THOMSON REUTERS TRADING MARKET VOICE

December 2017

A Very Taxing Tax Plan

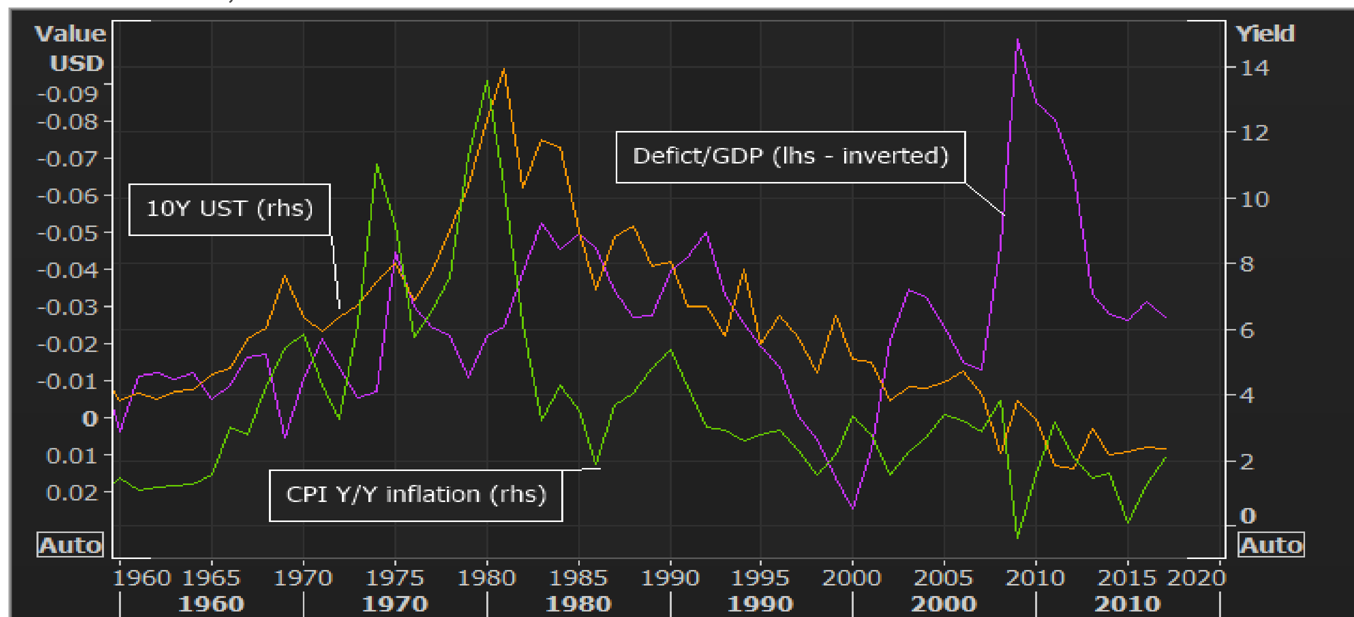
The Senate managed to pass a tax plan on Friday night and the reconciliation needed with the House version passed earlier in November will likely be finished in the next few weeks so a final version should be ready for Trump's signature well before year end. This is an extremely complex piece of legislation so even after reconciliation it will be months if not years before its implications – and unintended consequences - are fully evident. But most main themes of the package should remain so we think it worthwhile to consider what the likely impact of the legislations bodes for the major markets – bonds, the dollar and equities – in the year ahead.

For Bonds the Outlook is Either Bad or Very Bad

There seems to be little argument that the immediate impact of the tax package will be a significant increase in the Federal government deficit. The Congressional Budget Office estimated last week that the Senate Tax Plan would add $1.4 trillion to the deficit over the next decade. There have been arguments that the long-term deficit will be reduced by a positive GDP growth response (and possibly by expiration of some of the cuts) but there seems little question that the Plan will result in a significant increase in the deficit over the next year or two.

With the Fed in a mode of balance sheet reduction the incremental bond issuance needed to finance this deficit will have to be absorbed by the market. It is hard to spin a positive story for yields with a lot of new supply hitting the market so at best this is neutral. The least negative take is, as shown below, there is not a very tight relationship between the deficit and rates – indeed, rates went down as the deficit soared during the financial crisis.

