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ON OUR MINDS

Investing in a New Tax Regime

Michael A. Tyler, CFA®, Chief Investment Officer

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Republicans pushed their tax bill through Congress a week ago, and President Trump signed it into law just before Christmas. Accountants and tax experts sacrificed their holiday breaks to assess whether the reform will be good or bad for their clients, and to suggest year-end ploys to prepare for the emerging tax rules. Each client's situation is unique, of course, so the assessments and recommendations may show wide variation across an advisor's client base: Don't just assume that the generic advice in the Wall Street Journal or Boston Globe is right for you.

On the other hand, assessing the *investment* implications of the new law is more easily generalized; it doesn't matter whose money is pouring into (or out of) a given security. What matters to us is whether the tax legislation is likely to increase or decrease the value of a stock or bond, and whether Wall Street has already recognized (i.e. "priced in") the change.

Most economists have concluded that the tax law will jolt the economy into faster growth, because the lower corporate tax rate will encourage more investment and raise asset prices, while the modest personal tax cuts (for most people) will encourage more spending. Jim O'Sullivan at High Frequency Economics, one of the most respected economists on Wall Street, noted that the final legislation includes more fiscal stimulus than either the House or Senate bills did; he suggested recently that the law can boost GDP growth by 0.9% in 2018, and by slightly lesser amounts in the following few years. If true, then tax reform could keep GDP growth above 3% for another year or more, thereby accelerating and extending the current economic up-cycle.

The fiscal stimulus comes from several factors, most notably repatriation of foreign profits and lower overall corporate income taxes. These benefits are likely to be offset, at least in part, by concerns over the law's impact on corporate debt financing and on the housing market; investors should also be wary of the Federal Reserve's possible response.

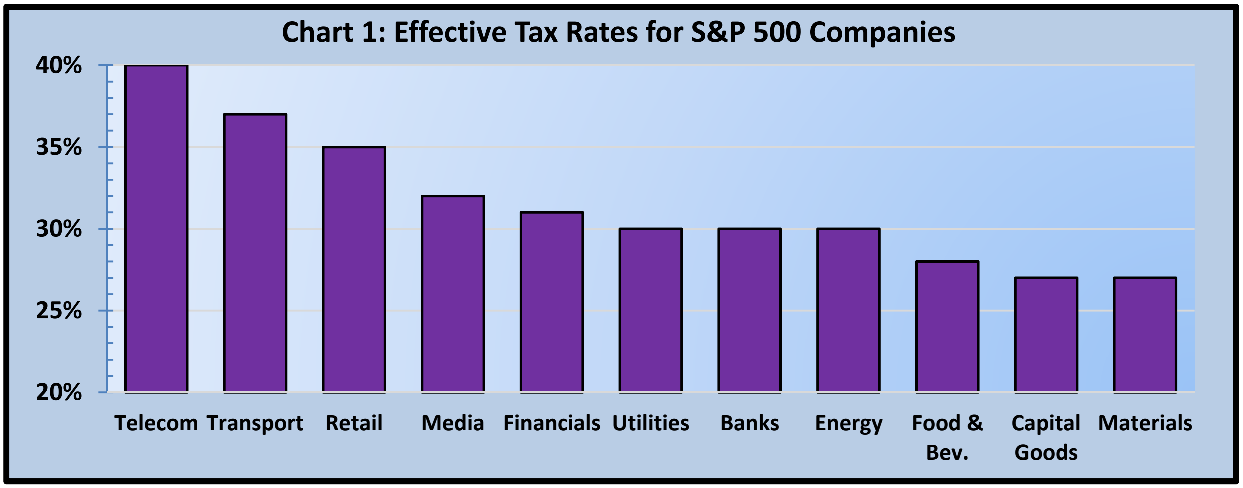
Repatriating Foreign Profits

The new law taxes repatriated foreign earnings at only 15.5%, which can give companies reason to invest here rather than abroad. This is especially true for the companies with the largest proportions of retained earnings held overseas, mainly in the technology and pharmaceutical industries. Some energy companies will also benefit handsomely if they opt to bring cash home.

How companies choose to use repatriated retained earnings will prove to be an interesting experiment. The Trump administration hopes that companies will reinvest the money in domestic facilities and employees; yet even if companies do nothing other than buy back stock or pay higher dividends, the resulting boost to asset prices could sustain consumer confidence and spending levels.

