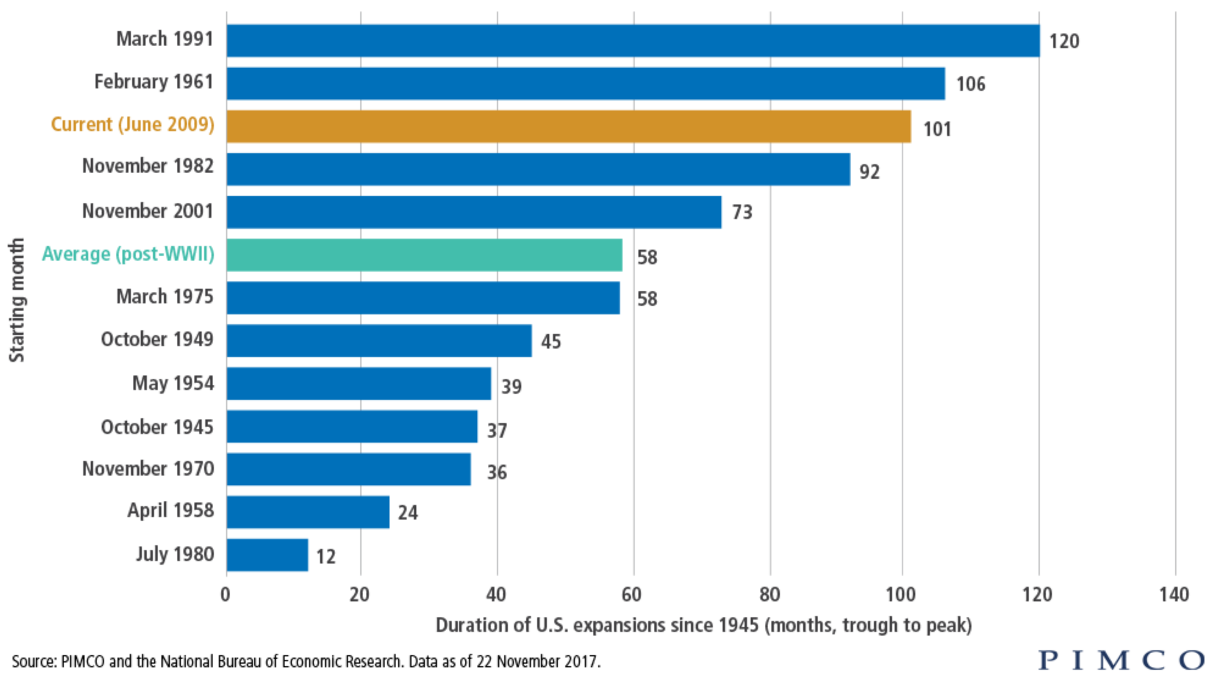
Investment Implications from the New Tax Law

Going into 2018 the global economy and capital markets look as strong as they have in decades. This is the third longest US market expansion recorded since 1945 (Chart 1). Barring some shock, we see little that can change the current direction of the economy especially after the historic U.S corporate tax cuts that may provide the economy an additional tailwind. However, as is well known, equity markets do not go up in a straight line and corrections may accompany any expansion. This business cycle has been fueled by low interest rates and thus the big economic risk that may alter the direction of the economy and tip the capital markets is a policy error by the Federal Reserve while raising rates. Since the new tax reform bill will impact certain asset classes and sectors more than others, the purpose of this paper is to analyze the investment implications arising from the changes in the law.

Chart 1



Impact on Asset Classes:

Bonds: The new bill provides for repatriation of foreign profits at a rate of 15.5 percent for cash and cash-equivalent profits, and 8 percent for reinvested foreign earnings. It is estimated that over half a trillion dollars of earnings will be repatriated over the next year. As much of the offshore money is held in cash or cash equivalents in the form of Treasury securities, liquidating them would cause yields to rise. So, when companies start pulling that money back to the U.S., that presumably would push up yields. This, coupled with the fact that the Federal Reserve will also be a seller of Treasury bonds as they accelerate rate increases, should raise the yields on US bonds as prices drop. Although not all bonds will react similarly, some may be impacted by other provisions.

