Tax Reform Moves the Needle on U.S. Corporate Tax Competitiveness

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The tax overhaul is the most sweeping in decades and puts most U.S. firms on more competitive footing vis-à-vis overseas corporate tax regimes. Smaller businesses with a domestic focus and little ability to lower their effective tax rates will benefit the most. Many companies should have more scope to invest, raise wages, cut prices, pay down debt, or return the tax savings to shareholders. The reform could affect corporate capital structures. It could even impact financial sector holdings of municipal bonds. But just how much it adds to economic growth and the fiscal deficit and how it figures into monetary policy, remains to be seen.

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- The tax reform, along with the reduction in regulation, should modestly boost economic growth, particularly over the next few years. But it could also add to the fiscal deficit and federal debt load at a time of rising benchmark interest rates, possibly reducing the economic tailwinds.
- The tax reform should be more inflationary than deflationary. Given that valuations for most assets—including U.S. equities, as well as high-yield and investment-grade debt—are on the richer end of fair value, the margin for error appears limited.
- But a lower cost of capital should stimulate investment, increase productivity growth, and raise potential gross domestic product. Lifting long-stagnant productivity growth is the key to rising wages. Small businesses, which account for nearly two thirds of net new jobs, should especially benefit from lower taxes.
- The reform's shift to a territorial from a worldwide-taxation system should reduce tax inversions by U.S. corporates, which will also have to pay one-off taxes on their past earnings parked overseas.

The U.S. has passed its biggest tax reform in more than three decades, meaningfully raising the tax code's competitiveness in the world's largest economy. The $1.4 trillion, 10-year overhaul cut the corporate income tax rate to its lowest level in nearly six decades, while most individuals will also see smaller federal assessments on their earnings.

The package is likely to lift economic growth 0.2 percentage points to more than 0.4 percentage points in 2018, with projections for 2019's boost ebbing a bit, as the reform is relatively front-loaded. Its long-run fillip to gross domestic product (GDP) is projected anywhere from 0.7%, according to the Joint Committee on Taxation's static-scoring forecast, to the Tax Foundation's dynamically scored 1.7%.

Such forecasts are always slippery. Incentive effects that spur greater corporate investment and consumer spending will also spur faster economic growth, but how much it offsets the revenue loss of lower taxes is hard to predict. Any shortfall will result in higher budget deficits without lower government spending. Yet fiscal outlays are likely to increase due to rebuilding efforts following a heavy 2017 hurricane season and the Trump administration's broader push to boost infrastructure spending. That suggests the plan won't be revenue neutral anytime soon, deepening the fiscal deficit by a point or two from 3.5% of GDP at the end of 2017 and further increasing federal debt that is already more than 100% of GDP. A heavier debt load would also come at a time of rising benchmark interest rates, which, in addition to raising interest costs on the debt, also factor into the pace of GDP growth.

The Federal Reserve is expected to hike three to four times in 2018, pressuring the short end of the yield curve at the same time that it's gradually reducing the size of its balance sheet. The "quantitative tightening" will continue amid two more slated key rate hikes in each of the following two years. A more aggressive Fed could slow the economy, which would then spin off less tax revenue. At its December meeting, the Fed raised its 2018 GDP forecast four-tenths of a point to 2.5%, even as the economy has lately been running well-above that pace: in the April-through-September period, it was chugging at more than 3% annual growth. Yet the Core PCE Index, its preferred inflation measure, hasn't been close to the 2% target for nearly a year, despite unemployment receding to 4.1%.

Some argue that slack remains in the labor market. The labor participation rate is still at four-decade lows. And, as Deutsche Bank's Torsten Slok points out, the main reason long-awaited wage growth has been slow to materialize is that people have been more or less steadily returning to the labor market since 2013, easing the pressure on employers to hike salaries. Given the economy's momentum, the Fed expects the labor market to tighten further, forecasting 2018 unemployment of 3.9%.

