no longer necessary to park its profits abroad and these can be repatriated, we can even see a part of the cash being returned to the United States.

In 2018, after Trump announced the tax cut, there was indeed an impressive migration. The US balance of payments details below show an explosion in the first quarter of 2018 of the “dividend” item. This item covers subsidiaries which have returned to their parent company the cash they had stored.

The same year saw a strong appreciation of the dollar. Whereas it was above 1.25 against the Euro briefly at the beginning of the year, it quickly returned to 1.15 in the middle of the year. Of course, it is always simplistic to attribute variations in a currency to a single factor, but these repatriations certainly played a part.



In order not to attribute undue weight to this factor, it should also be noted that, as a large part of the cash held abroad by US companies is in dollars (cf. above, the 1.369 billion Treasury held by tax havens), the repatriation of this cash will not be subject to foreign exchange transactions and will therefore be neutral on the dollar.

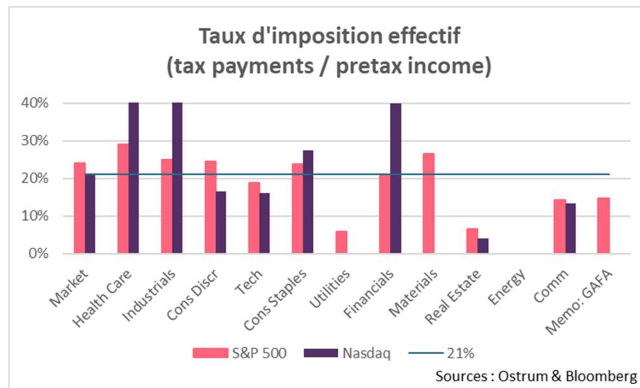
[2]« L’Union européenne est-elle vraiment excédentaire vis-à-vis des États-Unis ? » https://blocnotesdeleco.banque-france.fr/billet-de-blog/lunion-europeenne-est-elle-vraiment-excedentaire-vis-vis-des-etats-unis

Stock market: who benefits from the reform?

We have just mentioned an important market effect, the repatriation of cash. Paradoxically, the same effect as when Trump lowered the corporate tax rate.

At present, the effective tax rate for listed companies is reasonably close to Biden's proposal: 24% effective tax for S&P companies and 21% for Nasdaq companies.
NB: this exercise should be taken with caution as corporate profits are not at their normal levels after the Covid crisis and tax rates has also been impacted.

We can also note that the GAFAM are better off: 24% for Microsoft, but 14% for Apple, 13% for Facebook, 10% for Google and 7% for Amazon.

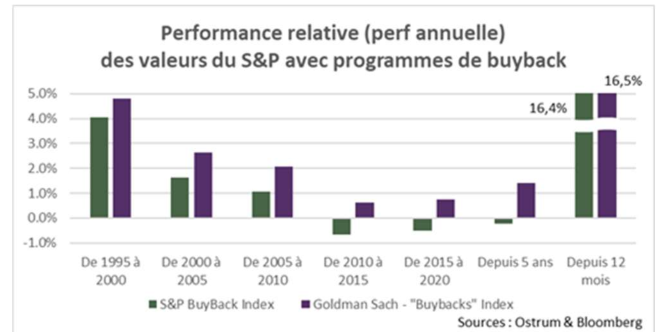


The first approach is simply the tax rate. Companies with a high tax rate had outperformed the S&P by 5% in 2018, the year of the Trump reform that had lowered the corporate tax rate, those with a low tax rate had underperformed by 4%. In this logic, Tech in particular seems at risk.

The analysis is also relevant in terms of the size of the companies, the largest are the most international and therefore have access to more options for tax optimization.

However, this approach needs to be nuanced: just as after the Trump reform, the Biden reform will make tax arbitration less attractive and thus lead to cash repatriations. In 2018, as shown above, volumes were impressive and similar movements can be expected this time. This liquidity in 2018 was largely returned to shareholders, in particular with a record level of share buybacks: 803 billion over the year, an increase of 48% over the year while investment spending had gained only 19%.

