MARKET INSIGHTS

from Ziegler Capital Management

Implications of the New Tax Law for Investors

With 2017 having come to a close perhaps the biggest news for investors out of the past 12 months has been the signing into law of a $1.5 trillion tax reform bill. While the bills construction and passage looked dubious after previous legislative failures, the bill was signed into law on December 22, 2017. While the overall merits of the 1,000 page law can be debated, it does enact changes that are likely to spur economic growth both on the personal as well as corporate side of the economy by lowering and simplifying tax rates as well as deductions. We will use this commentary to take a closer look at what the new changes mean for investors by examining its potential impact on equities, the fixed income markets and overall GDP.

As we examine our data to guide our outlook for 2018 it seems clear that the anticipation of some iteration of a tax reform bill was priced into the market. Subtle gyrations in market value around the time of the bills construction and passage capped off a run of record setting highs for the S&P 500 which experienced for the first time, a positive monthly total return for every month in a calendar year in 2017. Although there were unquestionably a series of factors that assisted this run, the hope of tax reform was certainly one of them.

The Economy and Investors:

Although perhaps the biggest surprise to come out of the tax bill was the larger than expected assistance to individuals, the headline that grabbed the most attention was of course the lowering of the corporate tax rate from 35% to 21%. Looking at individuals for a brief moment, when taking into account the estimated $100 billion net tax cut to individuals in 2018 and as the changes to the AMT work themselves out in 2019, the overall benefit to consumers could eclipse $200 billion. That works out to roughly 1.0% of GDP. Proponents of the new law are counting on this increased money flowing throughout the economy to create a positive feedback loop that, when combined with increases in productivity and

WRITTEN BY

Daniel T. Fink
Assistant Vice President,
Marketing and Client Service

ABOUT ZCM MARKET INSIGHTS

A series that provides a glimpse of our internal thought process through current topics effecting our clients and colleagues.

www.zieglercap.com/insights

Ziegler CAPITAL MANAGEMENT, LLC

We are a premier asset management firm comprised of investment teams employing repeatable processes providing tailored investment solutions across the fixed income and equity markets.

www.zieglercap.com

corresponding capital expenditures from businesses, would strengthen and cement themselves as permanent over time.

Helping in encouraging those investments is of course the realigning of the US corporate tax rate to a level more in line with the rest of the developed and industrialized world. The lowering of the rate to 21% could benefit corporations on average around $80 billion per year over the next four years. Assuming this math proves to be accurate the next question is, what will corporations choose to do with their additional income. We have already witnessed a multitude of companies promise to invest back in their personal capital, reflected in either one time bonuses or an increase in starting compensation. While one would assume CFO's would begin to take advantage of the 100% expensing provision on investments in property, plant, and equipment we believe that this process will instead be a gradual one. The path of least resistance and lowest risk would be steering that money towards more financial steps, i.e. stock buybacks and dividend increases. While the percentage of capital expenditures to financial expenditures is unknown, the specific provision encourages investment in hard goods which is a key step in restoring investment as a more essential driver in the business cycle. Many view these expenditures as a solid forward looking economic indicator and continued activity in this area could point to a rotation towards more traditional value orientated stocks as their investment decisions come into greater focus.

SUMMARY OF TAX LAW CHANGES

	Old Law	New Law
Corporate tax rate	35%	21% (permanent)
Corporate tax rate starts	Not applicable	2018
Top pass-through rate	39.6%	20% deduction for certain income until 2025 (with caveats)
Corporate AMT	20% tax to broadly defined alternative income	Repeals
Expensing	50% expensing through 2020	100% expensing through 2023
Interest expense deductibility	No limit	Limits to 30% EBITDA until 2021; 30% EBIT thereafter
Net operating losses	Allows carry backs 2 years; carry forwards up to 20 years	Eliminates carry backs; indefinite carry forwards (with caveats)
Taxation of foreign income	Worldwide (though only taxable when repatriated)	Territorial; 100% exemption
Deemed one-time repatriation tax	Not applicable	15.5%;8% illiquid
Carried interest	1-year holding period (minimum)	3-year holding period (minimum)
Minimum taxes from income	Not applicable	10% tax on high-return income; increase to 12.5% in 2025

Source: LPL Research, Joint Committee on Taxation, Senate Finance Committee, House Ways and Means Committee, PIMCO 12/26/17

GDP and the FED

With 2018 GDP predictions creeping ever higher over the past calendar year, the new tax reform is expected to add fuel to that fire. Estimates range from an increase in the neighborhood 0.25% to 0.50% of additional GDP due to the current law. However, what remains to be seen is what the Federal Reserve (Fed) is expected to do if those projections turn out to be a reality. With an already solid economy expected to get another shot in the arm from the new law, the Fed may increase its number of expected rate increases from three throughout 2018.

