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A New Look from the Brink of Historic Tax Reform

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Key Takeaways

» *The first major overhaul of U.S. tax reform since 1986 is likely to become law before the end of the year.*

» *Our initial, high-level review shows more economic stimulus and potentially stronger equity-market support than indicated in our current forecasts, which we made after the House passed its version of tax reform in November.*

What It May Mean for Investors

» *While it will take financial markets some additional time to digest the tax reform bill's implications, some investment connotations are apparent. We recommend that investors looking to benefit from the new stimulus focus on cyclical equity sectors, which we already favor.*

Latest developments, what's next, and what is the timing?

Congress is set to vote this week on the most comprehensive tax reform in more than 30 years. The House and Senate are likely to approve the bill by Wednesday and send it to the president for signature by the end of the week. If the bill advances according to this schedule, most of the new tax provisions will go into effect on January 1, 2018, although many companies will begin adjustments in the final quarter of 2017.

What are the key provisions of the bill that goes for floor votes in Congress?

We have outlined below some of the key provisions of the bill.

Individual Taxpayers
There will be seven tax brackets, and the top marginal tax rate will decline to 37% from 39.6% today.
Up to $10,000 (combined) in state and local property and income tax will be deductible on federal tax returns.
Mortgage interest deductibility is capped at $750,000 of loan principal (existing loans will be grandfathered), but home equity debt-related interest is disallowed.
The individual Alternative Minimum Tax (AMT) remains but with increased exemption amounts and phase-out thresholds.

Pass-Throughs
Owners, partners and shareholders of S-corporations, partnerships, and limited liability companies (LLCs), who pass through income from their businesses to their individual income, can take a 20% tax deduction on income.
The deduction is phased out beginning at $315,000 for those in service industries.
The deduction is available for pass-through businesses owned through trusts or estates.
Qualified real estate investment trust (REIT) dividends, cooperative dividends, and publicly traded partnership income are eligible for the 20% deduction.

Corporate Tax Rate
The corporate tax rate will be 21% in 2018, which increases the size of the aggregate tax cut.
The bill repeals the 20% federal Alternative Minimum Tax.

Interest Deductibility
For the next four years, through 2021, businesses (corporations as well as pass-through entities) may deduct interest up to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA).
Starting in 2022, this limit will become more restrictive, at 30% of earnings before interest and taxes (EBIT).

Capital Expensing
The bill allows businesses to expense all equipment purchases for the next five years, but it gradually reduces the percentage allowable for expensing beginning in the sixth year.

Territorial Tax System
Under the new tax legislation, businesses are taxed based upon where their profits are earned. So, profits earned overseas will be taxed by those governments; profits earned in the U.S. will be taxed in the U.S. Today, companies are liable for foreign and U.S. taxes on profits made overseas.
There will be a one-time, 15.5% tax on cash (8% on illiquid assets, such as intellectual property) on past unremitted overseas earnings that is payable over time.
A base erosion and anti-abuse provision (BEAT) imposes an additional tax on U.S. companies that try to shift income to lower-tax countries.

What economic and market impacts do we expect?

Front-loaded economic stimulus: The compromise bill for $1 trillion in tax cuts would add a disproportionately large $200 billion to the deficit in 2018 alone, roughly one percent of 2016 gross domestic product (GDP). The extra 2018 stimulus is double the forecast we made after the House passed its tax bill in November and should produce a stronger 2018 U.S. economic growth pace than the 2.6% estimate that we established in November. Higher inflation also could result, although we believe that the long-term downtrend in pricing pressures will moderate inflation's gain.

Potential for equity gains: The limited rise in inflation should have little effect on bond prices, but the new tax rules should be more significant for equities. The stimulus could raise new consumer spending and revenues. The corporate tax rate would fall steeply, from 35% to 21%, and this also should raise earnings. Another important positive is the provision that allows firms to expense new equipment, which should increase operating earnings and encourage managers to bring forward equipment spending. Together, the lower tax rate and the expensing provision should have a large, positive impact on corporate earnings.