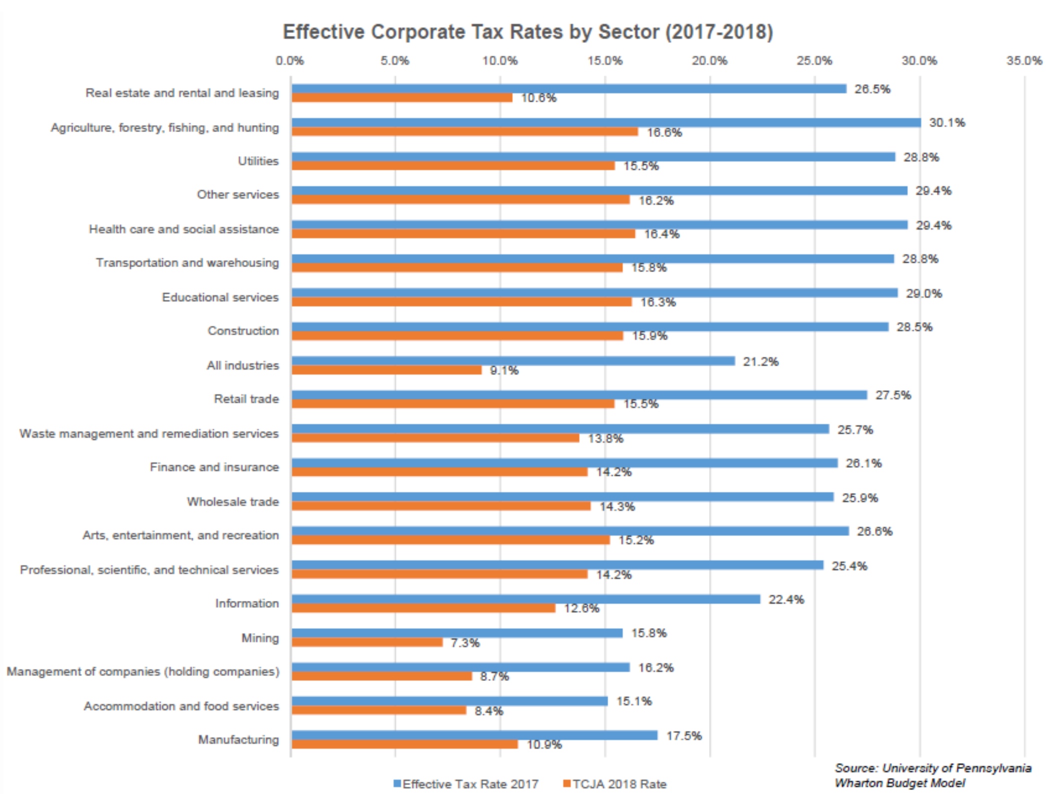
- *Junk (High Yield) bonds:* The new tax plan limits the deductibility of net interest expense to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) for four years, and 30 percent of earnings before interest and taxes (EBIT) thereafter. This should negatively impact CCC or below rated paper as many companies will not be able to deduct interest paid on such debt. However, in the long run, everything remaining the same, this provision may raise price (lower yield) of high quality junk even further and reduce the supply of lower quality junk.
- *Municipal Bonds:* While muni yields remain attractive despite the lower tax rates, the new tax bill has some major implications for muni bonds. Advance-refunding bonds would lose their tax-free status. Advance refunding bonds are sold to refinance an existing debt often to either take advantage of lower rates or to postpone the debt payment in the future. The removal of the exemption will take away the flexibility state and local governments have and lower the overall issuance. The other big issue impacting muni bonds is the restriction on deductibility of state and local taxes ($10,000; this restriction would make tax exempt income from high tax states even more valuable for residents thus putting upward pressure on their price. Consequently, national portfolios will carry less muni-bonds from high tax states due to lower yields. The changes are likely to impact relative yields and will make security selection even more critical to achieving portfolio objectives.

Equities: The most important impact of the tax reform on equities is the reduction in corporate tax rates from 35% to 21%. While it is impossible to forecast the movement of equity markets, all else being equal, Bank of America estimates corporate income should see a boost of 6-8%, the big beneficiary being small and mid-cap companies.

The act also encourages companies to repatriate offshore earnings as we discussed before. Large-cap companies which have significant assets offshore may have to take a onetime charge to repatriate earnings, and some may also invest the cash to take advantage of the lower tax on illiquid assets. Whether repatriation works or not remains to be seen but in any case, we don't think repatriation changes will have a long-term impact on earnings.

Not all sectors would be equal beneficiaries of this act, some industries will benefit more. Economists at the Penn Wharton Budget Model at the University of Pennsylvania have published the following table depicting the beneficiaries (Chart 2). Immediate expensing for spending on short-lived capital equipment is expected to save US companies $32.5bn in 2018, according to Congress's joint committee on taxation. Mining and hotels are likely to be the biggest beneficiaries of immediate expensing.

Chart 2



Another beneficiary will be MLPs and REITs. The Act provides a deduction to individual MLP unitholders generally equal to 20% of the MLP's domestic income and 20% of any recapture income of an MLP unitholder on the sale of an MLP unit. The wage-based limitation on the deduction that applies to other pass-through entities does not apply to MLPs or REITS. The combination of the reduced individual tax rate and the 20% deduction lowers the effective tax rate on income of an MLP to 29.6%. Although we must note, both the reduced 37% tax rate and the 20% deduction sunset after 2025.

In summary, we believe that the tax cut will further help capital markets but impact each sector and industry differently. We recommend active investing as opposed to passive investing for bonds especially in junk and the muni bond space. Among stocks, MLP's look like a good buy given the relative cheap valuation and the positive impact from the tax reform bill. We thank you for your trust and are always available to answer your questions.