Private Markets

May 9, 2024

Global Credit Weekly:

The U.S. election – early thoughts for credit

BlackRock.

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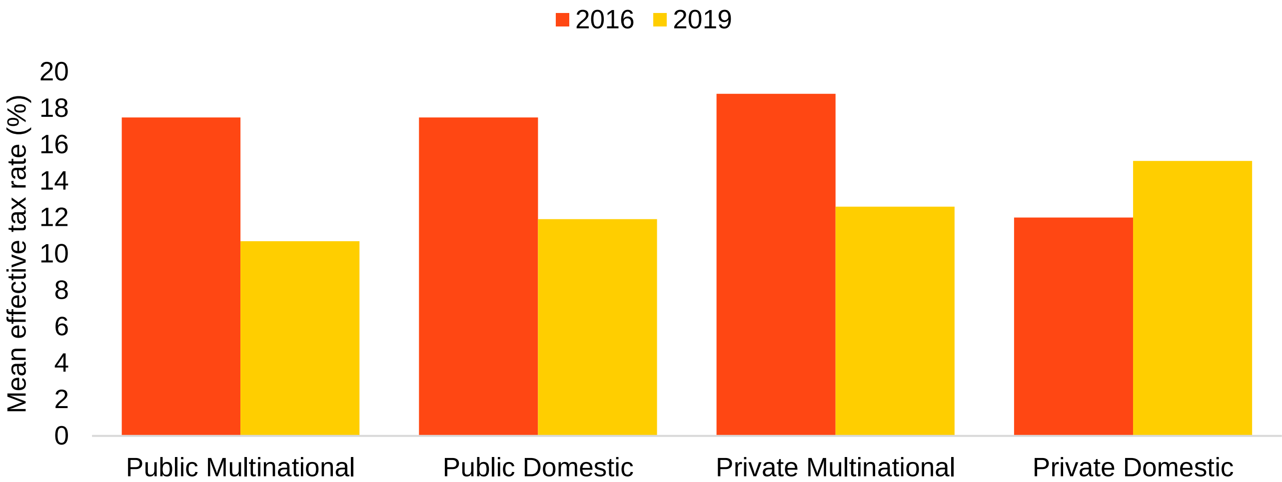
Key takeaways

- With the November 5th, 2024, U.S. Presidential election now less than six months away, market participants are increasingly focused on the potential impacts to the macroeconomic landscape and, by extension, the corporate credit market. In many ways, the Republican and Democratic presumptive candidates are somewhat “known” to the markets in terms of their policy priorities in past and current administrations, respectively. Nonetheless, we see scope for such policy priorities to evolve in response to the unique backdrop (i.e., a large U.S. fiscal deficit, heightened geopolitical risks, etc.).
- With this as a backdrop, in this *Global Credit Weekly*, we highlight the five areas we believe are most important for corporate credit investors to monitor over the coming months. These include: (1) potential changes to corporate tax policy, (2) the possibility of new tariffs, (3) any changes in discretionary non-defense fiscal spending, (4) any new developments related to regulation and anti-trust stances, and (5) policies related to immigration. In this context, sector and issuer selection should gain increased importance, in our view.
- Taxes are likely to be especially closely watched, given the upcoming expirations (at year-end 2025) for some personal tax cut provisions in the *2017 Tax Cuts and Jobs Act (TCJA)*. Extending this legislation could introduce changes to corporate tax codes, if a broader tax package is adopted. That said, using the TCJA as a guide, the impact across the corporate credit market is likely to be far from uniform. Indeed, a 2023 paper from the Federal Reserve Board of Governors highlighted how trends in effective tax rates – and exposure to the TCJA’s main provisions - varied substantially for public, private, multinational and domestic firms (Exhibit 1), as well as across the size spectrum.

Exhibit 1: The impact of the TCJA was far from uniform across the corporate landscape
Mean effective tax rates for cohorts of U.S. companies: 2016 vs. 2019



Source: BlackRock, Federal Reserve Board of Governors. For specific details on methodology please see: Dobridge, Christine L., Patrick Kennedy, Paul Landefeld, and Jacob Mortenson (2023). “The TCJA and Domestic Corporate Tax Rates,” Finance and Economics Discussion Series 2023-078. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2023.078.

