

December 28 2017

INVESTMENT IMPLICATIONS OF THE NEW TAX LAW

John Lynch, *Chief Investment Strategist, LPL Financial*Barry Gilbert, *PhD, Asset Allocation Strategist, LPL Financial*

KEY TAKEAWAYS

In this *Timely Topics*, we take a look at a few of the implications of the final tax bill.

The new law is intended to boost economic activity and simplify the U.S. tax code.

Given clarity on the new tax law, we are raising estimates for U.S. GDP and S&P 500 operating earnings for 2018.

After more than a year of political posturing and investor anticipation, Congress finally approved a \$1.5 trillion tax cut, the most sweeping U.S. fiscal overhaul since 1986. The 2017 Tax Cuts and Jobs Act was signed into law by President Trump last Friday, December 22, meeting his pledge to deliver tax reform before Christmas. The complex 1,000-page bill features changes that are intended to spur economic activity through a reduction in both individual and corporate tax rates, and simplify the tax code by eliminating or trimming a variety of deductions and exemptions. In this special commentary, we look at the likely impact of the final bill on the economy, monetary policy, and the financial markets in the coming years.

As we wrote in our [Outlook 2018: Return of the Business Cycle](#) publication, the combination of improved business fundamentals and fiscal legislation should sustain momentum in the economy and equity markets in the coming year and potentially beyond. After years of depending on the largess of monetary policymakers, investors can now focus on fiscal levers that we believe will support consumption and spur new business investment over the next few years. The law has important implications for major corporations, small businesses, and individual taxpayers [Figure 1], and may shift the trajectory for economic growth, the federal budget, monetary policy, and perhaps most critically for investors—corporate profits.

ECONOMY & THE FEDERAL RESERVE

Though much of the political posturing over the past year was a result of the reduction in corporate tax rates, the legislation offers a larger than expected boost to individuals. While higher income earners should experience the largest benefit, the breadth of the individual tax rate reduction may lead to higher levels of consumer spending over the next few years. For example, in 2018, the net tax cut is set to exceed \$100 billion, and as the effects of the alternative minimum tax (AMT) changes settle out in 2019, the consumer windfall could eclipse \$200 billion, or approximately 1.0% of gross domestic product (GDP). Of course, the goal of lawmakers is that the increase in consumption will have a positive feedback loop, generating increases in output, employment, income, and ultimately, tax receipts. Alas, without an increase in productivity, the gains in personal spending are unlikely to be permanent, which is another reason leadership in Washington, D.C. included incentives for business investment as part of the tax package.

SUMMARY: 2017 TAX CUTS AND JOBS ACT

| | Current Law | Final Bill | |
|------------|---|--|--|
| INDIVIDUAL | Top individual tax rate | 39.6% | 37% (until 2025) |
| | Individual tax brackets and rates | 10%: \$0; 15%: \$18,650; 25%: \$75,900; 28%: 153K; 33%: \$233K; 35%: 417K; 39.6%: \$471K | 10%: \$0; 12%: \$19,051; 22%: \$77,401; 24%: 165K; 32%: \$315K; 35%: 400K; 37%: \$600K |
| | Estate tax exemption | \$5.5MM/person | \$11MM/person |
| | State and local tax (SALT) | Deductible | Mostly eliminates; caps property tax/income up to \$10,000 |
| | Mortgage interest deduction | Deductible up to \$1MM mortgage + \$100,000 home equity | Deductible up to \$750,000 of new mortgages; no home equity |
| | Student loan interest deduction | Deductible | No change |
| | Personal exemption | \$4,150/person | Eliminates |
| | Standard deduction | \$6,500 single; \$13,000 married | \$12,000 single; \$24,000 married |
| | Individual alternative minimum tax (AMT) | Includes a \$86,200 exemption + \$164,000 phase-out | Increases exemption to \$109,000 + phase-out to \$1MM |
| | Child tax credit | \$1,000/child | \$2,000/child; refundable up to \$1,400 |
| | Obamacare individual mandate | Penalty of \$695 or 2.5% income for no health insurance | Repeals |
| | Requires first in, first out (FIFO) upon sale | Flexibility to optimize tax harvesting | No change (i.e., no FIFO requirement) |
| | Municipal interest tax exemption | Muni interest exempt from federal taxes | No change |
| | Municipal private activity bonds | Tax-exempt bonds for specific public/private projects | No change |
| | Advanced refunding bonds | Allowable | Eliminates |
| | Capital gains | Long term: 0/15/20% (income dependent); short term: taxed as ordinary income | No change |
| CORPORATE | Corporate tax rate | 35% | 21% (permanent) |
| | Corporate tax rate starts | Not applicable | 2018 |
| | Top pass-through rate | 39.6% | 20% deduction for certain income until 2025 (with caveats) |
| | Corporate AMT | 20% tax to broadly defined alternative income | Repeals |
| | Expensing | 50% expensing through 2020 | 100% expensing through 2023 |
| | Interest expense deductibility | No limit | Limits to 30% EBITDA until 2021; 30% EBIT thereafter |
| | Net operating losses | Allows carry backs 2 years; carry forwards up to 20 years | Eliminates carry backs; indefinite carry forwards (with caveats) |
| | Taxation of foreign income | Worldwide (though only taxable when repatriated) | Territorial; 100% exemption |
| | Deemed one-time repatriation tax | Not applicable | 15.5%; 8% illiquid |
| | Carried interest | 1-year holding period (minimum) | 3-year holding period (minimum) |
| | Minimum taxes from income | Not applicable | 10% tax on high-return income; increase to 12.5% in 2025 |

