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Investing after the U.S. tax overhaul

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The new year brought a new U.S. tax code. The implications for the economy and asset prices are complex and are likely to play out over years. We aim to address some of the taxing questions here:

Highlights

- The tax bill and potentially hefty government spending could boost global growth, push up U.S. inflation expectations, increase Treasury issuance and lead the Federal Reserve to increase rates at a slightly faster pace. This may shorten the lifespan of the current global expansion, but we're not worried about the end just yet. See page 2.
- U.S. equities look well-positioned in the short to intermediate term as the outlook for a profitability boost eclipses longer-term growth fears. Highly taxed companies are seen as early winners (and those with lower tax losers) on paper, but the top line hides great detail below. The impact of the various tax provisions will vary across sectors, subsectors and businesses. See page 3.
- We see investment grade companies generally as winners in U.S. credit, but most of the windfall will likely go to shareholders rather than to paying down debt. We expect more bifurcation between higher- and lower-quality issuers in high yield, as companies with large debt loads face limits to interest expense deductibility. And U.S. investors still have one place to turn for tax shelter: municipal bonds. See pages 4-5.

Early days

The new tax law is complex, and companies, tax advisors and investors are scrambling to digest it. Surprises and unintended consequences are expected — and appearing. We offer a look at some of the key provisions and their potential investment implications:

At a glance

Key tax law changes and investment implications

Tax provision	Timeline	Primary investment implication(s)
Corporate tax rate dropped from 35% to 21%	Effective beginning tax-year 2018; no expiration	Companies with high effective tax rates poised to see them fall, likely providing an immediate profitability lift.
Companies allowed to expense 100% of qualifying capital expenditures (capex) upfront	Effective from Sept. 27, 2017, with phase-out to begin in January 2023	The ability to write-off expenses immediately is positive for companies and could accelerate business investment.
Limits on the deduction of net business interest	Limited to 30% of EBITDA from 2018-2021; EBIT-limited after	Could hurt highly levered companies, suggesting an up-in-quality stance in credit.
Move toward a territorial tax system and one-time repatriation tax on accumulated foreign earnings	Effective beginning tax-year 2018. Companies have eight years to pay the repatriation tax	Frees up cash held overseas. Could be used for paying down debt, dividends, share buybacks or investments.
State and local tax deduction capped at $10,000 including income, property and sales tax	Sunsets in 2026	Adds a de-facto price increase on home ownership and could affect the cost of living in high-tax areas.
Limits on mortgage interest deduction	Sunsets in 2026	Could dampen activity at the higher end of the housing market.
Lower individual tax rates	Pre-2018 rates restored in 2026	Potential boost to consumer spending.

Source: BlackRock Investment Institute. Note: Reflects BlackRock's interpretation of U.S. tax laws as of January 2018.

It's a small world

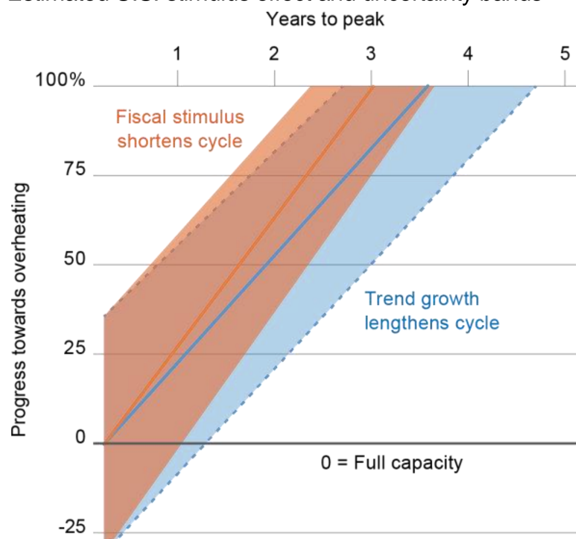
The tax cuts stoke investment and consumption, and the package provides further incentive to invest. We estimate this combination could boost U.S. gross domestic product (GDP) by 0.4 percentage point this year. A possible budget agreement that lifts discretionary spending caps could add another 0.4 percentage point. This faster growth comes just as the U.S. expansion enters its ninth year. It represents a sea change from U.S. fiscal policy's long drag on growth and bodes well for the global expansion, we believe.