Some negative features partially offset our constructive earnings outlook. In particular, the territorial system (discussed in the table on page 2) includes a one-time tax on unremitted foreign earnings. The new legislation sets this rate higher than we had expected and applies it to overseas earnings since 1986. This would be a significant new tax. In addition, U.S. companies would face an extra tax to discourage them from avoiding U.S. taxes via income transfers to foreign subsidiaries. Many firms will need time to comply, and some may have to change some elements of their international strategies. These adjustments could delay the equity market's efforts to price in tax reform.

Crosscurrents for the U.S. dollar's value: Tax reform should raise U.S. economic growth, and rising U.S. short-term market interest rates reinforce that outlook. Both factors support the dollar. Yet, other major world economies already are poised to pick up as much (or more), which is a main reason why our 2018 dollar outlook is mixed.

There has been speculation that the territorial tax system will encourage firms to repatriate funds. While our research suggests that between $200 billion and $300 billion could be brought home over the coming years, there is strong evidence that these funds are already in dollars and, consequently, their repatriation probably would not help the dollar appreciate. Repatriated cash could be more significant in driving stock buybacks. In this regard, the Information Technology, Health Care (pharmaceuticals), Financials and Energy sectors have the most overseas cash.

Have financial markets anticipated the changes already?

It is likely that tax reform is only partially priced into financial markets. The S&P 500 Index has appreciated significantly since tax reform began in September, for example. Yet, the index has risen steadily for most of the year and, at least since June, this increase correlates more closely with the U.S. economy's pickup, accelerating global economic growth, and large volumes of cash available for investing. Tax reform may be helping, but it is a relatively recent market support (in our view).

Other financial-market signals suggest that tax reform is not driving markets consistently yet. Ten-year U.S. Treasury Note yields have shown little upward movement, despite tax reform's promise of stronger 2018 economic growth and moderately higher inflation. Despite its concentration with high-tax and domestic companies that are favored by tax reform, the Russell 2000 Index (small-capitalization companies) has not outperformed the S&P 500 Index since the House passed its bill on November 16. For much of the year, moreover, the highest-tax companies in the S&P 500 Index have underperformed the index's lowest-tax companies, and that disappointment has begun to reverse only recently. Another positive is the recent rotation out of Information Technology into Financials and Industrials—sectors that should be more favored by tax reform. The mixed picture suggests that tax reform is still not completely anticipated in financial markets.

What should investors be doing now?

Tax reform should still be a positive, but the magnitude remains the question: We adjusted our year-end 2018 targets and forecasts in November and anticipate more changes after we gain a deeper understanding of the latest— and likely final—version of the bill. The extra 2018 stimulus of $200 billion is significant, but this bill of nearly 1,100 pages is not quite the tax simplification that congressional leaders originally sought. There are many complex provisions, especially relating to international activities. During the coming weeks, we will be analyzing the most meaningful fiscal policy change in more than 30 years.

Investors should remain diligent about risk: Tax reform should be a strong positive and may help to insulate financial markets from some political risks in 2018. Still, political developments may create volatility. Some of that news may be positive for markets, particularly if the administration continues to deregulate the U.S. economy. Yet, there is room for disappointment, if the infrastructure-improvement initiative or financial deregulation fails in Congress. Possible immigration limitations and trade restrictions pose other negative risks. Investors also may face new uncertainties, if inflation unexpectedly accelerates and raises questions about the pace of Federal Reserve interest-rate hikes.

Our current equity sector recommendations align closely with tax reform: Fortunately, those equity sectors best positioned to benefit from tax reform are among those we already favor, including Industrials, Consumer Discretionary and Financials. Industrials likely will benefit, especially from the provision that allows expensing of machinery and equipment. We expect stronger orders and revenue and a flow-through to earnings. These firms also should be able to pass rising wages through to prices. Financials should benefit, as well, once demand for equipment sparks fresh loan demand. Meanwhile, individual tax cuts should stretch household budgets further and allow stronger retail sales, which favor the Consumer Discretionary sector, particularly those retailers who derive most of their sales domestically. And, as mentioned above, repatriation could benefit Financials as well as Health Care, which is another of our favorite sectors. Overall, tax reform favors an improving economy, and our recommendations already align with that improvement outlook.

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Definitions

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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