Source: LPL Research, Joint Committee on Taxation, Senate Finance Committee, House Ways and Means Committee, PIMCO 12/26/17

Indeed, the corporate tax rate has been lowered from 35% to 21%, bringing the United States more in-line with the rates charged to businesses in other developed nations (compared to the average of 22% for OECD member countries, which includes most major developed economies). Assuming the net benefit to corporations averages approximately \$80 billion per year over the next four years, the logical next question would be what we expect them to do with the additional income.

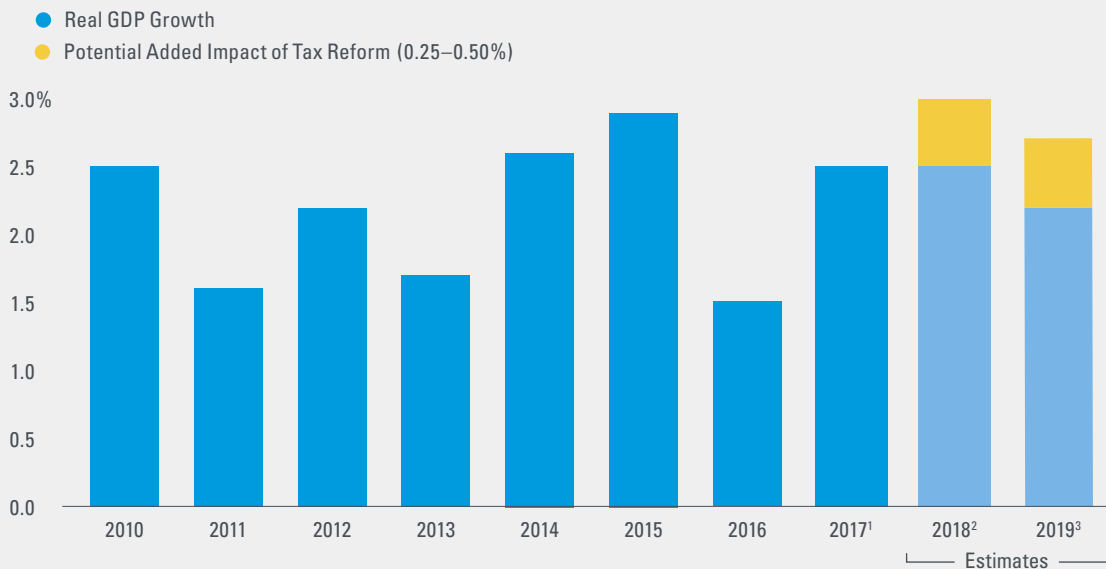
Ideally, the majority would take advantage of the 100% expensing provision for investments in property, plant, and equipment, as highlighted in our *Outlook 2018*, yet economic growth below the long-term trend suggests not all business leaders will be confident enough to take these “economic” steps. Instead, it is likely that many companies (we estimate up to one-half) will still choose the path of least resistance and choose “financial” steps, using the cash to buy back shares or increase

dividend payouts. The other \$40 to \$50 billion or so, we estimate, will be used for the “economic” steps of capital expenditures, further propelling business investment and restoring investment to its more central role in driving the business cycle.