U.S. Presidential election: The six-month countdown

With the November 5th, 2024, U.S. Presidential election now less than six months away, market participants are increasingly focused on the potential impacts to the macroeconomic landscape and, by extension, the corporate credit market.

Prediction markets – which can provide insight, even if only directionally, on the prevailing consensus view – indicate a 51% probability of President Biden winning the 2024 U.S. Presidential election, compared to 47% for former President Trump (as of May 7th, 2024; Exhibit 2).

These Republican and Democratic presumptive candidates are somewhat "known" to the markets in terms of their policy priorities in past and current administrations, respectively. That said, we see scope for such policy priorities to evolve in response to the unique backdrop, which includes: the large fiscal deficit in the U.S. (Exhibit 3), the timing of upcoming personal tax cut expirations, and elevated geopolitical tensions.

Former President Trump and current President Biden have started to publicly frame (at preliminary levels) some of their initial policy stances. We expect more details to emerge as we progress later into the summer, as the Republican and Democratic national conventions will be held in mid-July and mid-August, respectively. Scheduled debates for September and October will also likely shine additional light on their policy priorities. And beyond the Presidential election, of course, the composition of Congress will also have important implications for the ability to implement new legislation (i.e., in a split vs. unified government).

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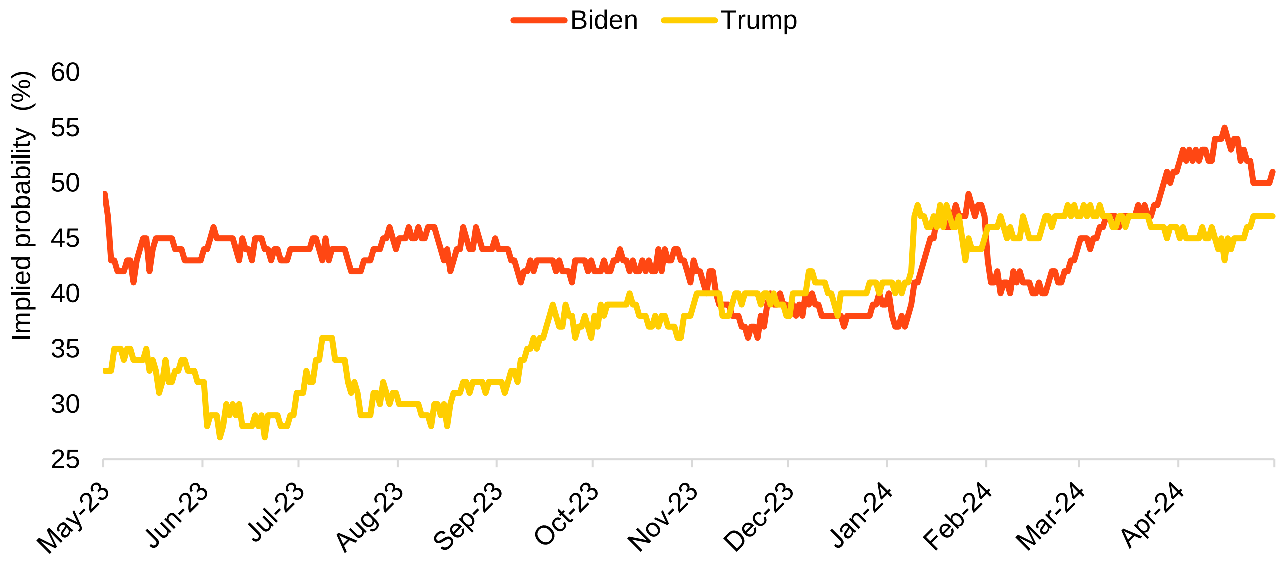
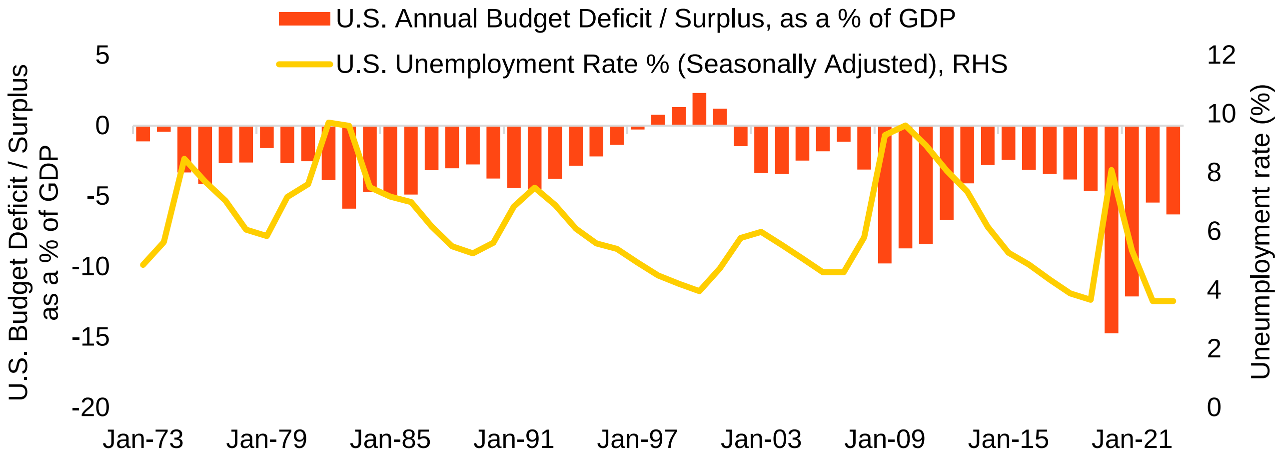
Taxes are likely to be especially closely watched, given the upcoming expirations (at year-end 2025) for personal tax cut provisions in the *2017 Tax Cuts and Jobs Act*. Extending this legislation could introduce changes to corporate tax codes, if a broader package is adopted. That said, using the TCJA as a guide, the impact across the corporate credit market is likely to be far from uniform.