The Fiscal Deficit, CPI Inflation and 10-Year Bond Rates



Source: Thomson Reuters Eikon

Supply is not the only factor driving bond rates. As is also shown in the chart, inflation is more important for driving yield trends than is the size of the deficit. Ironically, this means the lower deficit scenario is potentially more bond negative. In contrast to when the deficit surged in the wake of the 2008 financial crisis, the US economy is operating at high capacity with relatively low levels of unemployment so there is clear risk that a strong positive growth surge risks a significant upside impact on inflation. So at best, this tax plan will be a non-event for the bond market but there is significant risk that the combination of increased supply and rising inflation could make for a very ugly picture. Keep a close eye on CPI next year!

But for the Dollar it is Either Very Good or Very Very Good

The primary intent of the Tax Plan is to remove a disincentive for corporate repatriation of offshore holdings which are estimated to be around $2.6 trillion. Although much of these holdings may already be held in dollars or hedged, even if a modest proportion needs to be converted this could give the dollar a strong temporary boost. By comparison, the broad (JP Morgan) nominal dollar index rallied 5% in year following the 2001 enactment of the Bush corporate tax plan which was also designed to attract offshore holdings adding to a 5% rally in the year ahead of the plan.

In addition to the repatriation affect, the rising yield environment that is bad for the bond market is potentially good for the dollar. The chart below, however, suggests the relationship between rates and the dollar is complex. There is very little apparent connection between the level of bond rates and the dollar's performance and, in particular, the dollar rallied over the past three years with bond yields trending sideways. The more important driver for the dollar is the direction of Fed policy. The recent rally of the dollar was underpinned by a flattening of the yield curve (shown as 3M rate rising relative to the 10Y rate) in response to hikes of the Fed funds rate. So the worst scenario for bonds of rising inflation – and presumably more aggressive Fed hikes – would be the most positive for the dollar.

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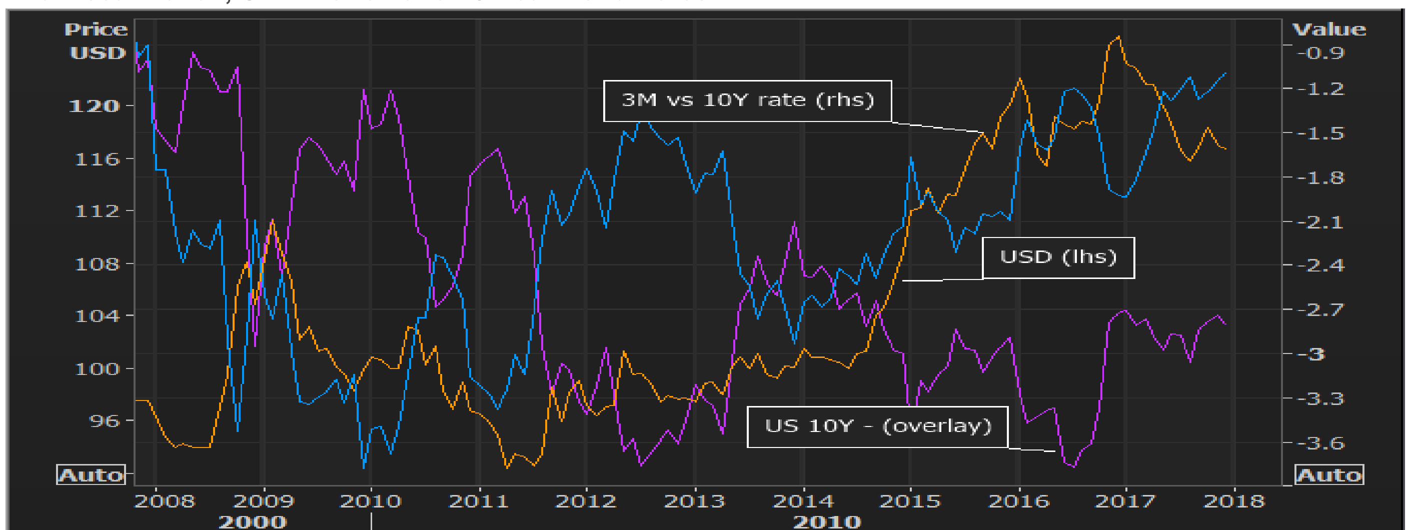


Source: Thomson Reuters Eikon

Good For Equities (and Corporate Bonds too) but ...

