MULTI-ASSET

The Market Implications of US Tax Reform a Bit Unclear

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Efforts to overhaul the US tax code have been a long time in coming (more than three decades), but this year it finally came to fruition. Congressional approval of sweeping tax reform will impact individuals, businesses—and the entire economy. Ed Perks, chief investment officer, Franklin Templeton Multi-Asset Solutions, offers his perspective of the likely economic and market implications.

Broadly speaking, the market appears to have been pricing in the passage of the tax reform bill, thus we don't expect a major reaction as President Trump signs it into law. Some market observers have expressed optimism that US tax reform will prove bullish for stocks—and the economy overall—but the reality is that there will be some winners and losers and we don't ultimately know what the magnitude of the impact will be. We would point to some areas that stand out to us that could have broad market and economic impacts.

Corporate Income Tax Rates

In the reconciled version of the tax reform bill, corporate income tax rates were reduced to 21% from 35%, which wasn't as low as in prior versions of the legislation but is still quite significant. It seems obvious that lower US corporate income tax rates would lead to higher net after-tax income for US companies, which would in turn boost the S&P 500 and other major market indexes. However, given the significant differences between companies' current effective tax rates, the after-tax net-profit impacts of the tax bill will in reality vary considerably from company to company.

A reduced tax rate on repatriated foreign earnings and mandatory back payment on those past earnings will likely lead to a larger quantity of foreign cash coming home to the United States. That repatriation of cash could lead to possible increases in share buybacks, dividends and US domestic capital expenditure (capex). Capex could also get an additional boost from accelerated depreciation.

Many observers are also optimistic that tax reform will be the key to boosting US economic growth. Overall, we believe the tax legislation could stimulate higher US gross domestic product (GDP) growth, but we would have to make some positive assumptions. The Goldilocks scenario is where the combination of lower corporate tax rates, more repatriated foreign earnings, and accelerated depreciation all lead to higher US domestic capital spending, which in turn contributes to a faster pace of economic growth going forward.

That said, the factors influencing economic growth are complex, and taxes are only one aspect.

The Deficit Downside

One thing we are more certain of is that the new tax legislation will add to the size of the US federal deficit, with some estimates putting the amount added to the deficit upwards of $1 trillion (via reduced federal tax revenues) over the next decade. Though the actual impact of a larger federal deficit from tax reform will depend in part on how much incremental new US GDP growth, income growth and federal tax revenue growth it stimulates within the US economy, we believe the likely outcome will be an increase in long-term US interest rates.

Prospects for a growing deficit coincide with the US Fed's shift to unwind its balance sheet while several major buyers of Treasuries (e.g., foreign governments, Asian central banks and oil-producing nations) have been scaling back their purchases. With more debt for global markets to absorb, one has to ask if current yield levels are high enough to entice buyers. Our expectation is that yields will have to migrate higher in order to find a supply/demand balance.

The likelihood of tax reform stimulus on continued economic expansion eventually contributing to an inflationary environment also supports our expectation of rising rates. We agree with the views of our Templeton Global Macro colleagues that multiple factors, even aside from tax policy, have created conditions for rising inflation over the next couple of years. As the Fed unwinds its balance sheet from unprecedented levels, any market uncertainties could have an outsized impact on bond valuations, in our view. We think investors have reason to be cautious about return potential in long-duration Treasury securities.

What This Means to Us

In this environment of synchronized global economic growth, modest inflation, and supportive liquidity conditions, we favor risk assets; generally this translates into a preference for equities over fixed income within our multi-asset strategies. Within equities, we prefer non-US exposures, including Japan and emerging markets; within fixed income, our bias is toward short-duration exposure over longer-duration exposure.[1] Given our assessment that the impact of these tax-policy changes will vary by industry and by company, we believe the implementation of fundamentally driven active management in security selection will be an important differentiator going forward.

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1. Duration is a measurement of a bond’s sensitivity to interest-rate movements.