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Tax reform investment implications: How much bang for the bucks?

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Finally, after months of debate and shifting expectations, President Trump and the Republican Congress have their hallmark legislative victory as the 2017 Tax Cuts and Jobs Act makes its way into law. But investors are still left with several key questions about the changing political environment, the short- and long-term impact on the economy and how tax law changes will affect their portfolios. While no one has all of the answers, we can offer some views as to how investors may be affected in 2018 and the years ahead.

Political and policy impacts remain unclear

From a political perspective, it's tough to gauge the effect that this bill will have. At present, polling suggests this tax bill is broadly unpopular. At the same time, voters may only fully realize positive effects after the 2018 midterm elections (since they will be filing 2018 returns in early 2019). As such, it is hard to predict that tax reform will help Republicans in next year's elections. It is equally unclear whether the passage of this bill will translate into additional legislative victories before the end of 2018. President Trump has indicated he would like to move on to an infrastructure spending bill, while congressional Republicans seem more interested in welfare and entitlement reform. In our view, neither seems likely to progress.

Key points

- The fiscal stimulus from tax cuts will likely provide a modest boost to U.S. growth and inflation next year.
- We estimate tax reform will provide a 0.5% contribution to real GDP growth in 2018, but the longer-term effects depend on whether the incentives for business investment in the bill add to worker productivity.
- Equity markets have rallied on expectations for lower individual and corporate tax rates. Tax reform provides a clear tailwind for stock prices.
- We expect a modest increase in Treasury yields and a slight tightening in corporate credit spreads. Tax reform should benefit high quality corporate bonds.
- Despite earlier fears to the contrary, tax reform is unlikely to have a negative effect on municipal bonds, and currently issued municipal bonds are not affected by any changes.

Investors also need to consider how tax reform and the associated fiscal stimulus will work alongside shifts in monetary policy. The bill will cut taxes by $1.5 trillion over the next decade, reducing federal revenues by the same amount (although some of that may be recouped in the form of stronger economic growth). This represents a significant amount of fiscal stimulus that is occurring nine years into an economic expansion. At the same time, the Federal Reserve is in the process of tightening monetary policy. The combination of fiscal stimulus and monetary tightening is rare and its effects are uncertain. It is possible that fiscal stimulus could prompt the Fed to become slightly more aggressive in its rate hikes and probable that we'll see at least some additional inflation pressures as a result of these changes.

The economic impact appears front-loaded

Designed to boost both short- and long-term U.S. economic growth through increased productivity and competitiveness, the tax reform bill contains across-the-board tax rate reductions for households, small businesses and corporations, mixed with significant changes in the laws governing exemptions and deductions. But how effective will it be?

We do expect to see a short-term lift in economic growth as a result of the changes. The reductions in individual tax rates should increase the low U.S. savings rate and lead to a moderate upturn in household spending, especially among lower- and middle-income households. Additionally, the lower corporate tax rate will bolster cash flows that will likely be used for a variety of purposes, including pay raises, hiring, merger-and-acquisition activity, capital expenditures and share buybacks and dividend increases. Other changes in the corporate tax structure incentivize greater business investment and encourage expansion of domestic operations. Together, all of these actions have the potential to boost productivity and broader economic growth.