Exhibit 2: At this stage, prediction markets are indicating a close U.S. Presidential election
Implied probability of a win in the 2024 U.S. Presidential Election, based on quotes available on the PredictIt website



Source: BlackRock, PredictIt (https://www.predictit.org/) Bloomberg. As of May 7, 2024. There can be no assurance that such predictions or forecasts will come to pass.

Exhibit 3: The current U.S. budget deficit exists against a backdrop of low unemployment
The U.S. annual budget deficit (or surplus, when positive) as a percentage of U.S. annual gross domestic product (GDP), compared to the U.S. unemployment rate at each calendar year-end (RHS)



Source: BlackRock, Congressional Budget Office, Bureau of Labor Statistics. As of each annual period, through 2023.

For corporate credit, the following policies are among the most relevant to monitor, in our view:

- **Taxes:** The *2017 Tax Cuts and Jobs Act* made significant changes in multiple areas of the U.S. tax code, including lowering the top statutory tax rate from 35% to 21%. President Biden's 2025 Budget calls for raising this rate to 28%, alongside other tax-related actions. The personal provisions of the TCJA are scheduled to expire at year-end 2025. But an April 2nd, 2024 analysis by Goldman Sachs Global Investment Research noted that a substantial portion of the individual tax cuts have broad political support, suggesting they may be extended. Changes to corporate taxes could be included in a broader tax package, if one materializes. This may have meaningful implications for some firms' credit fundamentals and capital management priorities. That said, as we detail later, the impact will likely vary substantially – consistent with the initial TCJA experience (again, Exhibit 1).
- **Trade and tariffs:** The U.S. imported $3.1 trillion of goods in 2023, per the Bureau of Economic Analysis (BEA). In recent interviews, former President Trump has proposed two potential tariff plans: a 60% tariff on imports from China and a 10% universal tariff on imports from the rest of the world. The details are very preliminary at this stage, and it is not clear what countries, sectors or goods may be excluded. Nonetheless, at a macro level, tariffs have the potential to be inflationary, as some portion of higher costs may be passed on to consumers. And at a micro level, certain sectors may be disproportionately impacted (i.e., those heavily reliant upon imports). Beyond watching for tariff implementation, we are also focused on (1) how any revenues from new tariffs may be spent (i.e., to fund tax cuts, or reduce the deficit), and (2) whether there is any retaliation from trading partners.
- **Fiscal spending:** Any potential efforts to reduce the U.S deficit by paring back on government spending may negatively impact certain sectors. According to data from the Congressional Budget Office (CBO), discretionary non-defense outlays totaled $917 billion in FY2023 (3.4% of GDP). These include programs related to health care, education, transportation, and income security, among others.
- **Regulations and anti-trust:** In 2023, the Department of Justice (DOJ) and Federal Trade Commission (FTC) jointly issued a revised set of "Merger Guidelines." This followed the establishment of the White House Competition Council, which called on the DOJ and FTC to "enforce the antitrust laws vigorously" and "challenge prior bad mergers." Any easing of anti-trust constraints could encourage more M&A in the corporate credit market, in our view, as it may reduce uncertainty related to deal closing.
- **Immigration.** This is largely a macroeconomic consideration. As discussed by Federal Reserve officials, the increased labor supply due to immigration (coupled with higher labor force participation) has allowed the U.S. to generate above-trend job creation over the past several months, while keeping wage pressures largely contained. To the extent that immigration policy is tightened, this could have an impact on the supply of labor and could place upward pressure on wages.

