Market Bulletin

December 20, 2017

The investment implications of tax reform

In brief

- The 2017 Tax Cuts and Jobs Act should soon be signed into law. While much of the motivation for U.S. tax reform has come from a desire to cut corporate taxes, most of the net benefits will accrue to individual taxpayers.
- For individuals, while upper-income households should see the biggest benefits, a broad reduction in taxation should spur stronger consumer spending growth, particularly in 2018.
- For corporations, a lower U.S. corporate tax rate along with 100% expensing of capital spending should boost investment, although with the repatriation of overseas earnings mostly flowing to shareholders, the total impact on capital spending will be limited.
- The combined impact of increased consumer and business spending could boost real GDP growth to 3%+ in 2018 with even lower unemployment, putting upward pressure on wages and inflation and leading the Federal Reserve to raise rates faster than expected. This, alongside rising wage costs, could limit gains in U.S. corporate operating earnings.
- Tax reform's long-term impact on productivity growth should be modest and, given the impact of a retiring baby-boom generation in limiting labor force growth, real GDP growth should slow to 2% in 2019 and beyond, leading to higher fiscal deficits.
- In the near term, a faster-growing U.S. economy and a steady increase in U.S. interest rates suggest a continued tilt towards stocks over bonds. More specifically, small companies should benefit more than large, as should high-tax sectors like banks, telecoms and consumer discretionary stocks. Municipal bonds in high-tax states should also see a small positive impact.

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Introduction

In the next few days, we expect the Tax Cut and Jobs Act of 2017 to be signed into law. This legislation has important implications for major corporations, small businesses and individual taxpayers. It will impact both the U.S. economy and the federal budget and, as a consequence, Federal Reserve interest rate policy. In addition, the provisions of this act have significant implications for the path of after-tax corporate earnings and for investment strategy for both individual and institutional investors.

In the following pages, we outline the main provisions of the act along with their cost over the next decade. We then discuss how the new law could impact the behavior of consumers, businesses and investors. From this, we turn to the big picture, looking at how this law could affect U.S. economic growth, both in the short run and the long run, and also how it could impact the federal finances over the next decade. Relative to current perceptions, we believe that the law represents a stronger stimulus to consumer spending and aggregate demand but a smaller positive for productivity and corporate profits. As such, it raises the risk of over-heating in the economy and the stock market.

It should be emphasized that the new law runs to over 1,000 pages. By necessity, we can only look at its impacts with broad brush strokes, and nothing in the pages that follow should be considered to be tax advice, investment advice or political opinion.

The main provisions and their cost

Exhibit 1 breaks down the changes proposed by the Tax Cut and Jobs Act of 2017. A line-by-line analysis of the cost of these provisions can be found on the website of the Joint Committee on Taxation (JCT)[1]. In broad terms, before accounting for either the interest costs on increased debt incurred or the dynamic effects on revenues and spending caused by the impact of the act on the economy, the total cost of the act over 10 years is estimated to be $1.456 trillion.

This is comprised of a net tax cut for individuals of $1.126 trillion, or 77% of the total, and a net tax cut for corporations of $329 billion. It should be noted that the individual number includes $1.441 trillion in gross tax cuts offset by $314 billion in reduced government spending on health care subsidies triggered by the repeal of the Affordable Care Act individual mandate. On the corporate side, $654 billion in gross tax cuts is offset by $324 billion in extra government revenue, mainly due to a one-time tax on the accumulated overseas earnings of U.S. corporations.

It should also be noted that the tax cuts are heavily front loaded, with 62% of the benefits occurring in the first four years. This is partly because of the expiration of the individual tax cuts in December of 2025. As a practical matter, this expiration was added to adhere to Senate rules, with a strong expectation that these tax cuts will be extended by a future Congress.

Tax reform has broad implications for consumer and business behavior

EXHIBIT 1: PROPOSED CHANGES BY THE TAX CUT AND JOBS ACT

Individual	Corporate
Rates and brackets	
Maintains seven tax brackets, but with lower rates and higher thresholds. The top rate is cut from 39.6% to 37%	Cuts corporate income tax rate from 35% to 21%
Substantially reduces scope of personal alternative minimum tax	Repeals alternative minimum tax
Adopts the use of slower-growing chain CPI in adjusting brackets going forward	
Deductions and exemptions	
Nearly doubles standard deduction while eliminating personal exemption	Exempts U.S. corporates from future U.S. taxation on overseas earnings
Doubles child tax credit to $2,000	Applies repatriation tax to accumulated overseas earnings of U.S. corporations
Doubles exemption on estate tax to $22.4 million for a married couple	Allows for 100% expensing of investment spending
Expands the use of 529 Plans to include up to $10,000 per year in K-12 educational expenses	Provides a 20% deduction on personal income tax for pass-through income of small businesses
Repeals the Affordable Care Act requirement that Americans have health insurance	
Restricts deductibility of mortgage interest and state and local taxes	

Source: U.S. Congress, J.P. Morgan Asset Management. Data are as of December 20, 2017.