The blue area in the *Shades of expansion* chart shows how things might have played out if GDP growth kept running at a pace slightly above trend. The orange area shows how faster, above-trend growth could shorten the U.S. economic cycle, mainly by pulling forward demand. The recessionary tipping point moves forward by about a year. Yet we estimate the U.S. expansion can power on for at least another two to three years. If overheating pressures are contained, we could see it press on for longer. See Heating up, slowly of January 2018.

Lingering global spare capacity helps here, moderating U.S. overheating and underpinning the expansion as stimulus spills abroad. Higher business investment should lift U.S. growth potential and lead to more U.S. imports, we believe. This is how the stimulus-growth boost could be shared beyond U.S. borders, and give the expansion more breadth and longer life. Deeply intertwined global trade and supply chains mean demand is better redistributed around the world. One potential corollary: recent U.S. dollar weakness. If U.S. stimulus lifts *global* growth prospects — and global risk appetite — reduced demand for safe havens, including the dollar, could follow.

Shades of expansion

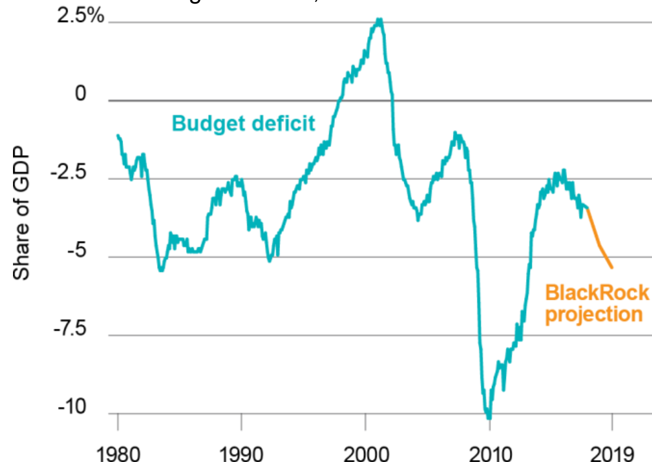
Estimated U.S. stimulus effect and uncertainty bands



Sources: BlackRock Investment Institute, with data from the IMF, CBO, OECD and Thomson Reuters, January 2018. Notes: The chart shows the likely number of years left in this U.S. economic cycle reaching an overheating point based on two scenarios: 1) our expectation for higher growth versus potential (2.6% actual versus 1.8% potential) over the next two years due to fiscal stimulus with a modest but delayed rise in potential; 2) a no-stimulus scenario where growth remains only slightly above potential in line with post-crisis trends. The bands represent the different outcomes based on averaging four measures of prior cycle peaks since the early 1950s: the IMF's, the OECD's, the CBO's output gap and the CBO's measure of the non-accelerating inflation rate of unemployment gap.

A deepening hole

U.S. federal budget balance, 1980-2019



Sources: BlackRock Investment Institute, with data from the U.S. Treasury and IMF, January 2018. Notes: The chart shows the U.S. budget balance as a share of nominal GDP. The projection is based on BlackRock's expectations for the effect of the 2017 fiscal package and greater federal spending relative to the IMF's forecasts for nominal GDP.

At what price?

Tax law was a contentious negotiation on Capitol Hill. A central sticking point: its cost. The target became a price tag of $1.5 trillion in added deficit over 10 years. In that sense, it was mission accomplished: The package came in at $1.456 trillion in deficits between 2018 and 2027, according to the basic scoring model of the Joint Committee on Taxation (JCT). Proponents suggest the economic growth generated by the tax plan may soften that blow.

The JCT shows the law's impact on the deficit is greatest in the first three years. We see the federal deficit hovering near 5% of GDP by 2019. See the *A deepening hole* chart. The full impact over the medium term will depend on whether the stimulus leads to a sustained pickup in potential growth, and on any government measures to address the deficit. Rising deficits would exacerbate a U.S. debt trajectory already set to expand as health care and Social Security obligations mount amid an aging population, shown by projections from the Congressional Budget Office (CBO). The long-term sustainability of the law itself is another question. Unlike the 1986 tax reform legislation, the 2017 package was not a bipartisan effort. This makes it more susceptible to efforts to amend it — especially the corporate provisions — if political leadership changes.

