Portfolio Advisory Group

RBC Wealth Management

U.S. market brief

Tax reform: Time for the rubber to meet the road

Since President Trump was elected last year, investors' and financial markets' expectations for fiscal stimulus have been high. After several fits and starts during 2017, the president is now poised to sign into law what is being billed as "the most comprehensive tax reform in three decades."

The focus of the Tax Cuts and Jobs Act (the Act) is to provide tax relief to individuals and corporations together with a recapture of corporate funds currently held offshore, all of which is forecast to result in robust economic growth.*

Following are our initial thoughts on how the Act could impact the equity and fixed income markets, along with Fed policy and the economy.

Sorting out the equity puzzle

While some of the good news about the tax cut package is already priced into U.S. equities as the market rallied ahead of the votes, its full effect may not be completely incorporated into share prices.

The S&P 500 and other major indexes should see a meaningful boost in earnings growth. Upward earnings adjustments are not yet fully embedded into the consensus forecast, in our view.

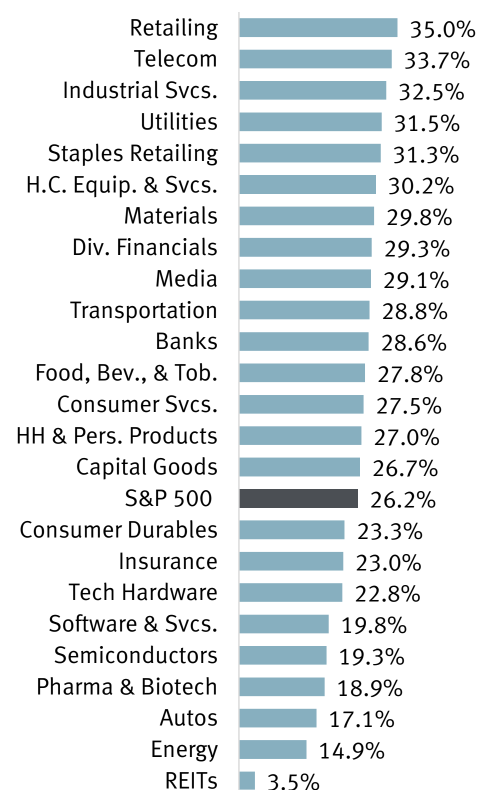
Instead of the S&P 500 growing earnings at our 7.5% y/y estimated rate without tax cuts, we anticipate profits could expand 13%–18% or more with tax cuts in 2018. This higher growth range would represent $148–$155 per share in earnings, above the current $146 consensus forecast (or 11% growth) compiled by Thomson Reuters I/B/E/S.

Earnings growth could jump meaningfully because the corporate tax rate has been slashed substantially to 21% from 35%. This takes the U.S. from nearly the highest statutory rate in the world to a rate well below the G7 and G20 averages and slightly below the European Union, according to the Tax Foundation.

If stronger earnings growth pans out as we anticipate or is even more robust, it would push the S&P 500 forward price-to-earnings ratio down to a more reasonable level—from 18.4x currently to 17.7x based on the midpoint of our higher growth range.

Domestically oriented groups carried the highest tax rates

Effective tax rate of select industry groups (before tax cuts)



Source - National research correspondent, Thomson Financial, FactSet, Standard & Poor's; data based on 3-year trailing dollar weighted effective tax rate; data as of 12/3/17

Priced (in USD) as of 12/21/17 market close (unless otherwise stated).
For authors' contact information and important disclosures, see Page 4.

Industries with a large share of domestic revenues and high capital spending levels should capture the greatest incremental increases in free cash flow. Among large-cap companies, many are in retailing, telecommunications, industrials, utilities, and financials, and the list goes on (see chart on previous page).

U.S.-based multinational firms that had high tax rates will be able to compete more effectively with low-taxed foreign rivals.

Also, small-capitalization public companies and small private firms should see the biggest declines in tax rates as they previously paid the highest effective rates.

Many companies may use the extra cash flow to initiate or increase stock buybacks, hike dividends, embark on acquisitions, and/or expand by other means—all of which could be positive for shareholders.