More interestingly, almost two-thirds of that $803 billion was spent by businesses with low effective tax rates of less than 20%. But the market in the United States has almost always rewarded companies that have implemented buyback programs as shown in the chart below.



Paradoxically, Tech, at least the big multinationals, could benefit from this movement. The five GAFAM, in 2017, implemented 34 billion of buybacks, a level consistent with previous years, they repurchased 114 Bn the following year and have increased this figure ever since.

The stock market evolution will therefore be important with a marked sectoral differentiation, but we must be careful not to just look at it through the prism of the tax rate.

Conclusion, a real revolution

Under the assumption that the reform is actually implemented, and that the details of the implementation do not distort the project as presented, this reform is indeed a potential revolution.
Paradoxically, while the American tax authorities, once again, would claim the right to extraterritoriality, this could appease international relations since setting a minimum tax rate would eliminate the bickering over tax havens.
On the economic front, beyond the trivial implications for tax optimization, a major reform could also have a significant indirect impact on international flows and on external imbalances.
Finally, the market balance would be disrupted by induced flows, Treasury demand, pressure on the dollar and sector-based rotations would be affected.

Stéphane Déo

Market review

Complacency risk

Growth and inflation do not guarantee higher bond yields

The financial week was marked by the abrupt downturn in US bond yields, even as economic indicators come in on the strong side of expectations. T-note yields thus fully retraced upward pressure since mid-March. The outlook for QE tapering mentioned by Jerome Powell seems to be largely priced in by markets. The positioning of speculative investors and flows had the upper hand last week over macroeconomic fundamentals. Stock indices are trading at record highs in the United States. The downshift in long-term rates obviously benefitted growth stocks. At the same time, the cutback in short positions in the US dollar is easing. The euro is approaching the $ 1.20 threshold. The numerous syndications of sovereign debt ahead of large redemption payments in April have weighed on long-term bonds in the euro zone. Bund yields trade slightly above -0.30%. In turn, credit spreads remained flat.

The yield on the US T-note fell 9bp this week. The trend intensified in Thursday's session with a 12bp plunge to a weekly low of 1.52%. This decline comes at a time when indicators paint a bright picture of the US economy. Retail sales jumped 9.8% in March, with private consumption immediately responding to income transfers implemented last month. Consumption of goods is 17% above January 2020 levels. The sharp drop in new jobless claims points to continued improvement in employment. The first April survey readings (PhilFed, Empire, NAHB, etc.) also show sustained growth despite supply and recruitment difficulties and significant pressure on input prices. The bond market is ignoring the inflationary risk of the current policy mix. In addition, James Bullard and then Jerome Powell mentioned tapering. The first, a non-voting FOMC member this year, sees an announcement when 75% of the adult population will be vaccinated. At the current rate of vaccination, this would coincide with the Jackson Hole Symposium at the end of August. Jerome Powell said the reduction in monthly intervention would come before the rate hikes. This scenario is consistent with the sequence between the tapering announcement in December 2013 and rate liftoff in 2015. Powell's communication had no upward impact on bond yields. The explanation lies elsewhere. The comeback of foreign private investors to the Treasuries market is now confirmed. The inflection point has been evident since mid-March in weekly data from the Japanese MOF. Japanese investors earn a premium of around 105bp by hedging the currency risk for one-year on US Treasury securities. Speculative accounts have also reverted to buying again on the T-note futures. There were also significant buybacks of short call positions on 5-year futures. These buybacks follow on from the cutback in short positions in the dollar early this year. The first quarter was indeed marked by a dollar rebound of 2.8% (broad index). April's relapse is only a reminder that something always has to give. In other words, the bearish consensus on Treasuries is migrating towards the dollar. Against this backdrop, breakeven inflation rates escape nominal pressure as the price of a barrel ($ 67) takes into account the more optimistic demand forecasts from the IEA. The 10-year inflation swap (2.45%) gained 2bp last week.