For 2018, the key question is how the Fed will react to the stimulus. The central bank has signaled three rate hikes in 2018. The fiscal boost could tip it toward four, depending on inflation trends. Our view: U.S. inflation is on a comeback, and markets appear to be catching on fast.

All other things equal, the stimulus will likely nudge the Fed toward a slightly faster pace of rate hikes. We expect U.S. Treasury yields to climb higher as result — even if forces such as ample global savings keep interest rates historically low. We see room for greater rate and policy divergence as central banks in the eurozone and Japan remain accommodative amid limp local inflation. We could see emerging market (EM) central banks start to pivot away from easing policies, challenging return expectations for EM local debt.

Winners and losers in equities

The new tax law drops the statutory corporate rate 14 percentage points and offers companies easier and cheaper access to cash held overseas. The former is generally a bigger boon for domestically oriented companies, which have likely been paying an effective tax rate closer to the U.S. statutory level. The latter gives multinational companies greater reason to cheer, allowing for more flexibility in deploying cash. We note an uptick in mergers and acquisitions (M&A), for one, and companies generally have more cash to increase their business investment.

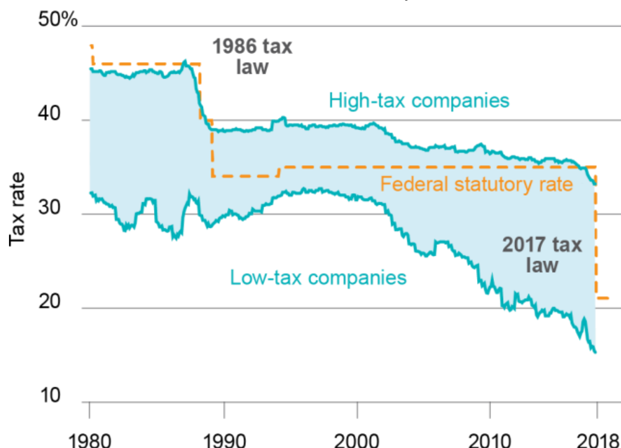
Yet the top lines mask a great deal of nuance. A 30-year rewind is informative: The dispersion of effective tax rates of Russell 1000 companies peaked in 1986, just before the Tax Reform Act came into effect, and was followed by a decade-long convergence, our analysis shows. The *Divergence to convergence* chart shows the tax rates of high- and low-tax payers in the Russell 1000 Index over time. Those paying hefty tax enjoyed a decline in effective tax rates whereas lightly taxed companies saw a small rise as the changes leveled the playing field and closed loopholes. Effective tax rates started diverging again in the late 1990s as globalization, the adoption of territorial tax systems and relatively high U.S. tax rates encouraged tax reduction schemes.

Something similar could play out today. The top quartile of U.S. companies currently pay an effective tax rate of 34% or more, our analysis shows. This leaves plenty of room for relief as the top rate is slashed to 21%. Multinationals, which enjoyed lower effective tax rates thanks to their international operations, will see less of an immediate benefit.

The most obvious effects of U.S. tax cuts are likely to be front loaded and dissipate with time. Expect multinationals to scrutinize the international rules to manage their effective tax rates; greater clarity on the taxation of foreign assets should help inform spending plans. Beyond that, the details matter and vary by company, giving stock pickers room to capitalize.

Divergence to convergence

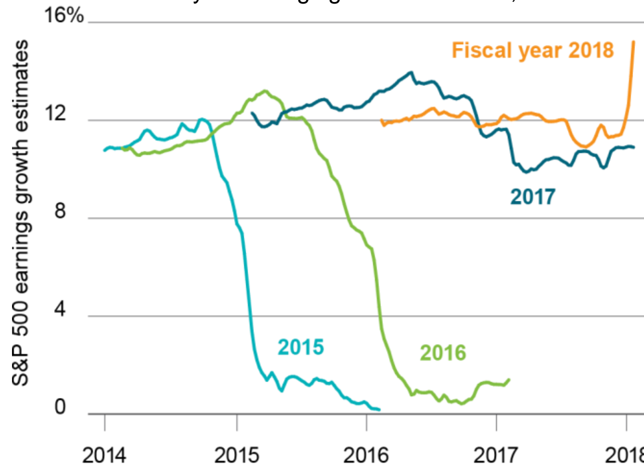
Effective tax rates of Russell 1000 companies, 1980-2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters and Compustat, January 2018. Notes: We take data from financial statements for Russell 1000 companies to arrive at an effective corporate tax rate at the company level (tax expense divided by pretax income). The blue lines show the effective tax rates of the 75th and 25th percentile of taxpayers over time. The orange line shows the federal statutory rate.