Tax implications from the TCJA were nuanced

The TCJA (passed in December 2017) made sweeping changes to the U.S. tax code, and the key provisions affecting corporate credit issuers were multi-faceted. These include but are not limited to:

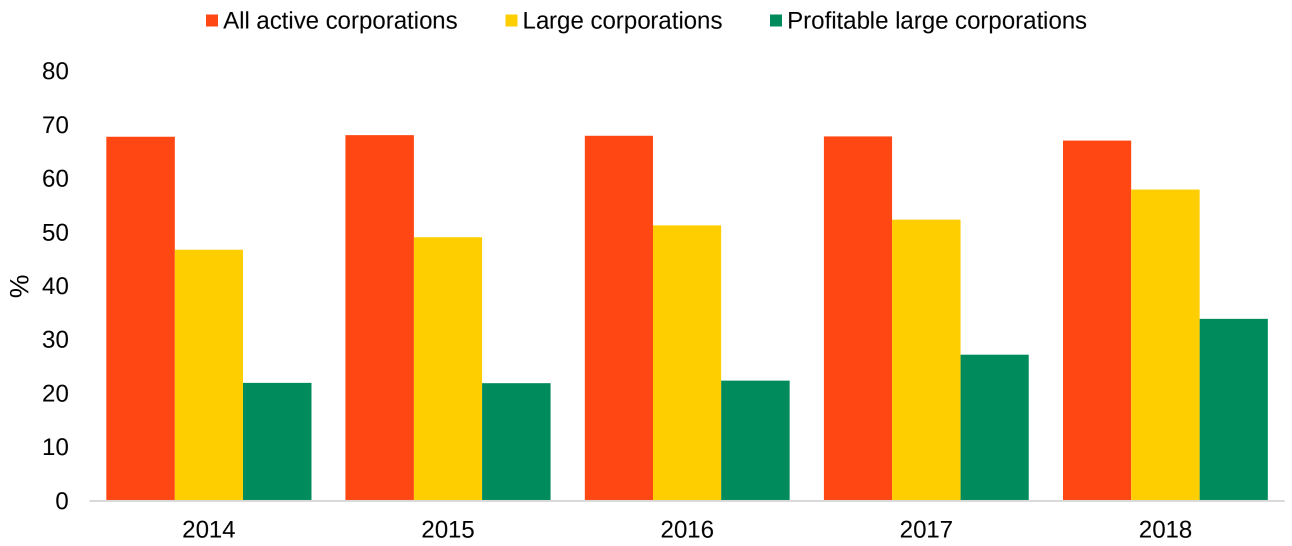
- Lowered the corporate statutory tax rate to 21% (from 35%) and repealed the corporate alternative minimum tax.
- Allowed for full and immediate expensing of US-based capex through 2022 (with a plan to phase out this "bonus depreciation" in 20 percentage point increments through 2026).
- Implemented a "deemed repatriation" provision, which – along with a new territorial tax system – allowed previously "offshore" cash to flow freely across borders (while increasing taxes on foreign sourced income and generating tax liability from income that was not previously taxable under U.S. law).
- Limited the deductibility of interest expense to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) for four years. Beginning in 2022, the limit on deductibility was set at a more restrictive (i.e., smaller) amount of earnings before interest and taxes (EBIT).
- Restricted the use of net operating losses (NOLs) generated after 2017; NOL carrybacks were also eliminated, and carryforwards were limited to 80% of taxable income.