Implications for consumer and business behavior

The tax act will increase after-tax income for most American households either directly, through lower personal taxes, or indirectly, through the impact of higher dividends and stock prices resulting from the cut in corporate taxation. But for investors, a more important question revolves around how consumers and businesses will react to the tax law changes.

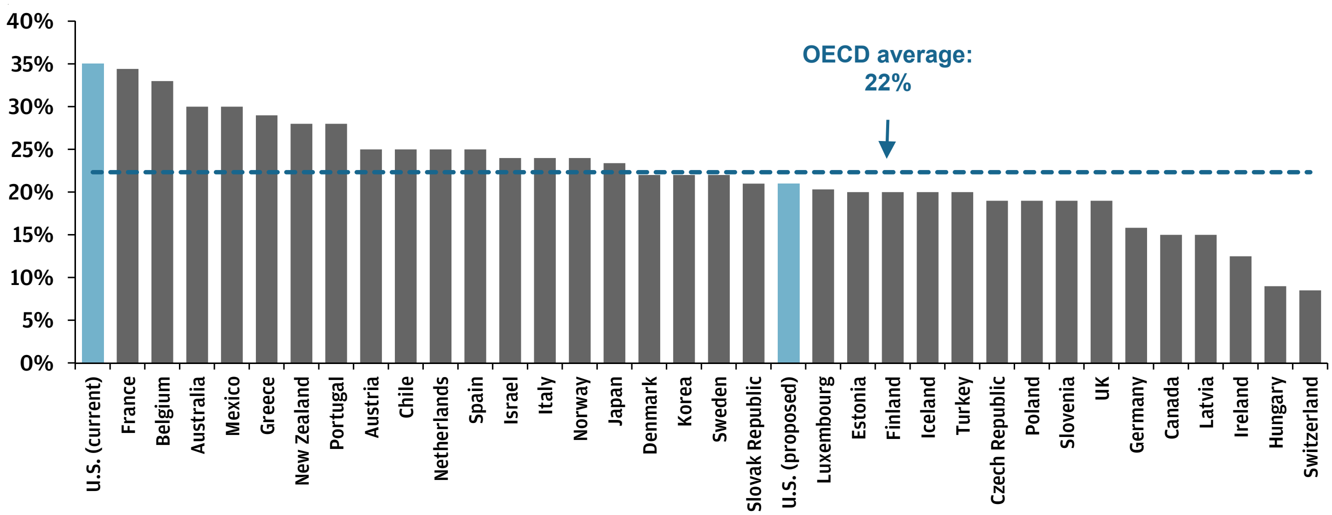
On the individual side, tax cuts net out to about $100 billion in calendar year 2018 and $200 billion in calendar year 2019[2]. The bigger cut in 2019 is largely due to lower annual taxes due in April 2019 because of the reduced scope of the alternative minimum tax. One key question is how this will impact consumer spending, particularly given that many of the benefits will be received by higher income households who have a lower marginal propensity to consume. However, distributional analysis by the JCT[3] suggests roughly even percentage declines in tax liability (admittedly ignoring the more regressive changes in estate tax and Affordable Care Act provisions). Given this, it seems reasonable to assume that 60% of the tax cut flows through directly to higher consumer spending in 2018 and 50% in 2019. In an economy of $20 trillion, these gains could add 0.3% to real GDP growth in 2018, and a further 0.2% in 2019.

These impacts could, of course, be increased by the multiplier impact, as more spending could lead to higher employment and wages. They could also be trimmed if they lead to higher imports, or push the Federal Reserve to tighten more aggressively. Crucially, however, these impacts should not result in a permanent increase in the pace of consumer spending *growth*. Without stronger productivity gains, a surge in consumption growth would necessarily be temporary.