+0.5%

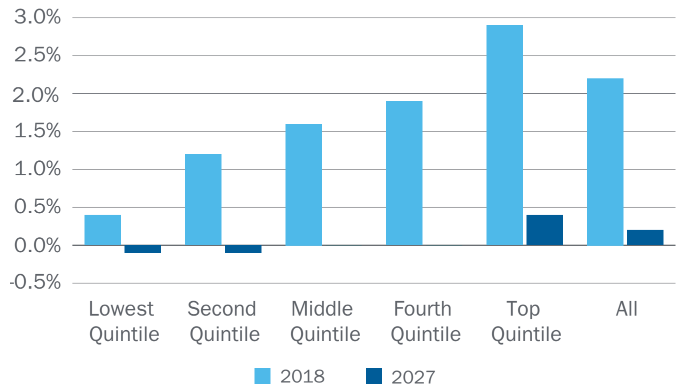
Expected contribution to 2018 GDP

A key question is how much of this impact will be front-loaded as opposed to supporting longer-term growth. Because of the way individual tax rate changes are implemented and ultimately phased out, workers will see a much more notable tax cut in 2018 than they will 10 years from now. From a corporate tax perspective, the fact that tax cuts will kick in next year reduces the near-term investment incentive for some tax write-offs, but should immediately improve corporate cash flows. Altogether, we estimate that changes in the tax laws should provide a 0.5% bump in real gross domestic product growth next year. But that may begin to taper off by 2019.

Over the longer term, it is more difficult to forecast how the economy will be affected. Corporate investment incentives may result in a prolonged boost in productivity, while incentives to keep and expand corporate operations in the United States could benefit growth. But we don't believe these changes will result in a meaningful sustained increase in long-term U.S. economic potential. Demographic challenges in the form of generational shifts (such as the baby boomer retirement wave) remain the main challenge to U.S. economic growth, and this bill does not address those issues.

The income boost may be a short-term phenomenon

Percent change in after-tax income levels



Source: Tax Policy Center. Income quintiles are based on expanded cash income percentages.

For equities, Tax reform is icing on the cake

Even before tax reform became a reality, we had a bullish view toward equity markets. Our positive outlook remains in place, although some areas of the market should benefit more than others. We will likely see a shift in U.S. market leadership from growth to value, with better relative performance among specific sectors closely tied to accelerating economic growth. Meanwhile, non-U.S. equities (notably in Europe and select emerging markets) also look attractive given lower valuations and stronger economic growth rates than in the U.S.

Equity fundamentals appear sound

Many of the same factors that drove U.S. stock prices higher in 2017, including modestly accelerating economic growth and strong corporate earnings, should continue in 2018. We expect strong earnings growth in the low double digits this year, driving U.S. market returns, while valuations will likely remain flat due to their already high levels.

Corporate tax cuts should provide a tailwind

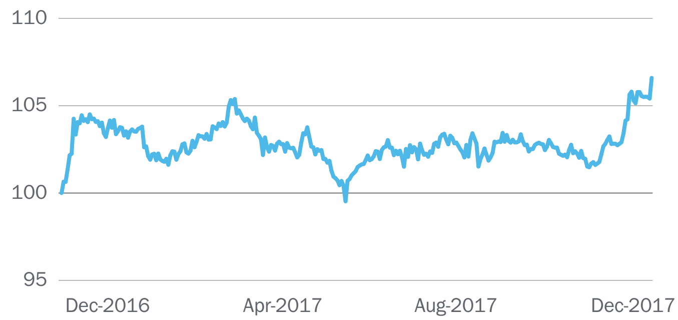
The most notable aspect of the tax package from an equities perspective is, of course, the reduction in corporate tax rates from 35% to 21%. Because these tax rates become effective in 2018, many companies will see an immediate jump in their levels of free cash flow. Corporate management teams will have a variety of options for how to deploy this cash: increase hiring, raise wages, invest in their businesses, fund corporate deal activity, increase dividends or engage in share buybacks. All of these actions could help lift their stock prices.

Sector performance may vary

In general, as inflation and spending move higher, value-oriented sectors with stronger ties to economic growth—such as financials, industrials and materials—should be the chief beneficiaries of tax reform and lead the U.S. market. Energy and consumer-related sectors appear poised to rise, too. In contrast, technology and health care companies already pay lower effective tax rates and thus will not benefit from the cut in the corporate rate. Utilities and real estate, which are more sensitive to rising interest rates, may be vulnerable to underperformance.

U.S. stocks have been boosted by tax reform prospects

U.S. versus non-U.S. markets



Source: Bloomberg. Daily data from 11/1/2016 through 12/15/2017. U.S. stocks are represented by the S&P 500 Index. Non-U.S. stocks are represented by the MSCI All Country World ex-U.S. Index. Values are indexed to 100.