Great expectations

Evolution of analyst earnings growth estimates, 2014-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, January 2018. Note: The lines show how expectations for S&P 500 earnings growth have changed for each fiscal year through time, based on bottom-up aggregate analyst estimates.

Digging in

The various aspects of the tax package — and how they interact with and offset one another — will have differing implications across sectors, subsectors and individual companies. One example: property and casualty insurers. They look to be low-tax payers already, suggesting little room for upside. But the tax changes will allow these companies to lower their tax liability on underwriting revenue while maintaining their low rates on investment income thanks to tax-free municipal bond income. Result: Most will likely be able to lower their effective tax rates further.

Overall, we expect U.S. company earnings and spending will receive an early boost under the new tax plan. The *Great Expectations* chart shows 2017 earnings estimates turned the corner after a string of disappointments, with 2015 and 2016 depicting the more typical pattern in post-crisis years. This year shows a clear sprint out of the gate. Our analysis finds earnings revisions are solid in Japan, Europe and EM as well, but the U.S. strength is unmatched. Understanding what comes next will require astute listening — particularly given that companies have up to a year to clarify and update their "provisional" estimates — and learning. Some questions our portfolio managers are asking:

- How will your company finance growth derived from lower tax rates — through equity, debt or free cash generation?
- To the extent M&A is part of your growth plan, what is your strategy to ensure the high prices being demanded today can translate to growth?
- Will your company be subject to the extra taxes under the law's new anti-base erosion rules? Can you estimate their impact?
- Are you considering opening or relocating to U.S. sites based on the new provisions, particularly the added tax benefit to companies exporting U.S. goods and services to foreign customers?
- To U.S.-based multinationals with effective tax rates below 13%: Will you be able to maintain your current tax rate given the law's new minimum tax of roughly 13%? How, and is this sustainable?

A deluge of government debt

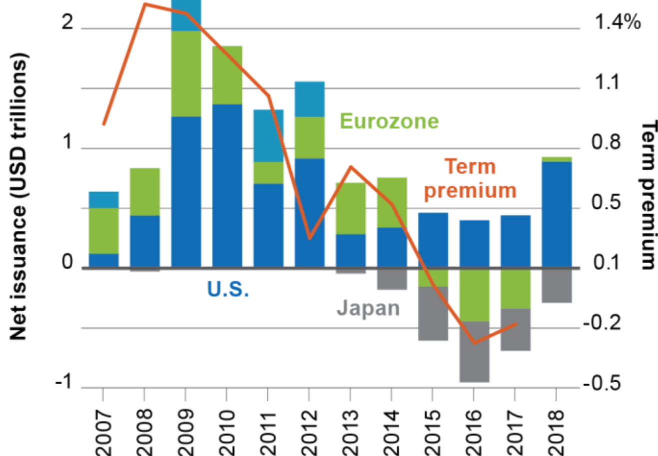
With tax cuts eating into federal government revenues, and potential for a not insignificant government spending spree, issuance of Treasury debt can only go in one direction — up. The market is left to contend with the question of who will sop up newly issued Treasuries.

A once big and reliable buyer of Treasuries, the Fed, will be trimming back purchases as it unwinds the quantitative easing (QE) program once needed to prop up the economy. We estimate the combined effect of Fed normalization and rising fiscal deficits means the private sector would have to absorb as much as $1.25 trillion in newly issued Treasuries in 2018 (including bills), based on an analysis of federal tax and spending plans and the Fed's plans for balance sheet runoff. This would be more than double the amount of "net net" issuance (net issuance net of Fed purchases) in 2017. All told, the U.S. is driving an increase in G3 net issuance. See the *Supply step-up* chart. Meanwhile, the hedged yield pickup for foreigners buying U.S. Treasuries has been on a steady decline since the Fed started normalizing policy, keeping the U.S. curve flat relative to global peers. A counterforce is a global savings glut in search of perceived safe-haven assets, as detailed in The safety premium driving low rates.