This brings us to the question of business behavior. First, as shown in **Exhibit 2**, cutting the corporate tax rate from 35% to 21% will take the U.S. from having the highest corporate tax rates in the OECD to something close to the global average. A lower corporate tax rate should boost investment spending by improving the internal rate of return on investments made today, compounded by the new ability to completely expense capital spending. But spending may not be boosted by as much as some expect: the U.S. economic expansion is old and long-term growth prospects are subdued. In addition, a lack of skilled labor in many areas should make some businesses reluctant to be too bold in their plans.

The proposed corporate tax cut would put the U.S. more in line with average

EXHIBIT 2: 2017 CORPORATE INCOME TAX RATES BY OECD COUNTRY



Source: U.S. Congress, OECD, J.P. Morgan Asset Management. Central government taxes only. Data are as of December 20, 2017.

Even more doubt could be attached to the impact of "deemed repatriation." Under the new law, companies will have to pay a tax on their accumulated foreign earnings but, having done so, will be free to repatriate this money without further taxation. Many companies may well do this. However, the lion's share of this money will likely go to special dividends, M&A and stock buybacks. Crucially, those companies that have been accumulating cash overseas would have had little difficulty borrowing for worthwhile investment projects in recent years; easier access to a pot of internal funds is thus unlikely to boost their capital spending in a significant way.

The net benefit to corporations of corporate tax cuts should be roughly $80 billion per year over the next few calendar years. One simple assumption might be that companies spend roughly $40 billion of this on capital spending and their workforce and return the other $40 billion to shareholders who, in turn spend half of their windfall, providing, between investment and consumption, another $60 billion of fiscal stimulus and adding 0.3% to GDP in 2018 although nothing further in 2019 and beyond. It must be noted that these assumptions are even rougher than on the consumer side, given the difficulty in predicting corporate behavior in the face of multiple changes to the tax and investment environment. If anything, however, it may be that the fiscal impacts of lower corporate taxation are a bit stronger in 2018 and a bit weaker thereafter because of the potential front-loading effects of expensing and repatriating foreign earnings on corporate behavior.

Short-term impacts on growth, unemployment and wages…

Does this mean that companies won't, in fact, share their profit windfall with workers as some have alleged? The answer is complicated. Clearly businesses will try to maximize profits, normally achieved by charging customers as much as possible and paying employees as little as possible. This won't change. However, the timing of the tax cut does suggest that workers could benefit more than would normally be the case. To see this, we have to look at the macro-economic impacts of the tax cut.

The key point to recognize is that, even without a tax cut, the American economy was heading into 2018 at full employment and with significant momentum:

- Consumer spending has continued to grow solidly in recent years, reflecting moderate gains in jobs and wages, strong increases in wealth and low interest rates.
- A weaker dollar and stable energy prices have helped investment spending to rebound after weakness through most of the expansion.
- Exports have shown some improvement, as the dollar has begun to retreat, and should benefit from very strong global growth entering into 2018.
- Government spending, while flat in 2017, could have been expected to rise a little in 2018 due, in part, to higher defense spending.

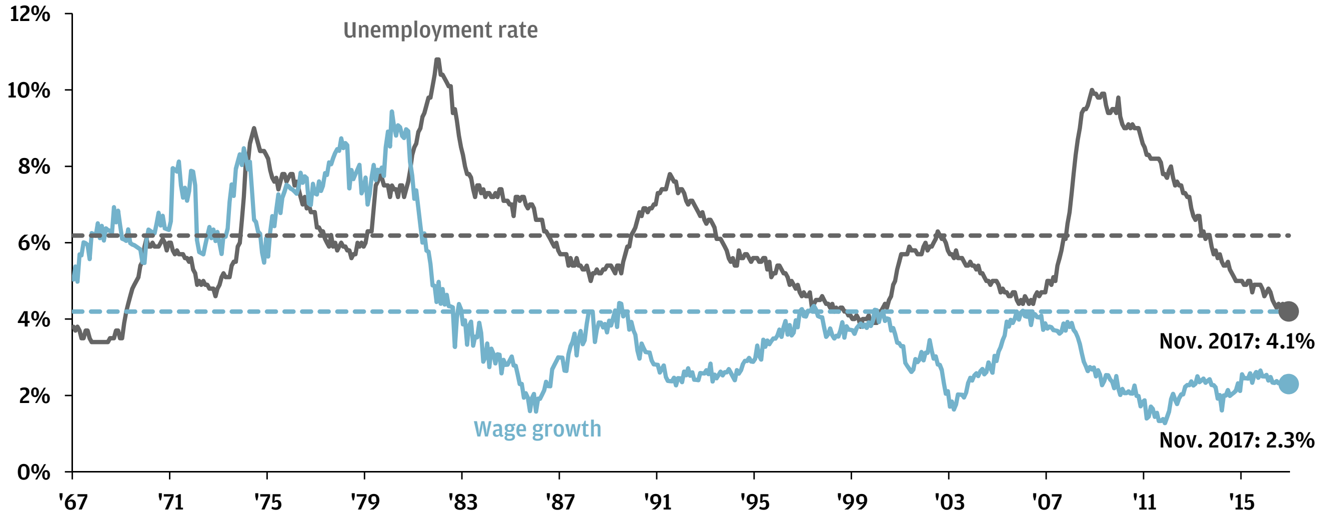
All of this, in the ninth year of economic expansion, had pushed the unemployment rate down to 4.1% in November, its lowest level in almost 17 years, as shown in **Exhibit 3**. With all the usual caveats about economic forecasting we believe that, in the absence of the tax cut, the U.S. economy would have grown by 2.7% in 2018 and 2.2% in 2019, pushing the unemployment rate down to a 48-year low of 3.6% by the fourth quarter of next year.

