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The New Tax Law: Winners and Losers

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act – a bill that was quickly pushed through Congress without the benefit of public hearings or a thorough impact analysis. Over the last several weeks, accountants, attorneys and financial experts have begun parsing through the entire 500+ pages to identify all the new opportunities and obstacles contained in the legislation. While this information continues to be digested by the markets, we can identify a number of winners and losers as a result of various provisions of the new tax law.

Before discussing the implications of this most recent tax reform, let's review how tax reform has historically impacted the economy. There have been six major instances of tax reform since the corporate tax was created in 1909. While the economy has often experienced subsequent growth post-reform, it has been consistently modest. Thus, expectations for explosive economic growth as a direct result of tax reform should be tempered.

Each time tax reform has been signed into law historically, winners and losers have been created as a result. For example, in 1986 sweeping changes to the tax code did away with the tax shelter afforded to real estate investors, wiping out the savings and loan industry in the process. More recently, varying corporate tax rates around the world have created incentives for domestic companies to offshore significant sections of their financial statements. Similarly, as the details were revealed for this most recent tax reform, winners and losers have emerged.

Broad market implications

The reduction of the corporate tax rate from 35% to 21% and the repeal of the alternative minimum tax (AMT) for corporations will likely boost corporate earnings per share by about $10 on average. While this should help to elongate the business cycle and sustain stock prices, it's important to note that much (if not all) of this windfall has already been priced into equity markets.

A $10 EPS increase at current P/E ratios roughly translates into a 180 point gain in the S&P 500®. Since this latest rally began with the S&P at around 2,500, we've already well exceeded the 2,680 mark where tax-related gains would lift us. The benefits of tax reform may already be fully baked into current market prices.

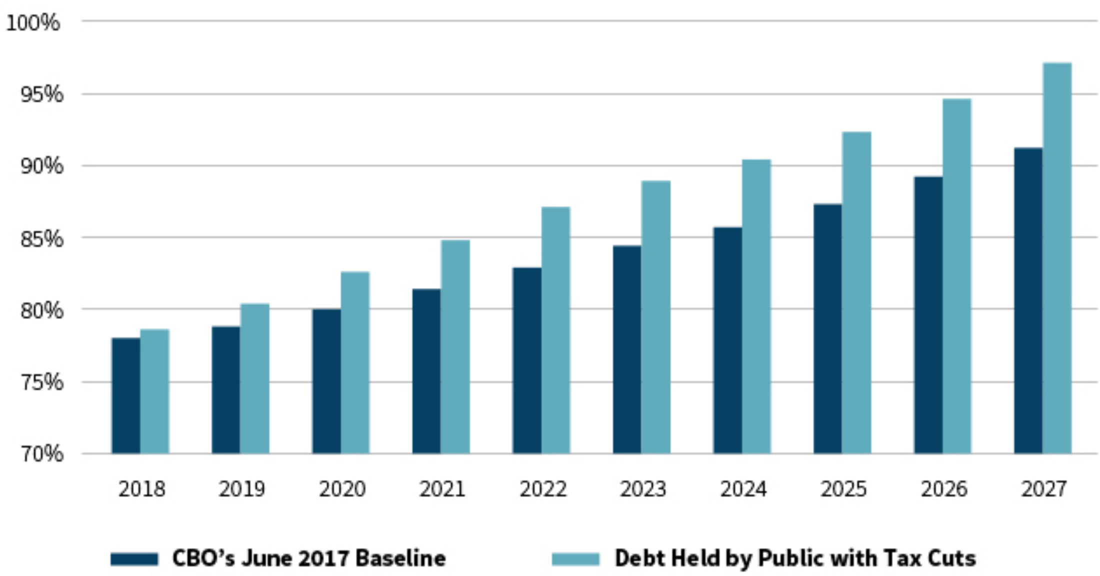
And while the debate heats up over how much of the 2018 anticipated $100 billion in individual tax cuts will actually translate into increased consumer spending, there's no question that it will provide at least some fuel to the year's GDP growth.