The tax reform and the White House's deregulation efforts create tailwinds for employers to invest in both labor and capital. Major companies, including AT&T, Comcast, Fifth Third Bancorp, The Home Depot, and Walmart, among others, have already declared increases in entry-level salaries, bonuses, or investment spending. Critics of the reform point out that major companies already had a lower effective corporate tax rate thanks to loopholes and accounting wizardry. But proponents note that smaller businesses, which account for about half of private sector payrolls and nearly two-thirds of net new jobs, should benefit from lower taxes and a more level playing field. All in all, as the Fed's out-going Janet Yellen noted in her last remarks as chairwoman to the press, the tax overhaul should lower the cost of capital, stimulate investment, increase productivity growth, and raise potential GDP. Lifting long-stagnant productivity growth is the key to lifting wages, and, potentially, inflation.

After the December policy meeting, Yellen also pointed out that the *Tax Cuts and Jobs Act* has "some potential to boost aggregate supply." It's definitely a supply-side reform. At 35%—or 39% including state taxes—the nominal U.S. corporate tax rate was the highest in the developed world. It created an incentive for U.S. companies to relocate to more competitive tax jurisdictions via mergers called tax inversions. The reform reduces the rate to 21%, three points below the average statutory corporate tax rate in the Organization for Economic Cooperation and Development. Businesses will also enjoy an immediate write-off on capital investments, and the corporate alternative minimum tax has been eliminated.

The reform also moved the U.S. from a world-wide taxation system, in which U.S. firms were effectively taxed at the previous U.S. rate on their foreign income, to a territorial system, which only taxes income earned within a country's border. That's how most countries handle their multinationals' foreign earnings. As a result of the U.S.'s previous high corporate tax and world-wide taxation approach, some $2.6 trillion in corporate profits are parked overseas. As part of the reform, U.S. firms will be taxed on those foreign earnings at a 15.5% rate, and an 8% levy on other, illiquid assets abroad. U.S. banks, tech and pharmaceutical companies with world-wide operations will be hit with billions of dollars in one-off charges. As noted, many had a lower effective tax rate, and so won't see as much benefit from the tax reform as their smaller domestic peers. Yet by forgoing convoluted, tax-driven domicile and financial engineering strategies, over the long run they could also come out more or less even, or potentially ahead with the lower domestic corporate tax rate and territorial tax system.

On the individual side, most people making tax payments will see tax cuts over the next few years, though after 2021, the Joint Committee on Taxation warns some low-income taxpayers might effectively see a net tax increase due to the elimination of the Affordable Care Act's individual mandate and subsequent cut in health insurance subsidies. They number an estimated 5%. In 2019, nearly a quarter of the aggregate tax cut—about $61 billion, or an average cut of $1,600—will go to middle-income earners making between $20,000 and $100,000 and representing about half of all tax filers. Given the progressive structure of the tax system, the bulk of the tax cut will go to higher-income groups, with 52% headed for those with incomes of $100,000 to $500,000. Around 23% will go to the "one-percenters" making more than $500,000 per year.

As for the debate over the contribution to GDP growth from increased personal consumption as a result of more disposable income through the tax cut, it's worth noting that, at 2.9% in November, the U.S. personal savings rate is at its lowest level in a decade. Higher-income groups might

save or invest more of the tax savings than spend it. In any event, the Conference Board's Consumer Confidence Index rose to its highest level in November since 2000. Animal spirits have also been stoked, with the National Federation of Independent Business Optimism Index nearing a record high in November, a level it nearly matched in December and making 2017 the highest year on record. Investors clearly like what they see in the tax reform, driving U.S. bluechip equity indices to record highs in anticipation of the tax reform, and in the weeks following it, as well.

As a bottom-up investment shop, Thornburg factors tax rates into its model assumptions as just one element of its fundamental securities analysis. Thornburg's Christian Hoffmann, CFA, Rob McDonald, CFA, and Nicholos Venditti, CFA, weigh in on the discreet impacts the tax reform should have in particular sectors of the market and for investors.