Even with this, however, we would have expected only a moderate increase in wage gains, in line with the firmly-established trend of this expansion, with the growth in average hourly earnings for production workers accelerating from 2.2% year-over-year in the fourth quarter of this year to 2.8% by the fourth quarter of next year.

If the tax cut does have the impact of boosting economic growth by a further 0.6% in 2018, the unemployment rate could be below 3.4% by the end of next year – the lowest rate seen in the U.S. since October 1953. In this scenario, wage growth would likely finally top 3.0% year-over-year.

The unemployment rate is low, and with tax cuts, could go lower

EXHIBIT 3: CIVILIAN UNEMPLOYMENT RATE AND YEAR-OVER-YEAR WAGE GROWTH FOR PRIVATE PRODUCTION AND NON-SUPERVISORY WORKERS
SEASONALLY ADJUSTED, PERCENT



Source: BLS, FactSet, J.P. Morgan Asset Management. Data are as of December 20, 2017.

...and on interest rates and earnings

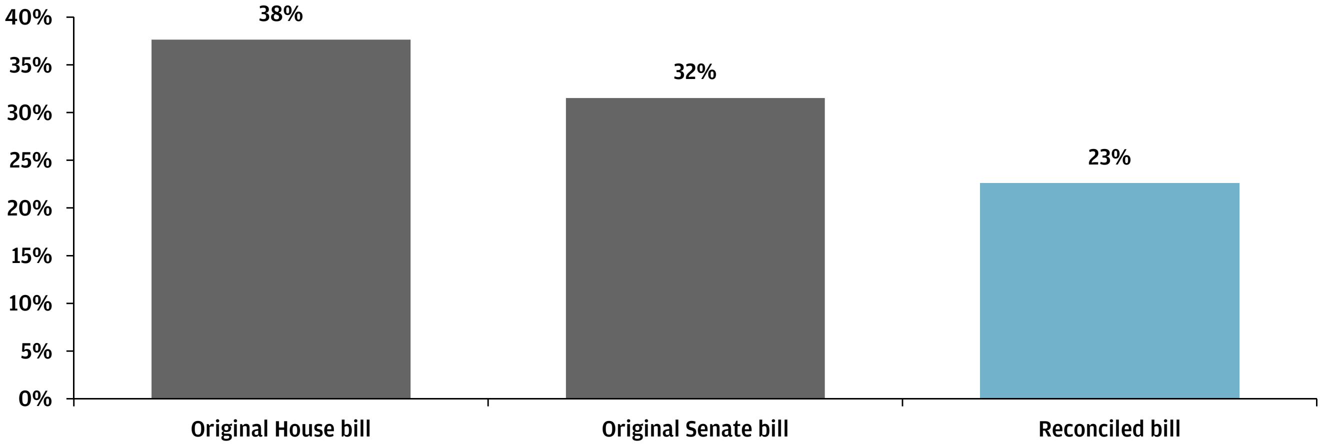
At its last meeting of the year, the Federal Reserve released new forecasts for economic activity and short-term interest rates over the next few years. For the fourth quarter of 2018, it now expects an unemployment rate of 3.9%, year-over-year real economic growth of 2.5% and year-over-year consumption deflator inflation of 1.9%. In her last press conference as Fed Chair, Janet Yellen noted that most members of the FOMC had factored in the potential impact of tax reform in making their projections. However, their forecasts suggest that they may not have fully done so, and barring any negative shocks to the economy, it is likely unemployment will fall faster, and growth and inflation will rise faster, than the Fed expects in 2018.