Given the many moving parts associated with this legislation, the impact was far from uniform or straightforward. With potential changes in tax policy moving closer into view surrounding the upcoming election and looming tax cut expiration deadlines, we revisit these nuances to help level set the backdrop.

For example, a December 2022 analysis by the U.S. Government Accountability Office (GAO) found that the effective tax rates (ETR) – which include tax deferrals and credits – for "large profitable corporations" (i.e., those with more than $10 million in assets) declined from 16% in 2014 to 9% in 2018. But the total tax liability among these same corporations was slightly *higher* in both 2017 ($278 billion) and 2018 ($267 billion) than it was in 2016 ($262 billion) – likely due to the additional taxes on "offshore" income.

Moreover, the GAO found that from 2014-2018, 51% of large corporations and 25% of profitable ones didn't owe federal taxes, on average, over that five-year period (Exhibit 4). Profitable firms may not owe taxes, for example, due to operating losses in the current taxable year (or from previous years).

Exhibit 4: A notable share of large, profitable firms did not pay taxes from 2014-2018
Percentage of U.S. corporations that reported no federal income tax liability after credits, 2014-2018



Source: BlackRock, Government Accountability Office analysis of Internal Revenue Service data. The number of profitable large corporations in the data ranged between approximately 25,000 and 35,000 between 2014 and 2018. For additional details on methodology please see https://www.gao.gov/assets/gao-23-105384.pdf.

Furthermore, a 2023 paper by the Federal Reserve Board[1] outlined an even more nuanced view vis-à-vis the impact on the broader corporate sector. Their analysis found that exposure to the TCJA legislation's main provisions varied for public, private, multinational, domestic, and large versus small firms. For example, ETR increased on average for privately held, domestic firms and for firms in the bottom 90% of the firm sales distribution after the passage of the TCJA. In contrast, public, multinational, and large firms saw substantial ETR decreases, on average. A subset of this analysis is illustrated in Exhibit 1.

The Federal Reserve Board paper also noted that firms' pre-TCJA exposure to changes in the corporate tax rate and treatment of NOLs had the strongest correlation with post-TCJA ETR changes.

By contrast, exposure to the alternative minimum tax, interest limitation, and multinational provisions was moderately correlated with changes in firms' ETRs, while exposure to bonus depreciation-related changes and repeal of the domestic production activities deduction was only very weakly associated with changes in firms' ETRs.

Overall, the analysis underscores the divergent impacts of the TCJA on different firm types and illuminates the nuances related to the legislation's many provisions.

Sector composition will likely become increasingly important

In the context of potential tax changes and possible tariff implementations, the sector composition across the credit landscape is likely to garner increased importance over the next several months, in our view. That said, at this early stage, we believe it is likely premature to make any sizable asset allocation shifts at the sector level, based solely on political outcomes alone. Additional color on policy priorities from the candidates will be critical to make more informed shifts, in our view.

Exhibit 5 illustrates how sector weightings vary across three widely tracked corporate credit benchmarks: The Bloomberg USD IG and HY Corporate indices, and the Morningstar/LSTA USD Leveraged Loan Index. For comparison, we also include two often referenced USD equity benchmarks: the S&P 500 (large cap) and the Russell 2000 (small cap).

As Exhibit 5 highlights, USD IG is most heavily concentrated in banking, while USD HY is skewed toward consumer, energy, and media. USD Lev Loans has sizeable weightings to technology and professional services.

The equity indices show similar sector variation between indices. As has been widely discussed by market participants, the S&P 500 has a large weight towards technology. The Russell 2000, meanwhile, is most exposed to technology, pharmaceuticals, and banking. Notably, the indices with the largest debt and equity issuers (USD IG, S&P 500) also have the highest sector concentration.