GDP and Interest Rates

We believe the combination of improved personal consumption and capital spending from the tax legislation could add anywhere from +0.25% to +0.50% to our original forecast of +2.5% in U.S. real GDP growth in 2018 compared to the 2.2% average during the expansion [Figure 2]. To be sure, the U.S. economy is entering 2018 with a fair amount of momentum, led by consumption and employment. Though housing in high-priced states may flatten, recent Institute for Supply Management (ISM) readings on manufacturing and services have displayed some of the best levels in more than a dozen years. Moreover, the weaker

2 SIGNING OF TAX BILL INTO LAW MAY ADD 0.25–0.50% TO 2018 AND 2019 GROWTH ESTIMATES



Source: LPL Research, Bureau of Economic Analysis, Bloomberg 12/26/17

¹2017 uses actual data for the first three quarters combined with the Bloomberg-surveyed consensus estimate for the fourth quarter.

²2018 is LPL Research’s *Outlook 2018* estimate, with the added section representing the potential impact of the tax bill.

³2019 is the Bloomberg-surveyed consensus, with the added section representing the potential impact of the tax bill.

The 2018 & 2019 estimates may not develop as predicted.

dollar in 2017 may support export growth, although dollar strength in 2018 may limit the effect. In addition, government spending, particularly on defense, is poised to potentially accelerate.

Considering the fiscal incentives and an already solid economy, the Federal Reserve (Fed) may feel the need to raise rates more frequently than our projected three hikes in the coming year. If the best case projections of the tax changes are realized in the next two years, readings on GDP, employment, and inflation could exceed current consensus forecasts. We believe wage growth should prove the key determinant for policymakers in 2018, though, as inflation has thus far failed to reach the central bank's target rate this cycle. It should be emphasized that wage growth is only up about 2.5% year-over-year and well below the greater than 4.0% pace that has historically caused the Fed to raise interest rates aggressively to get ahead of the imminent inflationary threat.

Other factors monetary policymakers may consider include dollar strength, inflation expectations, the geopolitical environment, financial conditions, and financial market behavior in the coming year. While these items are not part of the Fed's official mandates of full employment and low inflation, we believe the scope of the central bank's considerations have widened heading into 2018, particularly since the financial markets typically "test" new Fed chairs, and midterm election years in the past have shown increases in financial market volatility, which could give policymakers reason to pause. We continue to believe the Fed's path for balance sheet reduction of approximately \$300 billion in the coming year will remain unchanged.

Federal Deficit

At the conclusion of its fiscal year 2017, the U.S. government ran a deficit of \$666 billion—devilishly high and an ongoing concern. This shortfall registered at 3.4% of U.S. GDP and brought the total debt held by the public up to \$14.7 trillion, or 76.5% of GDP, according to the Congressional Budget Office (CBO). A static scoring analysis by

the Joint Committee on Taxation (JCT) and the CBO suggests the new tax law will reduce revenue by ~\$1.65 trillion and decrease outlays by ~\$195 billion from 2018 to 2027, leading to an increase in the deficit of ~\$1.45 trillion over the next 10 years, while dynamic scoring (which adjusts for added growth) puts that level closer to \$1 trillion. Proponents of the fiscal legislation see prospects of a greater offset due to improvements in economic output, incomes, profits, and ultimately, tax revenue, which could serve to reduce the longer-term deficit figures further.

FIXED INCOME

When considering the overall environment for bond investors, the new tax law adds to our concerns previously highlighted in our *Outlook 2018*, including a less supportive Fed and a potential rise in inflationary pressures.

Investors in the U.S. Treasury market face several challenges, including a Fed that is no longer backstopping Treasury auctions, higher issuance of federal debt to support deficit spending, and the inflationary risk associated with stronger economic growth.

- Although he has not yet been confirmed, Jerome Powell, the presumed successor to Fed Chair Janet Yellen, announced plans in recent congressional testimony to raise the target for the fed funds rate at a gradual pace in 2018. Moreover, the central bank's plan to stop reinvesting proceeds of maturing securities on its balance sheet should result in "runoff" of approximately \$300 billion in 2018.
- The U.S. Treasury will need to increase issuance of debt in order to make up for the potential initial loss in tax revenue as the economy adjusts to the new dynamic. Though only time will tell what the additional tax revenue from the supply-side benefits of the legislation will be, the immediate need to fund U.S. government activities and programs is likely to result in

further deficit spending, which has historically resulted in bond investors demanding higher yields (by paying lower prices) for the extra risk of increased Treasury issuance.