While the Bush corporate tax package appears to have been a plus for the dollar, it did not seem to help equity values as the SPX sank in 2001 and 2002 and did not hit bottom until the middle of 2003. Of course the market was also reacting to the dot-com bubble burst and, in any event, the Bush corporate tax package was primarily focused on incentives for repatriation than on cuts – the tax cuts were largely directed toward individuals. This package includes both incentives for repatriation as well as a substantial cut in rates creating a double barreled benefit for corporations.

There is little reason to believe that the tax cuts will lead to a surge in investment activity. For one, even though the Bush tax package had built in incentives for companies to invest repatriated earning there is little evidence that there was a meaningful impact on overall investment. Secondly, corporates are not generally short of onshore cash and with rates low they should already be taking advantage of any attractive investment opportunities. Most important is that while the current corporate tax rate is 39%, according to the Congressional Budget Office (CBO), the average marginal tax rate faced by corporates is around 18%. As anyone who has taken basic economics knows, decisions are made on the basis of marginal costs so lowering the overall rate to 20% (a level which may not even be achieved in the reconciled package) is not likely to suddenly make a whole lot of projects suddenly attractive enough to act on.

While the Tax Plan's marginal impact on investment will likely be modest, the overall impact should be quite substantial; the CBO estimates the average tax rate while well below the headline 39% is a still hefty 29% so cutting the rate toward 20% should represent a significant net gain – at least on average – for corporations. If these gains – and repatriated earnings – are not directed toward new investments, the most likely use of these funds will be to do share buybacks and debt reduction. The chart below shows that the relative cost of equities (the SPX price/earnings ratio) to debt (the price of AAA debt) is at its highest level since the financial crisis. The relatively high price of equities to debt would project a bias for companies to favor debt buybacks. Overall then there is mixed outlook for credit spreads: a rising rate environment is generally negative but the prospect of debt buybacks is positive but debt should clearly outperform vs what would be suggested by the general rise in Treasury benchmarks.

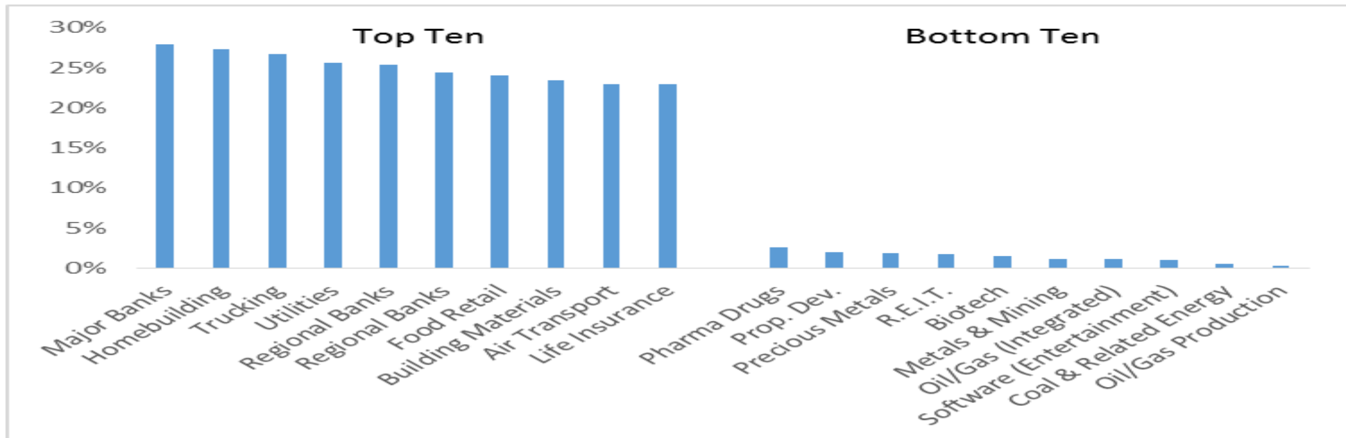
Ratio of SPX P/E Ratio to AAA Corporate Bond Price

Source: Thomson Reuters Eikon

..which companies stand to gain the most?