Piecing it together: Greater Treasury supply comes alongside reduced Fed support and potentially lower demand from non-U.S. buyers. Combined with a stimulative tax and fiscal package, we see higher yields and steeper U.S. Treasury curves. See the orange line below. This improves the outlook for short versus long maturities, we believe. It also increases the appeal of floating rate instruments and inflation-protected Treasuries for their ability to offer some insulation from rising rates and inflation. See Fuel for (over)heating of January 2018.

Supply step-up

G3 term premium and net issuance, 2007-2018



Source: BlackRock Investment Institute, with data from Morgan Stanley and Goldman Sachs, November 2017. Notes: The bars show net government bond issuance for the U.S., eurozone and Japan, net of central bank purchases via QE programs. 2018 figures are estimates. We assume ECB purchases of €30 billion per month, with no purchases after September 2018. We estimate BoJ purchases in line with the average pace of net purchases as of September 2017. The term premium represents the GDP-weighted average of G3 term premiums calculated based on the Adrian, Crump and Moench (ACM) model. See the August 2008 staff report from the Federal Reserve Bank of New York: Pricing the Term Structure with Linear Regressions.

Downhill run

Spread differential between short and long IG maturities, 2017-2018

Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Bloomberg, January 2018. Note: The chart shows the difference between spreads of investment grade credit with maturities of one to three years and maturities of 10 years and longer. Indexes used are the Bloomberg Barclays U.S. Corporate 1-3 Year Index and Long U.S. Corporate Index.

In credit corners

Lower corporate tax rates and the ability to immediately expense qualifying capex are good news for both investment grade and high yield companies, in our view. We highlight three aspects of the tax package with more nuanced implications for credit:

The repatriation provision affects credit spreads of different maturities. Large corporations invest their overseas cash in short-term corporate bonds. With greater incentive to put repatriated monies to different use, companies are expected to reduce their holdings in this area of the curve. The result: relative underperformance of short-dated credit spreads as the differential to long-dated spreads declines. See the *Downhill run* chart.

The tax overhaul has sparked a change in behavior of corporate pension plans that supports the long end of the credit market. They are pulling forward their investment in long-dated bonds, both to avoid higher Pension Benefit Guaranty Corporation variable fees in 2018 and to take these contributions as expenses against higher 2017 tax rates. Companies have until the extended Oct. 15 tax-filing deadline to claim this expense against 2017 taxes, potentially increasing long-end demand into 2018.

Finally, the provision limiting the deductibility of interest expense is expected to deepen the bifurcation between BB-rated companies and the more levered CCC portion of the high yield market. Companies with large debt loads will face increased cash flow pressure given higher cash tax payments. We could see management teams prioritizing deleveraging to move within the confines of the 30% EBITDA limit. This would push more CCCs up the rating spectrum. Overall, we see the high yield market faring well under the tax law. Some 75% of issuers will benefit from lower tax rates and the ability to expense investments, J.P. Morgan estimates. From a sector perspective, investment grade cable and telecoms are potentially big beneficiaries of tax cuts and investment expensing. Tech and pharma are well positioned for share buybacks and M&A. We see energy, gaming, lodging and transportation as potential winners in high yield.

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Tax shelter in place

Municipal bonds emerge from the tax overhaul as one of the last remaining tax shelters for U.S. investors and in a strong supply-demand position. The top marginal tax rate dropped from 43.4% to 40.8% (when including the 3.8% tax on net investment income established under the 2010 Affordable Care Act), doing little to deter the primary investor base — high rate taxpayers. Yet we find the market is underpricing the value of tax exemption. The *Underappreciated?* chart shows muni pricing relative to corporate bonds is factoring in a 27% tax rate, well below the top marginal rate. This tells us market pricing hasn't drifted back to the level of a proper tax shelter, though valuations have risen as investors flooded in late last year to achieve optimum benefit before tax cuts.