In this scenario, we expect the Fed to continue with balance sheet normalization along the path it has already laid out. It may be more aggressive in raising the federal funds rate than it projects, although with new, perhaps cautious leadership from Jay Powell, this may only amount to four rate hikes rather than three, leaving the federal funds rate in a range of 2.25%-2.50% by the end of 2018. Still, with this rise in short rates, stronger-than-expected domestic growth and inflation, a booming overseas economy, a fast-rising federal budget deficit, tapering of central bank bond purchases overseas and growing bond sales from the Fed, it seems reasonable to expect that most of the increase in short rates will feed through to long-term rates, taking the 10-year Treasury yield from its current 2.40% to above 3.00% by the end of 2018.

Corporate tax cuts will, of course, help grow after-tax profits. However, it is important to keep the extent of the benefit in perspective. In the original House bill, which passed the House of Representatives on November 16th, the net savings to businesses subject to corporate taxation was $561 billion over 10 years. However, concessions to get the bill through Congress, including those on state and local deductions and the child tax credit, were paid for through a higher one-time tax on repatriated earnings and a 21%, rather than 20%, corporate tax rate. This left net savings at just $329 billion, or an average of $33 billion per year. The result is that, as shown in **Exhibit 4**, corporations will receive less than a quarter of the tax cuts through 2027.

Tax cuts for corporations have fallen during the legislative process

EXHIBIT 4: SHARE OF TAX CUTS RECEIVED BY CORPORATIONS



Source: Congressional Budget Office, J.P. Morgan Asset Management. Net savings of corporations is defined as reduction in corporate income tax rate, plus taxes paid through repatriation. Data are as of December 20, 2017.

Of course, $33 billion is a nice number, but it needs to be taken in context: In 2018, if the tax act had not been passed, we expected that the adjusted after-tax profits of all American corporations would be $1.82 trillion, up 8.2% year-over-year. $33 billion would add less than 2% to this total. Of course, the expected tax benefit to corporations is, like individual tax cuts, front loaded, so the increase in corporate profits from the tax act should be more than 2% in 2018 once all the accounting smoke has cleared. In addition, the lift to S&P 500 operating earnings *per share* will likely be further boosted by the widespread use of repatriated profits to buy back shares.

However, the tailwind of share buybacks will fade over time and may be replaced by the headwinds of higher wages and interest costs. In addition, there is no guarantee that future governments won't try to raise corporate taxes to deal with rising deficits. In short, while every company and sector will be impacted differently, investors should think carefully about how to value what should in the end provide only a modest long-term boost to after-tax profits.

The long-term impacts of tax reform

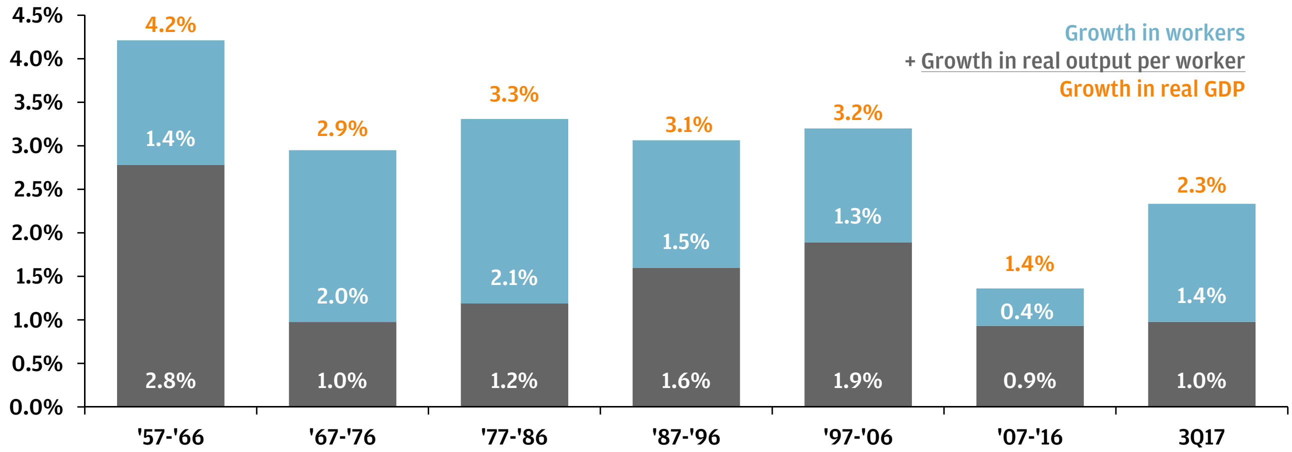
The long-term growth potential of the U.S. economy could be impacted by the act, to the extent that strong economic growth boosts labor supply, and enhances productivity growth either due to stronger investment spending or because of the impact that tight labor markets have on the efficiency with which labor is employed.