This boost in economic growth, however, may also drive unemployment lower and lift wages, making it easier for the Federal Reserve to continue raising rates. Consensus estimates are that we'll see four 25 basis point increases this year, lifting the fed funds rate to 2.5% and the 10-year treasury yield to somewhere around 3%.

Without spending cuts aligned to offset the tax rate reductions, the new law is essentially a debt-financed stimulus that will increase the budget deficit by at least a trillion dollars if not considerably more. In order to fund obligations (e.g., Social Security and Medicare), the Treasury will likely need to markedly increase the money supply which in turn may exert substantial inflationary pressures.

Beyond the near-term effect of tax cuts, we should consider the long-term impact on debt levels. The Congressional Budget Office (CBO) projects that at some point in the next five years, the US will cross the 85% ratio of debt to gross domestic product (Figure 1). The 85% ratio is a significant threshold because empirical studies suggest that at this level, we may begin to observe a meaningful slowdown in economic activity.

Figure 1: Estimated Debt as a Percentage of GDP



Source: Congressional Budget Office, as of November 30, 2017.

Sector implications

The likelihood is strong that by putting more cash into the system these new tax cuts will drive both higher interest rates and increased inflation in 2018. That should bode well for the financial sector in particular, which also stands to gain (along with consumer discretionary) from the tax reforms being skewed in favor of companies with high effective tax rates and earnings that are primarily derived from domestic operations.

Conversely, higher interest rates and inflation are likely to have an adverse impact on utilities, high-quality corporate bonds and REITs which are the most interest-sensitive investments. New limitations on state and local tax (SALT) deductibility along with restrictions on mortgage interest deductions may also act as a drag on the real estate sector (particularly home builders) as well as adversely impacting individuals residing in more expensive blue states. And a new cap on interest deductibility may serve as a headwind for small cap stocks, highly levered companies and high yield bonds.

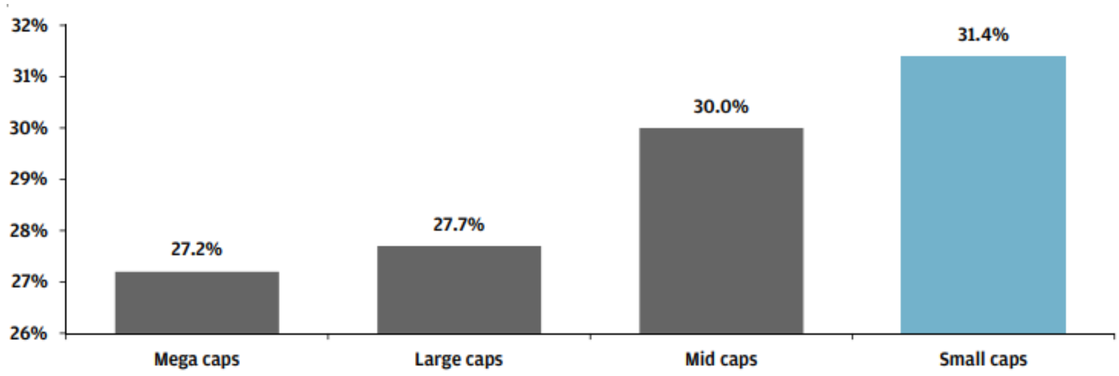
Tax Reform Winners and Losers At-a-Glance

Potential Winners

High Tax Large Cap Companies: Companies with lots of domestic income and low debt should disproportionately benefit from the new tax law.

Small Cap Stocks: Smaller corporations with primarily domestic operations currently face higher effective corporate tax rates. These companies may benefit more from local economic growth. (Figure 2)

Figure 2: Median Corporate Tax By Market Capitalization



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Mega cap stocks are represented by the S&P 100, and are a subset of large cap stocks; Large cap stocks are represented by the S&P 500; Mid cap stocks are represented by the Russell Mid-cap; Small cap stocks are represented by the Russell 2000. Data are as of December 20, 2017.