- Improved consumer demand and business investment could fuel increased economic activity, supporting GDP growth and corporate profits. Yet this growth is typically associated with higher costs, rising wages, and inflationary pressures, which can diminish the value of fixed income investments.

We believe these dynamics will combine to pressure bond prices in the next few years. For 2018, we maintain our estimated range of 2.75% to 3.25% for the benchmark 10-year Treasury yield.*

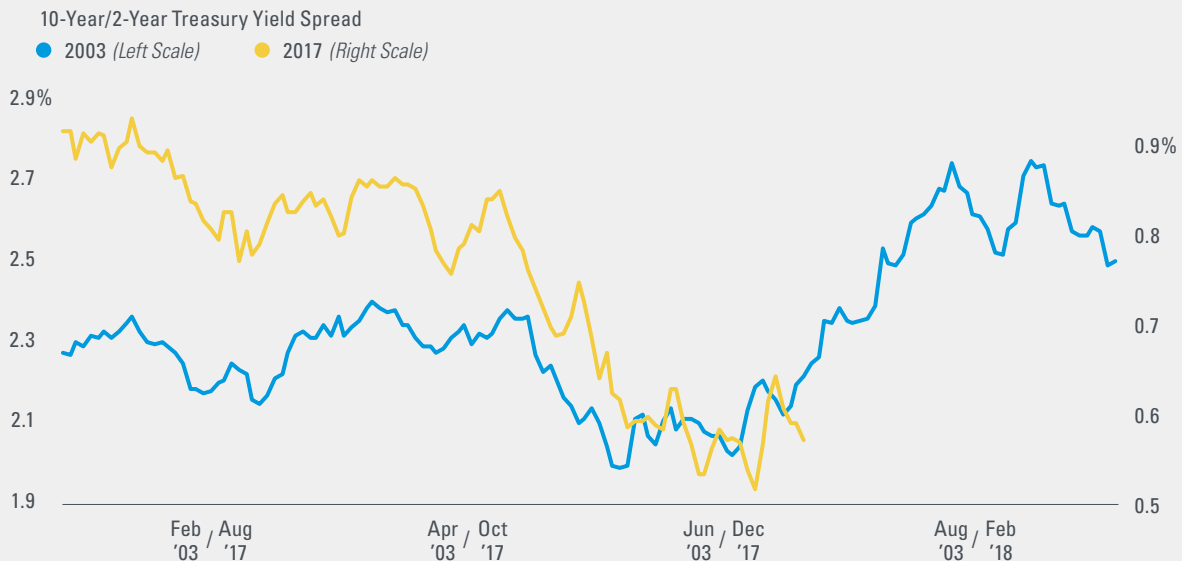
While global investors may continue to find relative value in the benchmark 10-year Treasury, supporting demand and putting some downward pressure on rates, we suspect the degree of dollar strength will ultimately determine whether this trade persists, as global investors must consider the currency impact on dollar-denominated investments. Even with recent dollar weakness, any move near a 3.0% yield for the 10-year Treasury will likely attract global interest, in our opinion, potentially limiting the risk of a move above our target range.

Nevertheless, we think investors should be mindful of some risk to the upside for rates. While the yield curve (the difference between long-term and short-term rates) has not seen any real steepening due to

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

*As noted in our *Outlook 2018: Return of the Business Cycle*, we forecast flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index, based on our expectations for a gradual pickup in interest rates across the yield curve. We also expect the 10-year Treasury yield to end 2018 in the 2.75–3.25% range, based on our expectations for a modest pickup in growth and inflation.

3 YIELD SPREAD RESPONSE TO TAX CUTS WAS INITIALLY MUTED IN 2003 TOO



Source: LPL Research, Strategas Research Partners 12/26/17

The 2003 tax cuts were signed into law by President Bush on May 28, 2003.

Performance is historical and no guarantee of future results.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread (yield advantage), the greater the difference between the yields offered by each instrument.

the new law as it worked its way through Congress, the yield curve response was delayed following the 2003 Bush tax cuts [Figure 3]. If the Fed should hike rates three times in 2018, current spreads would put the 10-year Treasury yield near the upper end of our range. Our base case is for only slight yield curve steepening given the likelihood of foreign buying, but bond investors should be prepared to ride out a larger move.

Muni Bonds

Investors in the municipal bond market should also expect to confront some challenges, and some benefits, from the new fiscal dynamics. Uncertainty during negotiations over the new law resulted in heightened volatility in the Bloomberg Barclays Municipal Bond Index these past few months. Specifically, investors were concerned about the tax-free status of private activity bonds (PAB) and advance refunding bonds, along with the potential impact of lower tax rates. The new tax bill allows for the tax-free treatment of PABs, but not for advance refunding bonds issued after December 31, 2017.