On the first issue, there may be some small increase in the labor force caused by higher wages and better worker confidence. However, this should not be overstated. Recent data show a low level of so-called "discouraged workers" as well as very positive perceptions of labor market conditions in the Conference Board's consumer confidence survey. In the year ended in the third quarter, the U.S. labor force grew by 0.7% despite a fractional decline in the population aged 20-64; this, together with a 0.6% fall in unemployment, contributed more than half of the 2.3% year-over-year gain in real GDP, as shown in **Exhibit 5**. It is unlikely that labor force can grow any faster than this, barring immigration reform to increase the number of immigrants, limiting the long-run GDP contribution from increased employment to well under 1%, once the unemployment rate stops falling.

Growth in employment contributed substantially to 3Q 2017 GDP growth

EXHIBIT 5: DRIVERS OF GDP GROWTH

AVERAGE YEAR-OVER-YEAR PERCENT CHANGE



Source: BLS, BEA, FactSet, J.P. Morgan Asset Management. 2017 figure is an estimate based on annualized data through September 30, 2017. Data are as of December 20, 2017.

On the productivity side, the single most important driving factor is the capital/labor ratio – if you give workers more and better tools, they can be more productive. Over the past five years, the output per worker of the U.S. economy has risen by just 0.9% per year. In theory, if the tax act increased nominal business fixed investment spending by 10% and held it at a 10% higher path, the business capital stock could rise 1% faster per year, which would boost the growth in output per worker by 0.5% per year. However, this 10% increase would amount to $250 billion per year, and it is unlikely that even a more investment-friendly configuration of the tax law could spur such an increase. Productivity may appear to surge in 2018 as unemployment falls in a fast-growing economy. However, in 2019 and beyond, the supply side of the U.S. economy strongly suggests a return to 2% growth at best.

The implications of the act for the dollar are somewhat ambiguous. A stronger U.S. economy and higher interest rates in the short run would be dollar positive and accounting changes by corporations may reduce the reported trade deficit in the short run[4]. However, the tax act, by boosting domestic demand without a commensurate increase in domestic supply, will tend to increase the real trade deficit in the long run. In addition, a large chunk of the extra debt incurred to finance tax cuts will be borrowed from abroad and servicing this extra debt in the long run should be dollar negative. Overall, the tax act does not change our view of a long-term decline in the U.S. dollar.

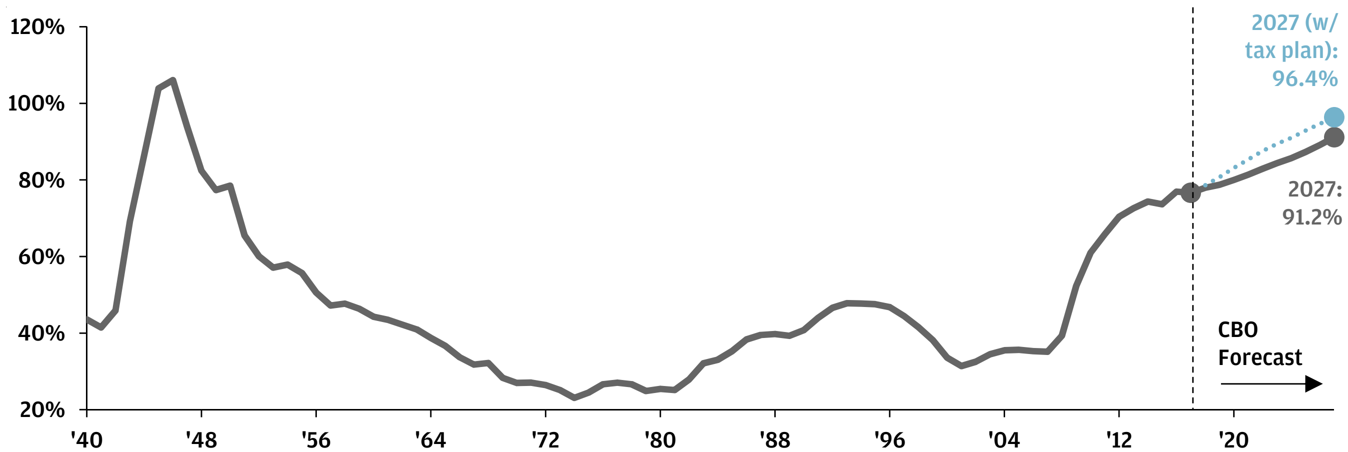
Finally, there is the issue of the long-term impact of the act on the federal budget. In fiscal 2017, which ended on September 30th, the Federal Government ran a deficit of $666 billion, with debt in the hands of the public of $14.7 trillion, 3.4% and 76.5% of GDP, respectively. Under current law, the Congressional Budget Office (CBO) estimates that, by 2027, the debt in the hands of the public would rise to 91.2% of GDP.

