Tuesday January 2, 2018

Investing and The Tax Cuts and Jobs Act

The recently passed, and hotly debated, Tax Cuts and Jobs Act (The "Act") is dominating investor attention today. Love it or loathe it, the Act will almost certainly have a positive near-term impact on growth, profits, confidence, spending and investment, and the prices of stocks and other risk assets.

The Act's material impact on the real economy and profits in the near-term, however, is likely to be fleeting, and its impact on long-term expected returns negligible, because current market pricing substantially reflects the benefits of the Act.

We hold these views for the following reasons:

- Consumer spending comprises nearly 70% of U.S. GDP, and consumer confidence is at its highest level in over 17 years. Historically, when consumer confidence is high, most good news is already priced into markets and the possibility of future disappointment is high.

- Lowering corporate tax rates from 35% to 21% does boost corporate profits, but with less impact than most believe. The effective tax rate for S&P 500 companies stands at 22%. U.S. small cap stocks, however, benefit most with a current effective tax rate of 35%.

- While lower tax rates will materially increase corporate profits in 2018 (Ned Davis Research estimates from 7%to 14%)[1], subsequent annual increases will prove challenging as the tax cuts happen only once.

- We think the impact of repatriated balances will also be disappointing.[2] Most of the balances are held by a few large tech companies with significant existing working capital. As a result, they'll more likely repurchase shares or engage in mergers and acquisitions.

- According to the Congressional Budget Office, the Act will add $1.4 trillion to the U.S. federal debt over the next 10 years.[3] While only an estimate, congressional fiscal hawks (mostly Republicans) will be reluctant to add more debt to pay for needed infrastructure.

- According to the Joint Committee on Taxation, the share of federal taxes paid by income groups does not change. Nonetheless, high income earners will receive bigger dollar cuts. With a higher savings propensity, the impact of these savings will also be muted.

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1 Most of the increase in corporate profits derives from the decrease in statutory tax rates. Corporate profits will also rise modestly by ending full taxation on foreign income; nonetheless, that benefit will be offset by immediate capex expensing, capping interest deductibility, and the removal of special provisions with base broadening.

2 A clear goal of the Act is to lower the cost of capital for corporations, prompting increased investment, and increased productivity and wages.

3 Increased federal borrowing will increase interest rates. Private spending will be decreased incrementally as the marginal attractiveness of investing versus consuming improves.

- The median stock multiple of 25.2x is very high by historic measures and a governor on upside performance. Since President Trump's election, U.S. stock multiples have expanded by 3 points, reflecting optimism the Act would become law, which it now has.

Because the current market has significant momentum, buoyed by investor optimism, we expect investors to drive market prices for risk assets like stocks, real estate, and high yield bonds up until the expectation of higher corporate profits becomes a reality.[4]

Implications for Strategic Portfolio Design

Whenever there are significant changes in the tax code, we rely on Greycourt's proprietary Cassandra model to evaluate the impact of the changes on the after-tax expected returns and risks we use to design strategic portfolios for our clients (based on a 10-year investment horizon).

Our analysis of changes to the tax code shows that most changes in forecasted after-tax returns are not meaningful. For no-income-tax states (e.g., WA, NV, and TX), returns are modestly higher (0 bps to 10 bps). For a very high-income-tax state (e.g., CA), returns are mixed but mostly lower (+8 bps for IG bonds but -15 bps for hedge and real estate).

Implications for Active Manager Strategies

As a practical matter, change invariably presents opportunities for security selection and active management. Summarized below are three examples of changes resulting from the Act that we believe will be exploited by astute investors.

High Yield Credits. The limitations on interest deductibility and future exclusion of depreciation and amortization from the calculation presents a significant challenge to many highly leveraged companies (e.g., CCC-rated companies). Sorting out winners and losers under a variety of economic scenarios will differentiate active managers.

Energy MLPs. In response to IRS rules that blocked mutual funds holding more than 25% in MLPs, many firms formed C-corporations that could hold 100% in MLPs. Unrealized gains, however, created sizeable deferred tax liabilities that are effectively cut in half by the Act's reduction in the corporate tax rate to 21%. Again, the complexities and change present opportunities.

Municipal Bonds. There are five major changes in the Act with significant implications for municipal managers.[5] These changes reduce demand (first two), increase demand (third), and reduce supply (last two). Changes to deductibility will materially affect portfolio construction for high SALT residents.

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4 With nearly one-third of US stock performance post-election explained by changes in the Act, and much of the additional performance attributable to regulatory reductions under the Trump Administration, expectations for growth, profits, and continued performance are surprisingly homogenous and priced for perfection. As the famous economist Hyman Minsky shrewdly observed, and we caution, stability breeds instability.

5 Modest reduction in the top marginal tax-rate for individuals; lower corporate tax rate; elimination of advance refunding; restriction on Private Activity Bonds; and significant reduction in State and Local Tax (SALT) deduction.

Greycourt's Views for Intermediate-Term Returns

Predicting how any single event such as the Act will influence market returns in the near-term is a fool's errand. Having said that, we attempt every quarter to systematically assess a wide range of economic and market factors to develop our views.

Following is a summary of our recent 12- to 18-month views:

U.S. Stocks. As the benefits of the tax cuts are realized in 2018, we expect investors to respond favorably, pushing equity valuations a bit higher than today's lofty levels. Once the initial wave of euphoria subsides, we expect valuations will revert to more normal levels.[6]

U.S. Bonds. With consumer demand rising with stronger earnings and wage growth in 2018, reported inflation will push through the Fed's 2% target. Speculation regarding the Fed's response will push rates up across the entire yield curve. As the temporary nature of the Act-driven earnings bump becomes evident, we expect inflation fears to subside and rates to revert to current low levels.

*U.S. High Yield Bon*ds. As our clients and friends know, we have not liked high yield bonds for some time, because spreads and risk-compensation have been inadequate. We acknowledge that rising corporate earnings and consumer spending support current holders. Nonetheless, we don't find the after-tax risk and reward tradeoff for high yield bonds attractive and continue to avoid them.

Jim Foster
Managing Director
Chief Investment Officer

[6] We define the normal level as 19.5x trailing twelve-month earnings. We expect the reversion to be associated with rising interest rates, increasing inflation, and slower earnings growth after 2018.