We believe the dynamic tension between the forces of supply and demand will be on full display for the tax-advantaged bond market in the coming years. Since the tax reform discussions pulled issuance forward into 2017, we could see a slowdown in municipal issuance next year, easing supply concerns. The lower individual tax rates may limit demand from top income earners, but the changes to state and local tax (SALT) deductions may actually increase demand in some high-tax states.

Corporate Debt

Investors in corporate debt must get comfortable with the changes in interest deductibility. The full deductibility of corporate interest is now limited to 30% of earnings before interest, taxes, depreciation, and amortization ("EBITDA"). While limits on the deductibility of interest expense is a negative for corporate debt, some of that can be offset by the positives of lower overall corporate

tax rates, the full expensing of capital expenditures, and other provisions within the bill.

- The impact of the deductibility provision is more negative for firms with increased leverage as there is larger relative loss from the deductibility limitation. Firms with the lowest quality debt are likely to feel the impact more severely than those companies with higher quality debt.
- The tax bill may slightly reduce issuance for corporate debt in the coming year, though it was forecast to be lower anyway, due to the record investment-grade issuance in 2017.
- Firms that repatriate cash may use some funds to buy back corporate paper to lower their debt levels, further reducing supply as demand for yield is expected to persist.

We believe demand for both investment-grade and high-yield corporate debt should remain robust amid the near historically low yields on government debt globally. We continue to favor higher-quality investment-grade corporate debt for suitable investors, and we encourage those investors who pursue high-yield bonds, which do offer added yield, to monitor overall portfolio risk levels. Fixed income exposure within a diversified portfolio can continue to play an important role, providing the potential for liquidity, yield, and smoothing out volatility during periods of weakness in the equity markets.

EQUITIES

As we wrote in our *Outlook 2018*, corporate profitability will likely be a significant beneficiary of any meaningful change in the corporate tax rate. Indeed, the reduction of the corporate tax rate from 35% to 21%, combined with businesses' ability to fully expense their capital expenditures for the next five years, are powerful tailwinds for profits, which have already enjoyed a renaissance in 2017, powered by improved domestic and global demand. We believe this will help elongate the expansion, which has thus far been powered by the U.S. consumer. Going forward, we look

for business investment and further gains in corporate earnings per share (EPS) to power the economy and equity markets.

Given the potential for an extended expansion due to the new tax changes, we encourage all diversified investors to remain diligent relative to their targeted allocations. To be sure, 2017 was a year of extremely low volatility and the coming year may not be as docile, particularly when considering the historic examples of financial markets tending to test new Fed chairs, as well as the volatile trading patterns leading up to midterm elections. But given solid global growth and firming corporate profits, we recommend that any market pullbacks be considered as an opportunity to deploy cash or rebalance back toward targeted allocations.

Size, Style, and Sector Implications

Entering the ninth year of this expansion, our view continues to favor small cap and cyclical exposure. Specifically, we prefer a slight overweight (relative to benchmarks) of small cap stocks and, despite the recent momentum supporting growth stocks, are positioning portfolios for a tilt toward the value

style of investing. Small caps may benefit from the new law due to a typically higher tax burden relative to large caps [Figure 4]. Small caps would also be more likely to benefit should the dollar push higher due to the pickup in economic growth, since their more domestic focus makes them less vulnerable to the negative impact of a rising dollar on international profits.

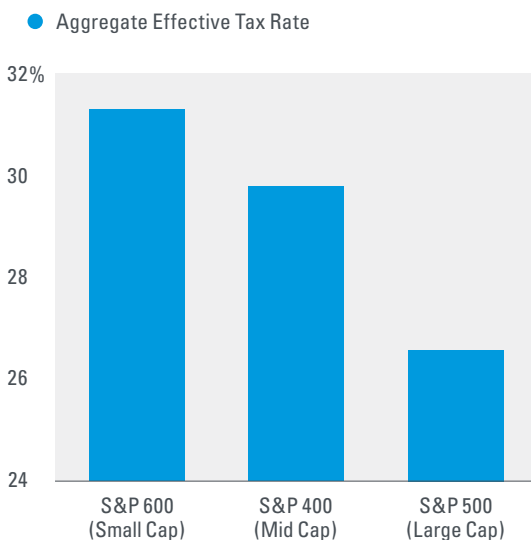
We also believe the value style of investing should benefit from the new fiscal legislation. As investors search for opportunities, the recent gains in the price-to-earnings ratio (PE) for growth stocks should attract the attention of value seekers. The tax advantages combined with relative value should enable the value style to garner added attention, especially since many value names are in sectors that are poised to benefit from tax cuts, infrastructure spending, and reduced regulation.