Exact analysis of the impacts of the Tax Act on economic growth, inflation and interest rates, all of which would have feedback impacts on federal finances, is difficult. However, using an analysis done by the Joint Committee on Taxation on the Senate version of the bill and including CBO estimates of the net interest costs of the House version suggests that economic growth triggered by the Act could trim its impact on the Federal Debt by about a quarter.

Even with this, however, the debt in the hands of the public would rise by a further $1.25 trillion by 2027, leaving the debt at 94.4% of GDP; excluding the impact of dynamic scoring and interest costs, as shown in **Exhibit 6**, the debt would rise to 96.4% of GDP. It is also worth noting that the JCT estimates, while complicated, predict a less than 0.2% increase in the annual growth rate of nominal GDP from the act. This is a reasonable estimate, given the stronger impacts of the act on consumption than investment, particularly given an economy starting at full employment. It also serves as further confirmation that the act is unlikely to increase the long-term growth rate of the U.S. economy to anything close to 3%.

Federal debt would be pushed up by tax cuts

EXHIBIT 6: NET DEBT HELD BY THE PUBLIC, % OF GDP
% OF GDP, 1940-2027, 2017 CBO BASELINE, END OF FISCAL YEAR



Source: Congressional Budget Office, Joint Committee on Taxation, J.P. Morgan Asset Management. Projection does not include the impact of dynamic scoring or interest costs. Data are as of December 20, 2017.

Conclusion

Much has been written and will be written about the winners and losers of the Tax Act of 2017.

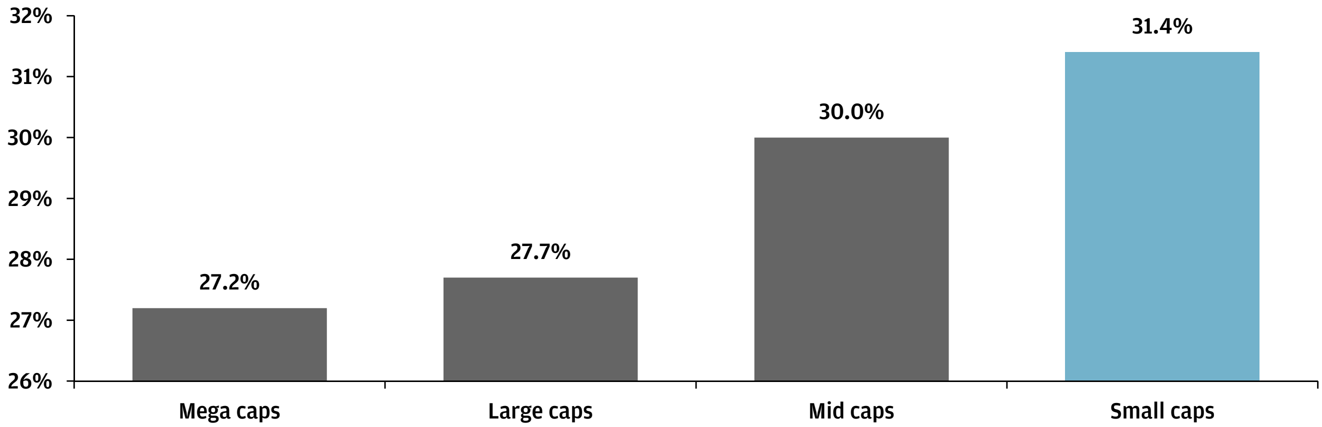
From a big picture perspective, stronger growth should favor stocks over bonds. At a more detailed level, smaller corporations with primarily domestic operations currently face higher effective corporate tax rates and should benefit most from the reduction in the rate, as shown in **Exhibit 7**. Similarly, there is a wide dispersion among the tax rates faced by sectors, as is shown in **Exhibit 8**, with the highest taxed having the most potential to gain.