Although it is moot to what degree corporates will favor buybacks of debt or equity – and this will clearly vary across companies – we believe there will ultimately be a substantial equity buyback as a result of repatriation and cut in the tax rate. Large corporations are likely to see the biggest effect as they are more likely to have the cross-border activities that would generate offshore holdings and also, on average, currently face a higher average marginal tax rate. The US General Accounting Office estimates that roughly 70% of all corporations pay no taxes at all; firms that do not pay taxes will not get any immediate benefit from a lower tax rate. The percentage of large-cap companies that do not pay taxes is much lower at around 40% and this percentage drops even further to around 15-20% for large-cap corporations that declared a profit.

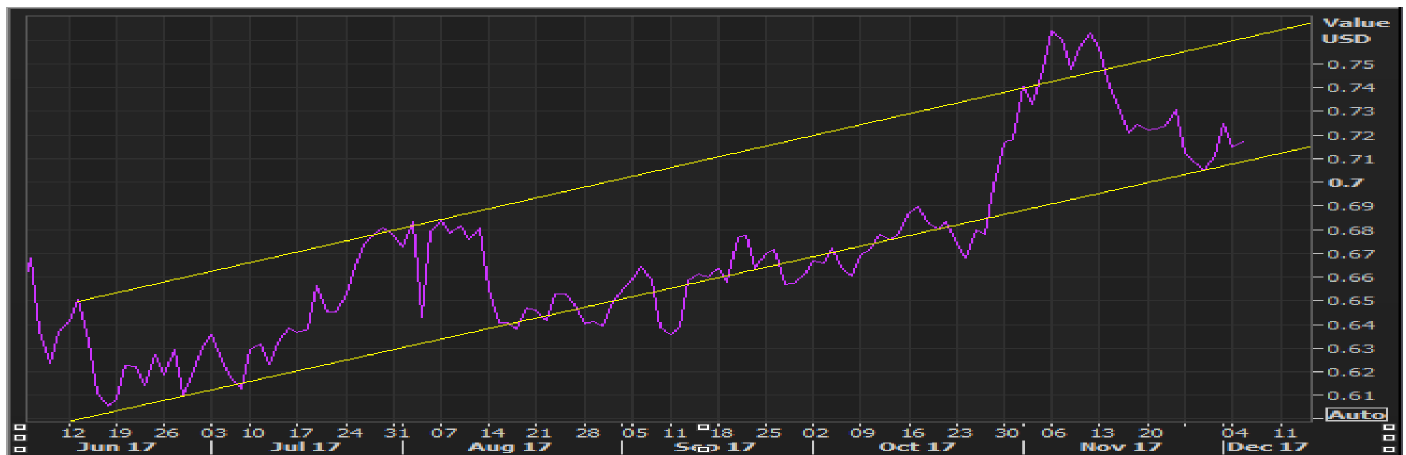
Top and Bottom Effective Corporate Tax Rates by Sector



Source: http://www.stern.nyu.edu/~adamodar/pc/datasets/taxrate.xls

The chart above shows the output of a New York University study on the average effective tax rate faced by different economic sectors as of January of this year (for more information access the link). While this is a general guide for which sectors will potentially see the biggest gains from the tax plan, within each sector the gains will primarily accrue to larger profitable firms. The study did not have a breakout for the high-tech sector which has been selling off sharply vs other sectors the past few sessions reportedly because on average the sector has a relatively low effective tax rate so will benefit less from the Tax Package. But we think there is more involved in this selloff; as discussed in last month's Market Voice, market rotation emerged early last month focused on the tech sector when the prospects for the Tax Plan were still highly problematic. We believe that a primary driver