Tax-related market risks appear low

Although inflation and interest rates are likely to move a bit higher than they would have otherwise, we expect increases to be modest in scope and frequency—not the type of inflation or rate spikes that would derail the equity bull market. At the same time, we acknowledge that the addition of fiscal stimulus to an already-expanding economy may accelerate the business cycle, but we see very little risk of recession in 2018 and into 2019.

The bottom line is that tax reform is a plus for stocks

Equity investors have been eagerly anticipating tax reductions and markets have already received a boost as prospects for tax reform have grown more certain. The accompanying exhibit shows the relative performance of U.S. stocks versus non-U.S. stocks. Global equities have been moving higher over the course of 2017, but the rally was, for the most part, relatively uniform. Once serious debate began on the tax bill in early November, however, U.S. stocks moved dramatically higher compared to equity markets in the rest of the world. There is a reasonable question about how much of the expected rise in stock prices is already "baked in" to the markets, but it seems clear that tax reform prospects are equity-market friendly.

In taxable bond markets, high quality corporates should fare best

In our view, tax reform will likely result in a modest increase in Treasury yields as well as a slight tightening in corporate credit spreads. The lower corporate tax rate is bullish for cash flows, but it is unclear how companies will use their newfound cash windfalls. Meanwhile, the new interest deductibility cap at 30% of income is likely to be a negative only for the weakest, most highly indebted companies. For most of the high yield market, the tax changes are neutral to positive.

Treasury yields should rise

Given the projected increase in the deficit, we expect yields on U.S. government bonds to climb slowly and unevenly over the coming years, creating a challenging market environment for Treasuries.

We have a favorable outlook for corporate bonds in general

As Treasury yields rise, corporate spreads should tighten modestly on stronger cash flows and decreased debt issuance levels, made possible by the permanent cut in the corporate tax rate. Cash flows should also increase given the combination of faster and immediate expensing of investments, a lower tax rate on repatriation of overseas capital and a territorial tax system whereby business taxes are assessed only on U.S. income (and not on income earned worldwide).

As a result, we could see a meaningful jump in investment spending. But because the individual tax cuts will be phased out over time, corporate investment may surprise to the downside, as long-term rather than short-term prospects for consumer spending are more likely to influence companies' investment plans.

There are other caveats. Corporations may choose not to spend the excess cash on higher wages or increased capex; instead, they could use it to fund more stock buybacks. In addition, some businesses do not pay the existing corporate tax rate but a considerably lower effective rate. This means the benefits of the cuts will not accrue evenly to all corporations.

Among corporate bonds, investment grade credits should be the chief beneficiaries. For most of the high yield market, the tax changes are neutral to positive, except to the extent that the economy may run too hot, causing the Fed to raise rates more aggressively and risking a recession sooner rather than later. Meanwhile, the weakest, most highly indebted companies are likely to feel the negative impact of the new interest deductibility cap at 30% of income.

Impacts on other fixed income assets will vary

The effects of tax reform will also depend in part on characteristics such as industry, security type, geography and duration, as well as idiosyncratic company-specific factors.

- Industries and companies that see the greatest benefit will include those that generate most of their profits in the U.S., where corporate tax rates have been higher than those of other countries; this would include many U.S. banks. Oil and gas companies will also fare well, as they tend to pay among the highest effective tax rates, while technology and pharmaceutical companies may benefit more from being able to repatriate overseas earnings.
- We could see lower supply in mortgage-backed securities, as provisions for interest deductibility favor pre-existing mortgages, providing a slight technical tailwind. Commercial mortgage-backed securities could benefit because of considerable tax reductions for commercial real estate sponsors and investors. In our view, there will be minimal impact on asset-backed securities.

- It's reasonable to expect lower issuance from U.S. companies in tax-haven locales and for bonds denominated in euros. A sustained strengthening of the dollar resulting from higher U.S. interest rates would be a negative for emerging market debt, but this effect could be countered by firmer short-term U.S. and global growth.
- Under tax reform, both short and long rates will rise initially, but over time the far end of the yield curve will likely decline relative to the short end, causing further flattening. This argues in favor of a shorter duration overall but a longer posture in the 30-year key rate duration.