The financial sector, typically exposed to higher tax rates, will be a primary beneficiary of the reduced corporate rate. In addition to fiscal policy changes, financial stocks may benefit from monetary policy in two separate ways. First, if economic growth lifts the yield on longer-dated Treasuries, it should help boost the spread between deposit and lending rates, known as net interest margin, which is a primary driver for bank profitability. Second, the new vice chair of supervision at the Fed, Randal Quarles, indicated a preference for less stringent regulatory burdens in his confirmation hearing, potentially freeing up more capital for lending in the coming years.

The industrial sector, which tilts toward the value style as well, may also benefit from a combination of lower taxes, infrastructure outlays, helped by 100% expensing, global growth, and increases in U.S. government defense spending.

Finally, the technology sector remains an overweight recommendation among growth-oriented sectors, despite its 2017 gains, given the combination of solid global demand and the large trove of profits held overseas that now have the opportunity for repatriation at attractive rates.

4 SMALL CAPS MAY BENEFIT MORE FROM TAX RELIEF DUE TO A HIGHER EFFECTIVE TAX RATE



Source: LPL Research, Strategas Research Partners 12/26/17

Repatriated profits can then be used for either capital investment or shareholder friendly share buybacks or dividend payouts.

Raising Profits Forecasts

Considering the changes in the tax law and the likely boost to corporate profitability, we have decided to raise our operating earnings forecast for companies in the S&P 500 Index by \$5.00 per share, from \$142.50 to \$147.50 in 2018. Assuming a trailing 12-month PE of 19–20, we believe the S&P 500 would be fairly valued in the range of 2,850–2,900 by year-end 2018. This represents a move of approximately 8.0% from current levels, not including dividends, as stocks have already begun to price in tax reform during the fourth quarter of 2017. We appreciate that this market PE remains above historical averages, but we view the market multiple relative to interest rate and inflation levels, which we expect to remain well below their typical norms over the course of the next year, likely boosting the amount the market is willing to pay for each additional dollar of earnings.

CONCLUSION

It's been our view since the election that the combination of a Republican president with a Republican Congress had a high chance of passing some form of tax relief, whether it be in

the form of tax cuts or more comprehensive tax reform. Early legislative setbacks led us to push back our timeline, but we remained confident that a tax bill would find its way to the president's desk. While the accelerated legislative process that led to the president being able to sign the bill into law on December 22, 2017 was a surprise to us, it does not substantially change our views.

The biggest impact of the accelerated timeline is decreased uncertainty, allowing individuals and businesses the opportunity to begin planning around the changes and pulling forward the new law's impact. As a result, we have upgraded our economic growth path to 2.75–3.0%, maintained our bond market view though we see greater risk to the upside for rates, and upgraded our S&P 500 target to align with our view of the law's expected impact on corporate earnings. Our upgraded S&P 500 target keeps our broad return expectations for 2018 at approximately 10% including dividends. While the new law should help provide fiscal support for the economy as monetary support is withdrawn and helps decrease the chance of recession in 2018 and even in 2019, we still expect to see market volatility increase from the extraordinarily low levels that persisted in 2017. But nevertheless, for markets and the economy, we believe the new law provides a firmer launching point as we enter the new year. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual security. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

There is no guarantee that a diversified portfolio will enhance the overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

All investing involves risk including loss of principal.

DEFINITIONS

Small cap is a term used to classify companies with a relatively small market capitalization. The definition of small cap can vary, but it is generally a company with a market capitalization of between \$300 million and \$2 billion. The prices of small cap stocks are generally more volatile than large cap stocks.

INDEX DESCRIPTIONS

The Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indexes are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The S&P Midcap 400 Stock Index is an unmanaged index generally representative of the market for the stocks of mid-sized U.S. companies.

The S&P Small Cap 600 Index is an unmanaged index generally representative of the market for the stocks of small capitalization U.S. companies.

This research material has been prepared by LPL Financial LLC.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 2994 1217 Intended Audience: Advisor and Client Use Tracking #1-681414 (Exp. 12/18)