Advanced refunding bonds can no longer be issued with tax-exempt status under the tax plan. This generates nearly $18 billion in revenue for the federal government over 10 years, according to CBO figures. It also means 15%-20% less muni issuance in 2018, based on our math. History suggests decreased supply is a big booster for the muni market. We place net issuance at potentially *negative* $50 billion in 2018. The last time we saw a number of this magnitude, in 2011, the market returned 10.7% for the year, based on Barclays Bloomberg data. This is unlikely against a backdrop of generally rising rates, but the potential for a performance lift is there. It may take time to gather steam as the glut of supply created in late 2017 (a rush to issue before advanced refunding bonds were eliminated) is digested.

We could see increased appetite for tax shelter from retail investors in high-tax states, where once unlimited state and local tax (SALT) deductions were capped. Corporate demand may weaken given that lower tax rates make munis a less competitive after-tax proposition. We have an eye on banks and insurance companies, which are likely to react to even small price changes. These represent approximately one-third of the market.

Underappreciated?

Market-implied benefit of tax exemption, 2016-2018

Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. Sources: BlackRock, with data from Bloomberg Barclays indexes, January 2018. Notes: The market-implied tax benefit is calculated by dividing the yield to worst of the Bloomberg Barclays Municipal Bond Index by that of the Bloomberg Barclays U.S. Aggregate Corporate Index, with the remainder representing the implied tax shelter.

More reason to refi

Hypothetical refinancing scenarios under old and new tax plans

	Before: itemized mortgage interest	Now: standard deduction
Loan size	$250,000	$250,000
Marginal tax rate	25%	25%
Existing mortgage interest rate	4.50%	4.50%
Monthly payment	$1,267	$1,267
Year-one interest	$11,167	$11,167
MID tax savings	$2,792	$0
Monthly payment	$1,034	$1,267
New mortgage interest rate	3.75%	3.75%
Monthly payment	$1,158	$1,158
Year-one interest	$9,297	$9,297
MID tax savings	$2,324	$0
Monthly payment	$964	$1,158
Change to effective monthly payment	$70	$109

Source: BlackRock, January 2018. Notes: The table shows that a borrower who is no longer taking the mortgage interest deduction (MID) will see a greater monthly savings for the same drop in mortgage rate incentive. The scenarios are hypothetical and for illustrative purposes only.

Bringing it home

The new tax law brings a few changes to the housing and mortgage markets. Chief among them:

1) The standard deduction was nearly doubled, removing the incentive to itemize and deduct mortgage interest on tax returns.

2) For those who continue to itemize, the $10,000 limit on SALT deductions, including property tax, adds a de-facto price increase on home ownership, disproportionately affecting high-tax areas.

3) The interest deduction on new mortgage loans was dropped from $1 million to $750,000 of debt, which could dampen activity at the higher end of market.

We expect any impact on agency mortgage-backed securities (MBS) to be contained. Implications for the housing market will vary by region. Just 30% of U.S. taxpayers itemized deductions in 2015, according to IRS Statistics of Income, with 25% deducting property taxes and 21% taking the mortgage interest deduction. Taxpayers in high-tax areas, where more itemize, will feel the pain of the tax changes most. We expect the reduced mortgage deduction to affect home values, but anticipate little to no impact on home ownership. Construction may wobble as a result, but it's good news for starter homes with smaller mortgages.

Fiscal stimulus and reduced tax rates for lower- and middle-income Americans should create a wealth effect that allows them to trade up to bigger homes and larger loans. Mobility and turnover on higher-priced segments could slow given new costs in these areas. We see buy-vs.-rent decisions skewing toward rentals. The new rules could make renting the cheaper proposition in some areas, and first-time homebuyers may await stability to enter the market. This would dampen supply in agency MBS. Finally, when not deducting mortgage interest, each dollar saved is important. We believe this could increase the urge to prepay. The *More reason to refi* example shows how a homeowner taking a standard deduction under the new law would have greater incentive to prepay and refinance an existing loan. When principal is paid early, future interest is lost, though we see this having a fairly mild impact on the mortgage market.

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