In the euro zone, the ECB has been buying more in recent weeks. The amounts bought under the ECB's PEPP hover about € 20 billion per week compared with 14 billion before Christine Lagarde's decision. ECB action has held the 10-year Bund around -0.30% for several weeks now. New issues, however, weighed on the government bond market. The repayment schedule prompted European det agencies to rush their funding. Spain (15-year bond) and Ireland (20-year) joined the schedule, which already had long issues in Austria (50-year), Germany and the Netherlands (17-year). This pre-funding acceleration likely anticipates to NextGen EU borrowing program which will begin at the start of the second semester. The EU will borrow as much as € 800 billion over time. Italian spreads are above 100bp. The budgetary situation will not improve this year (deficit of 11.8% of GDP), PM Mario Draghi having decided to extend the support mechanisms for businesses. Italian debt will stand above 160% in 2021.

Equity markets post double-digit performances so far in 2021. The lull in rates is once again benefitting the growth stock investment pattern. The earnings season kicks off with stellar releases from US investment banks. In Europe, the uninterrupted rise for several weeks amid tight volumes raises a lot of questions, especially as the weakness of implied volatility could spell complacency. The first quarterly earnings indications suggest solid publications. The euro IG credit market is broadly stable with a slight tightening last week. Sectors linked to the reopening outperformed. The credit order books are hinting at more tightening going forward on secondary markets, especially as issuance will diminish in coming weeks. The high yield market appears to be supported by new market participants who compensate for admittedly poor final investor flows. The primary market issuance since the beginning of the year is easily absorbed indeed. The relentless rise in equities now argues however for some reduction in risky positions in select AT1 securities and other subordinated securities.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	19-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.68 %	+2	+2	+2
EUR Bunds 10y	-0.23%	+6	+7	+34
EUR Bunds 2s10s	45 bp	+4	+5	+32
USD Treasuries 2y	0.16 %	-1	+1	+4
USD Treasuries 10y	1.59 %	-7	-13	+68
USD Treasuries 2s10s	143 bp	-6	-14	+64
GBP Gilt 10y	0.77 %	-2	-7	+57
JPY JGB 10y	0.09 %	-2	-3	+7
€ Sovereign Spreads (10y)	**19-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	25 bp	-1	+0	+2
Italy	102 bp	-1	+6	-9
Spain	65 bp	-3	+1	+3
Inflation Break-evens (10y)	**19-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	131 bp	+1	+18	-
USD TIPS	236 bp	+2	+5	+37
GBP Gilt Index-Linked	347 bp	-3	-2	+47
EUR Credit Indices	**19-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	86 bp	-1	-4	-6
EUR Agencies OAS	38 bp	-1	-1	-3
EUR Securitized - Covered OAS	31 bp	0	0	-2
EUR Pan-European High Yield OAS	298 bp	-5	-15	-60
EUR/USD CDS Indices 5y	**19-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	50 bp	-1	+2	+2
iTraxx Crossover	245 bp	-3	+1	+4
CDX IG	51 bp	-1	-1	+0
CDX High Yield	290 bp	-5	-10	-4
Emerging Markets	**19-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	339 bp	-10	-12	-13
Currencies	**19-Apr-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.203	+0.98	+1.08	-1.57
GBP/USD	$1.397	+1.66	+0.71	+2.34
USD/JPY	¥108.11	+1.2	+0.71	-4.45
Commodity Futures	**19-Apr-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$66.9	$3.6	$2.6	$15.2
Gold	$1 772.7	$39.7	$27.5	-$121.7
Equity Market Indices	**19-Apr-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 170	1.02	6.57	11.02
EuroStoxx 50	4 028	1.66	4.97	13.37
CAC 40	6 303	2.29	5.09	13.54
Nikkei 225	29 685	0.50	-0.36	8.17
Shanghai Composite	3 478	1.89	2.14	0.13
VIX - Implied Volatility Index	17.24	1.95	-17.71	-24.22

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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