Ratio of FAANG Index and the Russell Index

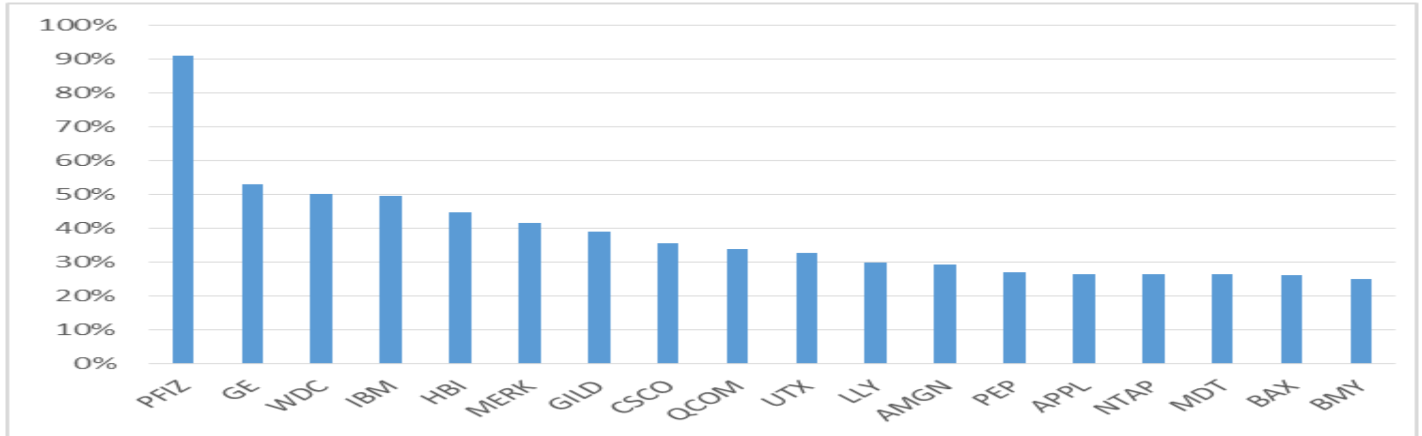


Source: Thomson Reuters Eikon

of this rotation is that the tech sector valuations were extended and growing optimism on the broad economy promised a more supportive environment for the traditional economy. The prior chart shows that the FANG (Facebook, Amazon, Apple, Netflix and Google) index trended lower vs the Russell index (IWM) index for most of November. It is now approaching the bottom of the range trend so the rotation is like to fade regardless of what happens with the Tax Program.

Moreover, in addition to the improved tax rate, there are also potential for gains via repatriation of offshore holdings. The chart below shows the intersection of firms that are both large absolutely – at least $1 billion in offshore holdings – and in relative terms – offshore holdings represent at least 25% of market cap. The marginal tax rates are not available for all of these companies but they generally range in the 25%-30% range so these appear to be the individual names that have particularly strong potential for share a debt buyback. Notably several high-tech firms – notably Apple which is also in the FANG index – will potentially be in a position for substantial buyback as a result of repatriation.

Offshore Tax Holdings as a % of Market Capitalization



Source: Thomson Reuters Eikon and Institute on Taxation and Economic Policy

The Bottom Line

We expect the reconciled Tax Plan will result in a significant – though maybe not down to 20% – cut in the corporate tax rate and incentives for companies to repatriate offshore holdings. With the flow through to new investment likely to be modest, the surge in cash will principally be used to buy down debt and fund equity buybacks. This should be positive for stocks and particularly for large-cap profitable companies – who on average face the highest average effective tax rate – that also have substantial offshore holdings. While debt buybacks are positive for the corporate bond market, this will at least in part be offset by a negative macro impact for bonds as the Tax Plan will almost certainly lead to an increase in supply and may also put upward pressure on inflation. The dollar broadly should be a big beneficiary of the plan; the experience in 2001 suggests repatriation will boost the dollar and higher – especially short-term – interest rates would be an additional plus.

Market Voice

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