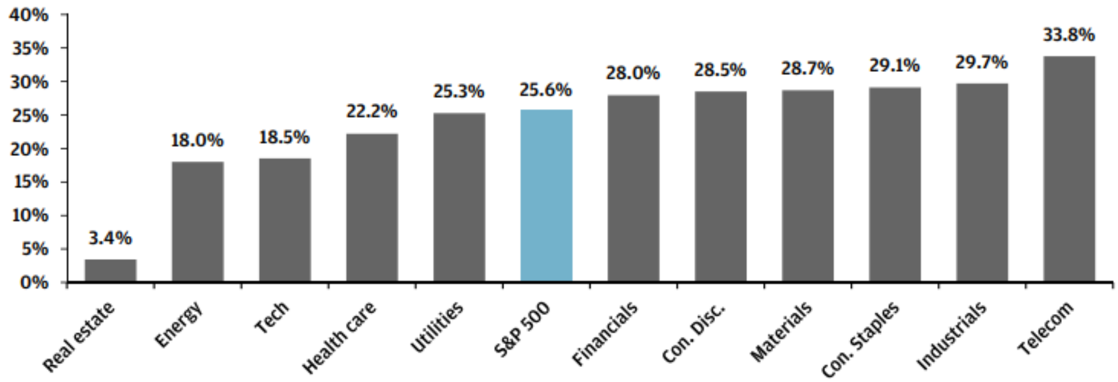
Financials: Banks, with profits that tend to be more US-based, benefit from higher yields, lower taxes, and more financial deregulation.

Industrials: Industrials benefit from lower tax rates and capital goods companies benefit from increased demand due to 100% expensing.

Telecom: Telecoms benefit from lower tax rates and from some significant tax deferred liabilities.

Consumer Sectors: The consumer sector, with profits that tend to be more US-based, benefits from the twin benefits of lower corporate tax rates and the potential for higher consumer spending. (FIgure 3)

Figure 3: S&P 500 Effective Tax Rates by Sector



Source: Standard & Poor's, J.P. Morgan Asset Management. Data are as of December 20, 2017.

Potential Losers

Highly Leveraged Companies: This legislation enacts the first real limit on corporate debt by eliminating the corporate deductibility for interest costs above 30% of EBITDA. This should weigh on more leveraged companies.

U.S. Companies with High Intangible Overseas Income: For decades, US companies sent their intangible income overseas to take advantage of lower tax rates. In order to avoid erosion of the corporate tax base, the new law places a tax on intangible income overseas.

Non-U.S. Multinationals/Inverted Companies: Provisions were added to limit the process of earnings stripping (non-U.S. companies sending their U.S. profits back home for lower tax rates while retaining their U.S. deductions) by imposing a minimum effective tax rate.

What does tax reform mean for you?

While the tax reform package will impact everyone uniquely relative to their personal financial situation, most of us will benefit immediately through tax cuts on assets and income. Though most cuts are temporary, income tax rates for individuals are lowered across all income groups. However, since the deficit is expected to grow by $1T+ over the next 10 years, it's quite possible that interest rates and tax rates may increase in the future more than they would have without tax reform, potentially costing us more over the long-term.

We will continue to keep a close eye on developments that arise with regard to this most recent tax reform and economic conditions in general. Regardless of the winners and losers that result from tax reform, you can work with your SEIA advisor to develop a personalized investment plan and a thoughtfully constructed investment portfolio that takes your personal tax situation into account. From tax qualified investment structures like IRAs to tax sheltered investment vehicles like municipal bonds to proactive tax loss harvesting techniques, your SEIA advisor has a wide variety of planning and investment tools that may be able to meaningfully reduce your tax bill.

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