Corporate Income Tax Rate

It's easy to see why tax reform can stimulate faster growth. The drop in the corporate rate from 35% (with plenty of loopholes) to 21% (with considerably fewer loopholes) puts American firms on equal footing with foreign companies that are typically taxed at about 20% to 25%. This change can boost American competitiveness and exports. Some companies and industries will benefit more than others, of course; those with the highest effective tax rates (which are often those with the least international business) stand to benefit most. Chart 1 shows some industries with both high effective tax rates and substantially U.S.-based sales:



Sources: Bloomberg, State Street Global Advisors

The tax law will affect companies in these industries in varying ways. The asset-intensive telecom and capital goods companies, for example, will likely see a double benefit, as their tax rates fall and as they take advantage of favorable new rules for treatment of investments in their networks and factories. The retail companies will undoubtedly use the tax windfall to cut prices in an effort to stave off further incursions from Amazon and other e-commerce vendors. Among diversified financial companies, health insurers will likely be hurt by the law's repeal of the Obamacare mandate; without that mandate, insurers are faced with the unhappy choice of lower profit margins or higher premiums.

Corporate Debt Financing

Corporate America didn't get everything it wanted. The biggest adverse impact comes from the law's partial elimination of interest expense deductions. Until now, American tax policy had favored debt financing over equity financing, because interest expense was deductible while dividend payments were not. In the new regime, this imbalance is partially rectified, as interest will not be deductible to the extent that it exceeds 30% of certain cash flow measures.[1]

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[1] The cash flow metrics are defined as earnings before interest, taxes, depreciation, and amortization (EBITDA) for the first four years, and earnings before interest and taxes (EBIT) afterward. Many asset-intensive industries have substantial non-cash depreciation of their capital equipment, so the use of EBITDA until 2021 makes for a gentler transition. Regulated public utilities, which are also asset-intensive, are excluded from this provision.

For most investment-grade companies (those rated in the A range or Baa/BBB by Moody's or Standard & Poor's), this interest expense provision is irrelevant because their interest expense is typically well below the 30% threshold; so too the best-quality speculative-grade (Ba/BB-rated high-yield) bonds won't be meaningfully affected.

However, weaker corporate bond issuers (those rated single-B or in the C range) could find this provision to be quite painful. Not only will a meaningful portion of their interest expense no longer be deductible, but their effective tax rates won't likely come down much because they are already closer to the new 21% statutory rate due to extensive use of tax breaks that are about to disappear. Further, their thin profit margins won't give them much breathing room to absorb higher tax costs.

Housing Market

One domestic industry sector is conspicuously and disturbingly not shown in Chart 1 despite having a fairly high effective tax rate. The housing sector is actually likely to be punished by the new tax law. The pain comes from the new restrictions on mortgage interest and property tax deductions.[2] These restrictions effectively raise the cost of owning and financing a home, and could therefore lead to lower prices – especially for new construction. Moody's Analytics estimated that prices could fall 4% nationwide and 10% in expensive high-tax markets like New York and California.

In this respect, housing represents perhaps the biggest risk of the new tax law on the broader economy. If housing prices fall in major urban markets – especially in centers of media and popular culture – the effects could ripple across the entire country. Yet we are not likely to see a repeat of the 2008 financial meltdown even if housing prices fall; among other things, consumers and banks are carrying much lower debt burdens (relative to income) than they were a decade ago. Even so, a mild housing-driven recession is hardly out of the question.[3]

What About the Fed?

Despite these concerns, the new tax law is likely to spur economic growth – especially in the first couple of years, after which its impact will be attenuated by the timing of various provisions. Yet the economy has been doing very well for a long time: The current expansion is the third-longest since World War II. Unemployment has hit a two-decade low, inflation is showing some signs of life, and capacity utilization has been rising.

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[2] Mortgage interest will no longer be deductible on more than $750,000 of principal (vs. $1,000,000 under the prior rules), and not at all on second homes. Existing mortgages will not be affected, however, even if refinanced in the future. Property taxes also will no longer be deductible to the extent that the combination of all state and local taxes exceeds $10,000 – a number that is not indexed to inflation, and thus becomes more restrictive each year.

[3] The tax law also will trigger mandatory cuts to programs such as Medicare, and its new "chained CPI" inflation indicator will reduce the benefit of inflation indexation. Some economists fear that these factors can also contribute to a recession, but their concerns are probably overstated.

In this context, the Federal Reserve's economists must consider not only the risk of recession (from housing prices falling or from a wave of bankruptcies among the weakest corporate bond issuers), but also the risk of overheating. If companies use their tax windfalls and repatriated earnings to invest heavily in U.S. facilities and people, a tight labor market (especially among skilled workers) could lead to a spike in wage inflation. Alternatively, if companies instead simply buy back stock and pay higher dividends, the boon to stock prices could lead to market speculation and a stock market bubble.