Fixed Income

As a result of changes outlined in the new law, we expect the high yield market as well as the muni market to be faced with the most challenges in 2018. As the implications of the new law became clearer towards the end of 2017 we saw an increase in municipality issuance towards the end of last calendar year. While the market for new issuances may be constricted given the new legislative landscape the surge in activity in 2017 allays the fears of a supply crisis somewhat. On the high yield side, changes in interest deductibility could present challenges for highly leveraged corporations used to the previous law's provisions. Currently the amount of interest that can be deducted is now limited to 30% of earnings before interest, taxes, depreciation, and amortization or EBITDA through 2022. Offsetting this will be the changes to corporate income tax as well as the full expensing of capital investment.

Equities

Looking into 2018, the twin tailwinds of the ability to fully expense capital investments and a reduced corporate tax burden should continue to boost profits. Profits grew throughout 2017 having been fueled by an increase in both domestic and global demand. Combined with these tailwinds we see no indication of this phenomenon slowing anytime soon. To understand how significant this could be for the continued bull market we first need to take a look at what's different. The amount of capital freed up by the cut in the corporate tax rate and the flexibility to fully expense capital investments should help extend our current cycle as well as boost EPS by roughly $10 over previous 2018 estimates[1]. Given the run that we have seen when a market is powered almost exclusively by the U.S. consumer we look at these other factors to continue to drive economic expansion and equity markets. Now, 2018 is an all new year with a completely different tax rulebook and it would be foolish to assume that the lack of volatility experienced throughout 2017 will continue unabated into 2018. Market downturns, if not complete corrections, could certainly appear. Such events should not be feared but rather welcomed as an opportunity to deploy reserves and maximize the opportunity that such events provide.

In Summary

Although at times thought of as a legislative impossibility, the new tax law adds another variable for investors to ponder as we open 2018. Whether or not the bill will be an overall negative or positive and work as designed remains to be seen, however certain provisions have certainly provided some investors with added enthusiasm. How the dynamic between the new tax law correlates with Fed tightening this year is an unknown and could bring about increased volatility as rates begin to rise again. As with most things in life there will be winners and losers as market participants adapt to the new rules. We will continue to monitor those areas that we consider to be opportunities and remain diligent in our active approach.

In a recent conversation with Ziegler Capital Management Senior Equity Portfolio Manager Christian Greiner, he offered these insights as to how we think the proposed changes will affect specific sectors.

Winners:

Companies with primarily US based operations and customers:

- They will benefit the most from the lower tax rate. Think brick and mortar retailers, smaller industrial names and smaller cap stocks in general. Less appreciated could be the positive effects on materials and industrial service sector earnings.

Stocks leveraged to capital spending:

- The bill will allow business investing in the US to write off equipment purchases at a much quicker rate. Those leveraged to the industry base and telecom suppliers are seen as more immediate winners.

Financial Stocks:

- Banks are going to benefit from the drop in the tax rate, and provisions about capital expenditures. We also see some positive action in the life insurers due to an anticipated steepening of the yield curve that comes with increased economic activities.
    - Keep an eye on the yield curve as the flattening has been concerning, especially when combined with the 3 projected Fed rate hikes in 2018.

Auto Stocks:

- They will benefit from the lower tax rate and ability to repatriate foreign earnings. Auto dealers could also benefit, as they traditionally pay a higher income tax rate.

Pharma Stocks:

- Another group that will really benefit from the repatriation of overseas earnings. Will the bill cause a consolidation in this space? We’ve had a pretty muted year in terms of pharma M&A, and that could change in 2018.

LOSERS

Stocks with lower tax rates:

- With a focus on the tech sector and healthcare. There are also higher than expected repatriation rates for foreign earnings that could hurt these companies.

REITS:

- REITS have some of the lowest effective tax rates.

Companies with high leverage:

- The reduced interest deductibility hits highly leveraged/speculative debt companies the hardest.

Health Care Service Companies:

- The repeal of the ACA individual mandate is going to be a net negative for the hospitals and insurers. Some of the impact should be offset by the lower tax rate though.

Certain Banks:

- The reduction in interest-expense deductions could cause some companies to borrow less. Banks with higher exposure to real estate and commercial loans could be sensitive to this (here we go again?).

Unprofitable Energy Companies:

- There are a good number of energy firms still operating at a net operating loss, leaving them unable to currently take advantage of this new tax environment.

References

1. US Tax Reform JPM

ZIEGLER CAPITAL MANAGEMENT, LLC
70 West Madison Street | Suite 2400 | Chicago, Illinois | 60602 | www.zieglercap.com

18-02001
Printed Internally