Q: The spread between 10-year and two-year U.S. Treasuries has compressed since the beginning of 2014, shortly after the Fed first flagged the "tapering" of quantitative easing and subsequent, albeit gradual, rate hikes. Historically, a flattening yield curve often portended an inversion in the curve, followed by recession. Do current economic conditions and the tax reform suggest that this time is different? Also, after considerable tightening in high-yield and high-grade corporate spreads in 2017, how much lower can spreads go in 2018, especially given liquidity risks associated with the Fed's monetary tightening.

Christian Hoffmann: Undue emphasis on any one data point or ratio ignores the complexity and interconnectivity of the global economic landscape. Much has been made of the flattening yield curve, but the flattening has been driven by rising short-term rates, which have been driven by Fed actions that the vast majority of investors believe are long overdue. Interestingly, the 10-year Treasury ended 2017 almost exactly where it started the year.

The Fed increasing short-term rates should assuage inflation fears, which are most apparent in the longer end of the yield curve. It's worth mentioning that investors are still taking a relatively sanguine perspective toward inflation risk and that at the margin, tax reform should be more inflationary than deflationary.

Another factor to consider is the global marketplace for assets. Compared to the vast majority of the world, Treasuries still offer compelling relative value among government debt issuers—remember that 10-year German bunds yield not even one-fifth of 10-year Treasury yields.

The world of early 2018 points to an environment of reasonable global economic growth and subdued inflation. On the other hand, valuations for most assets—including U.S. high-yield and investment-grade debt—are on the richer end of fair value. The margin for error appears limited. It seems fairly clear that we are in the later innings of an economic cycle, and there is virtually an endless list of events that could disrupt-to-negatively shock the marketplace.

Q: In recent years, U.S. businesses have benefited from the "bonus depreciation deduction" of 50% on new equipment, and aggregate non-residential fixed investment has in fact been growing since mid-2016. While the reform's 100% expensing of capital investment over the next five years will include both new and acquired equipment, do you expect much of an increase in aggregate corporate investment?

Rob McDonald: I would expect a modest increase in corporate investment due to the change in tax treatment for equipment. The tax law change will pull forward some purchasing that would have taken place at a future date. On the margin, overall equipment demand could increase a little—equipment purchases that didn't quite make the return hurdle historically—may make sense post tax reform.

Q: Do you anticipate a decrease in tax inversions, given the lower U.S. corporate income tax rate and the move to a territorial from a worldwide taxation regime?

Rob McDonald: I would expect a decline in tax inversions going forward. The government has tried to prevent companies moving abroad for some time. This tax reform plan decreases the attractiveness of domestic companies moving out of the United States.

Q: The U.S. retail sector pays an average corporate tax rate of about 31%, as retailers generally import many of their products and can't deduct much from research and development initiatives. So the sector, much of which has come under pressure from the "Amazon Effect," stands to benefit. Do you expect retailers to lower product prices to better compete, or do you think they might generally use the tax savings to pay down debt, invest or return more of it to shareholders?

Rob McDonald: In thinking about financial impacts of tax reform, the first question is how much a company's tax rate will decline. The second question is, can that company keep the savings or does it have to give it to customers? Retail is a tough business, where you have to evolve or die. Some of the tax savings will have to be passed along to consumers through lower product price or investments in stores.

Q: The net interest deduction is now capped at 30% of EBITDA for four years, and 30% of EBIT thereafter, ending the full deduction of interest payments. Do you expect that this will push more companies, particularly non-investment-grade corporates that are generally subject to higher interest rates on debt issued, to finance themselves less with debt versus equity going forward?

Rob McDonald: The new tax law will push company capital structures to a higher mix of equity and lower debt.

Q: In the prelude to the tax reform, the municipal bond market saw a gusher of issuance, with sales of both refinancing and new paper in December alone totaling approximately $64 billion, a record high. Prices plunged relative to U.S. Treasuries on the supply wave, only to climb back up as investors snapped up the lower-priced munis. In

its final version, the tax reform did away with the exemption on advance refunding bonds, which cities and states use to refinance older debt, but retained the exemption on private-activity bonds, which non-profits and some for-profits turn to for projects deemed of public benefit. Are fears of less muni market supply ahead as a result of the end of advance refunding bonds warranted? Also, marginal rates on top earners, although a bit lower with the tax reform, are still relatively high. Coupled with the new $10,000 limit on state and local tax (SALT) deductions for married couples (and $5,000 for individuals), do you expect more taxable income to shift to low or no income tax states from high tax states?