The legislation aims to provide U.S.-based companies with additional flexibility to grow their businesses, compete globally, and prosper.

"Need to Know" issues for fixed income

Even before passage of the Act, 2018 was setting up to be a pivotal year for the Fed as Janet Yellen is replaced by Jerome Powell (pending Senate confirmation) and the need to fill other vacancies at the Fed. Powell is not expected to deviate from Yellen's slow, deliberate approach, and as she noted at her final Federal Open Market Committee (FOMC) press conference, "We continue to think as you can see from the projections (of other FOMC policymakers) that a gradual path of rate increases remains appropriate even with almost all participants now factoring in their impact of the tax policy." The Fed is forecasting three hikes in 2018, although prolonged low inflation or faster growth could alter its plans. We see the March FOMC meeting as the likely next opportunity for a rate hike. However, after that, we think sticky, low inflation, will cause the Fed to pause and ultimately raise rates just twice in 2018.

The yield spike we've seen in recent days—10Y Treasury yields are up about 15 basis points—is somewhat reminiscent of the jump in rates after the 2016 election when markets anticipated that fiscal stimulus would result in faster growth and potentially a more aggressive Fed. Now, higher yields are a result of projections of stronger growth and Fed expectations, but also increased Treasury borrowing to fund the higher federal debt (about $1.5T) from tax reform. In our opinion, as was the case this year, the initial exuberance over tax reform will subside. The focus should then return to underlying economic fundamentals of modest growth and low inflation. In our opinion, the Fed's 2.75% forecast for terminal Fed Funds will act as a soft cap on the 10Y Treasury keeping rates relatively close to current levels.

2018 tax rate changes

Married filing joint		
	Year	
Tax bracket	2017	2018
$0–$19,050	10%	10%
$19,051–$77,400	15%	12%
$77,401–$165,000	25%	22%
$165,001–$315,000	28%	24%
$315,001–$400,000	33%	32%
$400,001–$600,000	35%	35%
$600,000+	39.6%	37%

Individual		
	Year	
Tax bracket	2017	2018
$0–$9,525	10%	10%
$9,526–$38,700	15%	12%
$38,701–$82,500	25%	22%
$82,501–$157,500	28%	24%
$157,501–$200,000	33%	32%
$200,001–$500,000	35%	35%
$500,000+	39.6%	37%

Source - Congress.gov, Tax Cuts and Jobs Act

Issues for individual investors: The most visible aspects of tax reform for fixed income investors will center on revisions to individual tax rates, revisions to both the alternative minimum tax and state and local tax deductions. But, as the chart shows, the individual tax rate changes are modest and, in our view, the lower top rates shouldn't reduce demand for municipal bonds especially as new issuance is expected to lag in 2018 due to the elimination of Advanced Refunding bonds. The lower corporate rate, 21% vs. 35%, could reduce the issuance of corporate debt, and possibly lower demand for munis from some corporations, but in our opinion continued low rates will fuel investor demand for yield in credit and munis.

The economy has been fine, even without tax reform

We have been hearing about tax reform for several months, but behind the scenes the U.S. economy hasn't been standing still. It has continued to chug along slowly, but steadily once again proving that the business cycle ultimately impacts the stock and bond markets far more than the political cycle. That being said, tax reform could very well result in stronger near-term growth.

GDP has posted two consecutive quarters of 3% growth and with 2.7% forecast for Q4, GDP growth in 2017 could come in at about 2.5%.

We pay close attention to several key recession indicators—yield curve, interest rates, employment, jobless claims, leading index, and manufacturing—and all are currently flashing green (showing no recession risks).To us, it is clear the U.S. economy, even before tax reform, had been on solid footing and the current expansion is poised to continue.

Forecasts from our colleagues at RBC Capital Markets and RBC Global Asset Management suggest tax reform could boost growth 0.4—0.5 percentage points over the next couple of years, increasing annual GDP growth to over 3%+, which likely further pushes into the future chances of a recession. It is noteworthy to consider however that with some components of tax reform set to expire in future years, the boost to growth could be temporary.

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