(1) Dobridge, Christine L., Patrick Kennedy, Paul Landefeld, and Jacob Mortenson (2023). "The TCJA and Domestic Corporate Tax Rates," Finance and Economics Discussion Series 2023-078. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2023.078.

Exhibit 5: Sector concentrations vary significantly across credit and equity indices
Sector composition of selected USD corporate credit and equity indices, as a percentage of total index market value

	USD IG	USD HY	USD Lev Loan	USD Large Cap Equities	USD Small Cap Equities
Aerospace and Defense	2%	2%	2%	2%	1%
Automobiles & Components	3%	2%	2%	2%	2%
Banks	23%	1%	0%	3%	9%
Chemicals	1%	2%	4%	2%	2%
Commercial & Professional Services	0%	0%	11%	2%	4%
Construction & Engineering	0%	0%	1%	0%	4%
Construction Materials	0%	4%	2%	1%	2%
Consumer Discretionary	1%	2%	6%	7%	6%
Consumer Services	1%	13%	7%	1%	2%
Consumer Staples	8%	7%	2%	5%	2%
Containers & Packaging	1%	3%	2%	0%	0%
Diversified Financials	3%	6%	4%	8%	5%
Energy	8%	12%	2%	4%	7%
Environmental & Facilities Services	0%	1%	0%	0%	1%
Healthcare	4%	5%	8%	5%	6%
Industrials	0%	1%	0%	0%	0%
Information Technology	9%	7%	14%	28%	15%
Insurance	5%	3%	3%	2%	2%
Machinery	2%	3%	4%	2%	4%
Media, Advertising and Cable / Satellite	4%	10%	6%	8%	2%
Metals & Mining	1%	2%	1%	0%	2%
Pharmaceuticals, Biotech & Life Sciences	5%	2%	3%	7%	10%
Real Estate	3%	2%	1%	3%	7%
Telecommunications	5%	4%	5%	2%	1%
Trading Companies & Distributors	0%	0%	3%	0%	2%
Transportation	2%	2%	4%	1%	1%
Utilities	8%	3%	3%	2%	3%

Source: BlackRock, Bloomberg, Pitchbook LCD, Morningstar/LSTA, S&P, FTSE Russell. Based on most recent sector weightings available as of May 6, 2024.

An update on this week's "Fed speak"

New York Federal Reserve President John Williams and Minneapolis Federal Reserve President Neel Kashkari both spoke publicly during the recent Milken Global Conference – adding to a long list of "Fed speak" this week.

There were three notable takeaways, in our view, from President William's remarks at Milken.

- The Federal Reserve intends to take a patient approach to normalizing inflation and will consider the "totality of the data" and the broader long-term trend – not monthly fluctuations.
- The U.S. economy (including forces driving supply and demand) is rebalancing, as part of a "continual process." Supply-side "boosts" – especially in the labor market – could result in continued above trend growth in 2024 (2.0-2.5%, per his estimates), albeit somewhat slower vs. 2023.
- He noted that, "right now I think policy is in (…) a very good place, and we have the time to collect more information and, hopefully, continue to see progress."

This emphasis on patient, data-informed decision-making mirrored Powell's recent messaging at the May FOMC press conference, which also conveyed patience in reaching the 2% inflation target – going so far as to call a rate hike as "unlikely."

Prior to his remarks, President Kashkari published an essay, entitled *Policy Has Tightened a Lot. How Tight Is It? (An Update)*, explaining that while policy rates are significantly elevated (in absolute terms and relative to what has previously been understood as "neutral"), there are some indications that policy may not be elevated enough.

President Kashkari said it is too early to know whether the trend in disinflation has stalled. He also noted that he cannot rule out a rate *hike* if underlying inflation pressures became embedded. Like President Williams, he cited a "constellation of data" as being key to future rate decisions.

In our view, President Kashkari's essay underscores an increasingly common debate among market participants: whether the Federal Funds rate is restrictive *enough*. As we highlighted in our *May 2nd Global Credit Weekly*, in the May 1st FOMC, Chair Powell was pressed during the Q&A to respond if the current policy was "sufficiently restrictive". In response, he noted "we believe over time, it will be sufficiently restrictive" but "that will be a question the data will have to answer," thus leaving the door open for future exploration.

Unless otherwise stated, all reference to $ are in USD.

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