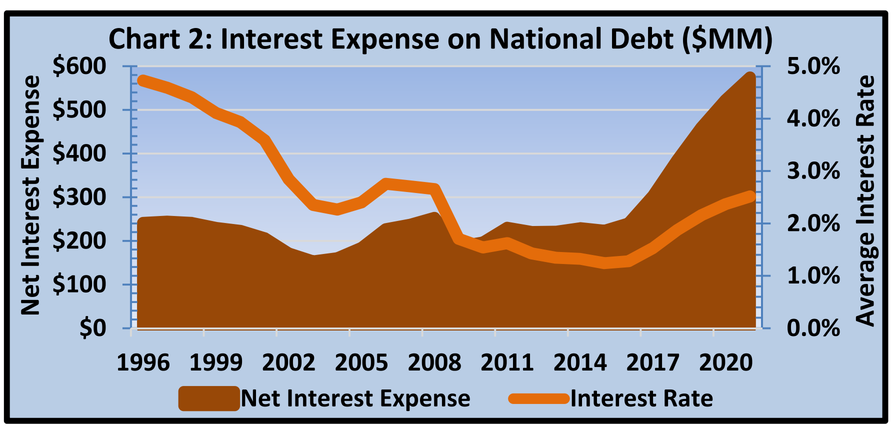
Either way, the Fed may respond to the tax law by tightening monetary policy more quickly than investors currently expect. Just in the past few weeks, investors have shifted their 2018 fed funds rate expectations from a single quarter-point hike to three hikes. Some Wall Street strategists even suggest that the Fed will raise rates four times next year, although the market-weighted probability (derived from prices of futures contracts) is still for only two hikes.

If the Fed does become more aggressive, either through higher fed funds rates or through a faster unwinding of its balance sheet (selling long-term bond holdings), it could send interest rates higher across all maturities. That could raise the value of the dollar and dim the outlook for stock prices. Done perfectly, such actions would offset any excess stimulus from the tax law; but done too aggressively, it could spook the bond market and cause a recession.

Federal Deficit and the National Debt

The Congressional Budget Office estimates that the tax law will add $1.5 trillion to the national debt over the coming decade, assuming "static" scoring (in other words, no impact on consumer behavior caused by the tax law itself). The Trump administration argues that the law will stimulate GDP growth and therefore pay for itself in ten years. The likely outcome will be somewhere in between, but the actual "cost" of the law is impossible to measure anyway.

What does seem clear, however, is that the tax law will substantially expand the federal deficit in the next few years. As the Fed continues to raise interest rates, the interest cost of servicing the growing national debt will grow much more quickly, as shown in Chart 2.



Source: U.S. Treasury Department

After two decades of stable interest cost (rising debt levels offset by falling interest rates), the federal government is just beginning what could be a long-term increase in both debt levels *and* interest rates. The resultant spike in total interest expense (shown as the brown section in Chart 2) could crowd out more productive government spending on infrastructure, science, education, military, and other uses.

Market Reactions

Equity investors have clearly embraced the tax cuts, as stock prices have continued to drift higher into record territory.[4] Yet small-cap companies – which should be among the biggest beneficiaries because they typically have higher effective tax rates[5] – have lagged their larger brethren this year: The Russell 2000 index is up only 14% year-to-date, compared with 20% for the large-cap S&P 500 index. This suggests that investors are at least somewhat wary about the future benefits of the new tax law – or, to put a more positive gloss on the same data, that investors haven't yet fully digested the potential for a longer and stronger economic cycle.

Bond investors have also been somewhat reticent to embrace the new tax law. Long-term bond yields have drifted up slightly in the past month, but remain well below the levels of a year ago. This suggests that bond investors see a slight increase in inflation and GDP growth, but they haven't (yet) concluded that meaningful change is on the horizon.

Investors in other asset classes are still assessing how tax reform affects them. As a general rule, as tax rates come down, the value of tax-advantaged investments likewise comes down. It's not surprising, therefore, that municipal bonds and REITs have lost some ground in the past few weeks as the tax law sped through Congress. Conversely, the special treatment of master limited partnerships has been retained, and many of those investments have held their value recently.

In the end, the bond market likely has it right: The tax law is likely to have a mildly positive impact on the economy and on securities markets over the coming year. From an investment perspective, it won't be as transformative as the Republican euphoria suggests, nor will it be as painful as the Democratic Cassandras fear. We had proactively positioned client portfolios for the advent of the new law, and we will remain vigilant as its impacts begin to filter through the real economy.

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[4] I am reminded of Country Joe McDonald's "Fixin' to Die Rag" anti-war anthem, which might need to be updated to address the market's zeal for tax cuts:

> *Come on Wall Street, don't be slow – why, man, tax law's au-go-go!*
> *There's plenty good money to be made by supplying the people with the stocks to trade.*
> *So put down your books, your work is now done – We're gonna have a whole lotta fun.*

[5] They often cannot take advantage of the many tax breaks available to large multinational companies, including the ability to park profits overseas through creative intra-company transfer pricing. Without those breaks, small-cap companies typically pay higher effective tax rates.