DECEMBER 2017

Alphalytics Research Market Bulletin

Tax Reform is on the Way for 2018. What's Next for Markets?

AUTHOR

Christopher Riggs, JD, CFP®
President and Lead Strategist

... it's critical for investors to suspend political biases and see the Tax Cut and Jobs Act with an unobstructed view.

...let this be clear: the most impactful elements of the Tax Cut and Jobs Act are about improving America's competitiveness for corporate investment and growth.

With the stroke of a pen on December 22nd, the promise of fundamental tax reform has now become a reality. Marked by sweeping changes for corporate taxes and last-minute cuts for individuals, the Tax Cut and Jobs Act (TCJA) is the most significant piece of tax legislation in a generation. So, with vast changes on the way in 2018, it's time to assess the impact to the economy and markets.

As a cornerstone promise in the presidential campaign from a year ago, tax reform has now become a reality. Most Americans will either applaud or denounce the passage depending upon whom they voted for last election. However, it is important not to confuse politics with investing. While tempting to think this way, it's critical for investors to suspend political biases and see the Tax Cut and Jobs Act with an unobstructed view.

What follows is a quick summary of the big issues investors should be aware of when assessing the potential impact to markets in 2018.

Focus on Corporate Tax Reform

Although most headlines focus on changes to personal income tax provisions, let this be clear: the most impactful elements of the Tax Cut and Jobs Act are about improving America's competitiveness for corporate investment and growth.

In response to the widely accepted narrative that America had long lost its competitiveness in a global marketplace, the TCJA makes three substantial changes to corporate taxes.

1. Lowers the Corporate Income Tax Rate from 35% to 21%.

The change moves the U.S. corporate tax rate from last amongst our top five trading partners to first. Such a move should slow the rate of corporate inversions, whereby companies re-incorporate abroad to reduce their tax burden.

2. Taxation on Multinational Corporations moves to a "Territorial" System.

The TCJA removes a major inhibitor for corporations to bring home foreign profits and reinvest domestically.

3. Full Expensing for Capital Investment in the First Five Years.

The TCJA offers accelerated deductibility for capital investments, providing extra incentives for U.S. businesses to invest in growth in the near term.

What About Changes to Personal Taxes?

Initially, reform-minded sponsors aspired to simplify individual taxes while eliminating special interest deductions. After the political machine was done, what came out was something much more complex.

The TCJA is loaded with off-setting changes, with winners and losers all over the board. Most Americans will see a lower tax bracket rate; however, they will also lose some of their favorite deductions. The child tax credit gets doubled, helping many low and middle-income families. Meanwhile, some of the most controversial provisions involve limiting deductions used by higher income tax-payers.

Ultimately, the net effect leads to a lower tax burden for most households.

> *…lower corporate rates can take what was already expected to be a solid year and propel it to an even better year.*

So, What's the Significance for My Portfolio?

While the objectives of the TCJA were aimed at long-term structural improvements, investors should refine their near-term focus.

Theme #1: Increased Corporate Profits in 2018.

According to Factset[1], S&P 500 companies are already expected to grow earnings by 11.1% and revenue by 5.4% in 2018. Those assumptions were made before consideration of a reduced tax rate. Therefore, lower corporate rates can take what was already expected to be a solid year and propel it to an even better year.

Theme #2: Putting Profits to Work.

Should U.S. corporations realize improved earnings or see repatriated foreign profits, then the next question leads to how they will put those profits to work. Four main activities emerge, all of which appear initially positive for markets.

- Capital Reinvestment.
- Increasing Dividends.
- Share Buybacks.
- Increased Wages.

Theme #3: Increased Consumption.

Most Americans will see their reduced tax burden through an increase in their paycheck. Lower tax bracket rates will convert to lower withholding amounts as early as February. It's safe to assume the pay bump will likely be treated as expendable income, quickly shifting to increased consumption in 2018.

Caution, Not Without Potential Problems

Achieving passage of the tax bill by year-end means 2018 certainly starts with a positive outlook. However, it doesn't mean the economy will move forward without facing challenges. On a number of fronts, caution is still warranted.

Caution #1: The Expansion is Getting Too Long.

From an economic lens, the timing of the tax reform seems precarious. After all, markets are presently in the second longest bull market run record and valuations are near historical highs.

Caution #2: The Fed Hastens Rate Hikes.

The Fed's record shows they are not favorably pre-disposed to the tax cut. After all, the economy is already at full employment and in little need of a near-term stimulus.

In the Fed's view, urgent reform should have been devoted to reducing the Federal deficit; instead, the deficit expands under the TCJA. Moreover, adding too much fuel to a mature expansion could be inflationary and may force the Fed to tighten at a steadier pace.

Caution #3: Lack of Reinvestment.

Let's face it, a lot of big, cash-rich corporations have simply chosen not to make capital investments during this expansion. Furthermore, a study from the Congressional Research Service on repatriation incentives in 2004 showed little evidence that repatriated profits led to new capital investment.[2]

> *While tax cuts may justify an optimistic tilt for 2018, savvy investors would be wise to remain diligent and nimble as well.*

Concluding Thoughts

In a world of insufficient growth, nationalism now manifests itself through competition for corporate dollars. The TCJA makes a bold move to tip the scale back in favor of the U.S., but, it likely won't be received favorably by its trading partners. Already, European and Chinese leaders have vocalized displeasure with the TCJA, and may consider countering with policy responses of their own.

We continue to view the global economy as a complex and dynamic eco-system. When significant changes occur, the effects naturally ripple through the whole eco-system and may elicit unintended responses. While tax cuts may justify an optimistic tilt for 2018, savvy investors would be wise to remain diligent and nimble at this stage of the business cycle.

Sources:
[1] FactSet Earnings Insight, December 1, 2017
[2] J. Gravelle and D. J. Marples. "Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis," Congressional Research Service, December 20, 2011.

ALPHALYTICS RESEARCH

For inquiries of Alphalytics Research, please email at info@alphalyticsresearch.com.