Nicholos Venditti: I am not convinced that the elimination of advanced refunding bonds will have a material impact on supply in the short term. While it is certainly true that refunding bonds have been a major driver of supply over the past several years, it is important to remember that the economic benefit of refunding debt is predicated on lower interest rates. To the extent that we believe rate pressure is shaded higher, the market likely would have seen substantially less advanced refunding issuance in the near term, regardless of tax reform.

The issue of outmigration is more interesting, albeit a longer-dated problem. Demographic trends have long been a cornerstone of credit analysis. Population declines have had a material impact on issuers in the past, largely due to the death of manufacturing. The financial problems in places such as Detroit, Buffalo, steel towns in Pennsylvania, and even Puerto Rico, all have been exacerbated by loss of the tax base. An increased tax burden that encourages people to vacate for greener, or in this case cheaper, pastures is absolutely a possibility.

But the SALT limit and a lower cap on mortgage interest deductions actually make munis that much more attractive for high-income individuals. And that, in turn, partially offsets the negative impact that the lower corporate tax rate has on the muni market, of which banks and property and casualty insurers own roughly 15% and 10%, respectively.

The tax reform's repercussions on relative valuations and risks in the muni and other markets once again highlight the absolute necessity of quality, fundamental research. At Thornburg, we have built a 30-plus-year franchise focused on disciplined, bottom-up analysis and are more than equipped to navigate the changing market dynamics. ■

Fund Holding Weights as of 11/30/17

Thornburg Core Growth Fund: Comcast, 2.05%, Walmart, 2.75%.
Thornburg Investment Income Builder Fund: AT&T, 1.37%; The Home Depot, 2.21%.
Thornburg Limited Term Income Fund: AT&T, 0.80%; Fifth Third Bancorp, 0.08%.
Thornburg Low Duration Income Fund: AT&T, 0.88%; Fifth Third Bancorp, 0.89%.
Thornburg Strategic Income Fund: AT&T, 0.22%; Comcast, 0.92%.
Thornburg Value Fund: Walmart, 4.19%.

Companies mentioned in the article but not listed above were not held in the above-mentioned Thornburg funds as of 11/30/17.

IMPORTANT INFORMATION

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Alternative Minimum Tax (AMT) – A federal tax aimed at ensuring that high-income individuals, estates, trusts, and corporations pay a minimal level income tax. For individuals, the AMT is calculated by adding tax preference items to regular taxable income.

Animal spirits – A term coined by John Maynard Keynes to describe human emotion that drives consumer confidence.

Bond Credit Ratings (Credit Quality) – A bond credit rating assesses the financial ability of a debt issuer to make timely payments of principal and interest. Ratings of AAA (the highest), AA, A, and BBB are investment-grade quality. Ratings of BB, B, CCC, CC, C and D (the lowest) are considered below investment grade, speculative grade, or junk bonds.

Consumer Confidence Index – The Consumer Confidence Index is an index by the Conference Board that measures how optimistic or pessimistic consumers are with respect to the economy in the near future.

Core Personal Consumption Expenditure Index is a measure of the Personal Consumption Expenditure Index that excludes the more volatile and seasonal food and energy prices.

Credit Spread/Quality Spread – The difference between the yields of securities with different credit qualities.

EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization. An approximate measure of a company's operating cash flow based on data from the company's income statement.

NFIB Small Business Optimism Index – The National Federation of Independent Business (NFIB) Small Business Optimism Index is a composite of 10 seasonally adjusted components and provides an indication of the health of small businesses in the U.S.

Quantitative Easing (QE) – An unconventional monetary policy in which a central bank purchases financial assets from the market in order to lower interest rates and increase the money supply.

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share. Forecasted P/E is not intended to be a forecast of the fund's future performance.

Yield Curve – A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

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