Municipals (mostly) breathe a sigh of relief

As the tax policy debate wound through the House of Representatives and the Senate, many investors focused on proposed and possible changes to the tax treatment of certain municipal bonds. Early in the process, there were serious concerns that tax law changes would have a drastic (and negative) effect on municipal bond supply. Fortunately, however, municipal bonds were largely spared serious pain. We outline specific provisions below, but the main takeaway is that all tax law changes apply only to newly issued municipal bonds, meaning existing municipal debt will not be affected.

Private activity bonds were spared

This is probably the best news from a municipal bond perspective. The House version of the legislation would have eliminated the tax exemption of private activity bonds (PABs) that are used to fund hospitals, nursing homes, charter schools and university facilities. The final bill retains PABs' tax-exempt status. Given that these bonds make up between 20% and 30% of the total municipal market, this is a welcome development for investors.

New issuance of advance refunding bonds will no longer be tax exempt

We do not expect these tax changes to have a significant impact on infrastructure spending, but issuers of these bonds will likely lose some funding flexibility. The advance refunding structure allowed issuers to refinance higher interest rate debt before the bond's scheduled call date. It was a common way for issuers to reduce interest expense. For investors, we could see some supply and demand effects as new issue supply has been dominated by refunding activity over the last five years. The lack of these types of bonds will reduce new municipal bond supply going forward, which could result in positive market technical conditions for existing bonds.

Changes to state and local tax deductibility could make municipal bonds more attractive

The bill caps the deductibility of state and local taxes (SALT) at $10,000 for those that itemize their taxes. The legislation allows for the $10,000 cap to be comprised of any combination of property taxes and income or sales taxes paid to state and local governments. This provision expires on January 1, 2026 and will revert back to prior law barring any subsequent legislation maintaining the cap on the deductibility of SALT.

While the legislation could increase the combined federal, state and local tax burden on certain individuals, the most direct implications are for state and local governments since future efforts to raise property and income taxes could become more politically challenging. Previously, any additional income and property taxes paid as a result of tax increases were at least partially federally tax deductible for most taxpayers who itemize. Under the new legislation, these taxes are no longer fully deductible.

Because future state and local tax increases will be felt more acutely, there could be more organized resistance to proposed tax increases, particularly in high-tax states. Some state and local credit profiles could come under additional pressure over time if these political challenges delay or prevent needed tax increases for priorities such as pension contributions, capital investment and other governmental needs. The proposed changes to the deductibility of state and local taxes likely increases the demand for tax-exempt municipal bonds, particularly in states with high income and/or property taxes.

Overall, municipal bonds continue to look attractive

Other portions of the bill could have some indirect effects on the municipal market, such as limits on mortgage deductions, excise tax on universities and colleges and the change in demand from banks and insurance companies as municipal bond purchasers due to corporate tax changes. On balance, we expect reduced supply in 2018 because of an onslaught of issuance in late 2017 that occurred before we had clarity on any tax changes, as well as from the elimination of tax-exempt advance refunding bonds going forward. We expect this reduction in supply to be positive for performance of the municipal market.

Near-term boost offers an uncertain future

For more information, please visit **TIAA.org.**

The rules of the road for U.S. tax policy have changed significantly. And the way in which households and corporations respond to those changes will greatly impact the U.S. economy in 2018. A near-term boost to growth—and stronger support for equities and high quality corporate bonds—seems all but assured. But the longer-term impact from incentivizing businesses to invest and operate in the U.S. remains uncertain. The costs of the policy in the form of more debt and higher inflation may lead to higher interest rates and hasten the start of the next recession. Even so, for at least the next year or two, investors should benefit from the Tax Cuts and Jobs Act.

Definitions

S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.
MSCI All Country World ex-U.S. Index captures large and mid cap representation across 22 of 23 developed markets countries (excluding the U.S.) and 23 emerging markets countries.

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