On the fixed income side, municipal bonds in high-tax states may benefit although some high yield bonds could be threatened by limits on interest deductibility. 529 plans could also look more attractive given a new provision for their use in K-12 private education. The building industry may be negatively impacted by reductions to deductions for state and local taxes and mortgage interest. The health care sector could be a very mixed bag, with highly-taxed pharmaceutical companies benefiting but hospitals and insurance companies being negatively impacted by the end of the individual Affordable Care Act mandate.

However, returning to the big picture, while the tax act is a positive for equity markets, investors should curb their enthusiasm. Compromises to get the bill over the finish line have chipped away at the net tax cut on earnings while the macro-economic consequences of a strong fiscal stimulus package in the ninth year of economic expansion could be problematic in terms of interest and wage costs.

Small caps could benefit more from a lower corporate tax rate

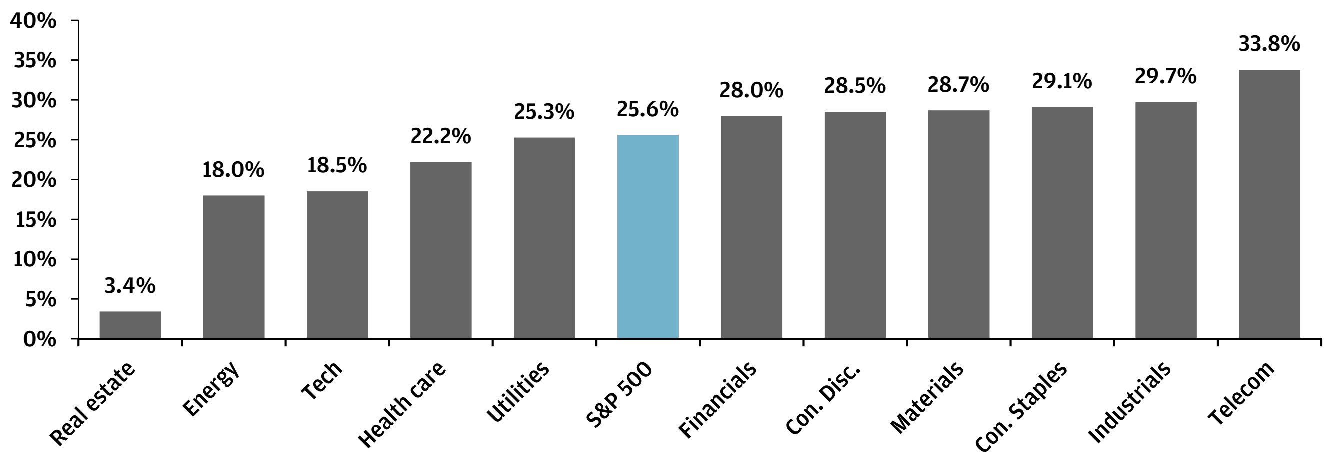
EXHIBIT 7: MEDIAN CORPORATE TAX RATE BY MARKET CAPITALIZATION



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.

Some sectors will benefit more than others from tax reform

EXHIBIT 8: S&P 500 EFFECTIVE TAX RATES BY SECTOR



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

Ultimately, the most important advice to investors is to try to avoid politics and be realistic in their assessment of the Tax Cuts and Jobs Act of 2017 and the economic backdrop of 2018. The former, while containing some welcome reforms, benefits corporations less than Democrats will admit. The latter is in far less need of fiscal stimulus than Republicans believe. In combination, these two misapprehensions may cause many to miss the key implications of tax reform – the potential for a sudden warmup in growth, inflation and interest rates. For long term investors, this is a time to take advantage of the details of tax reform while keeping a cool head about its long-term potential to boost the value of their portfolios.

References

[1] Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act", Joint Committee on Taxation, December 18, 2017

[2] For simplicity, the economic analysis uses calendar rather than fiscal years. This should not distort the calculations as the jump in tax benefits in fiscal 2019 should occur in April of 2019 with lower alternative minimum tax rates and April 2019 is in both fiscal and calendar 2019.

[3] Distributional of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act", Joint Committee on Taxation, December 18, 2017

[4] See "Tax Plan's Hidden Impact: Narrower Trade Gap", Wall Street Journal, December 19, 2017

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