Economic Views Brief

Russell T. Price, CFA®, Senior Economist
Justin H. Burgin, Director of Equity Research
Brian Erickson, CFA®, Director of Fixed Income Research

December 21, 2017

TAX REFORM CROSSES THE FINISH LINE

*This Brief is intended to be a high-level commentary on the broad economic and financial market effects of the recently enacted **Tax Cuts and Jobs Act**. No two tax situations are the same, and our analysis of the legislation is in no way intended to be an evaluation of the legislation's impact on the tax situation of any specific business, individual or specific groups of individuals. Please consult your tax advisor as to how the legislation may affect your personal situation. Please also see the most recent commentary from Ameriprise Chief Market Strategist, David Joy, for additional insights as to the potential impact on financial markets.*

- We forecast the "Tax Cuts and Jobs Act" could boost U.S. Real Gross Domestic Product (GDP) growth by approximately six tenths of a percent in 2018, and four tenths in 2019. (See GDP chart at top of page two.) Actual GDP results could be much higher as a result of a technical issue related to trade.
- Many of the tax provisions (both individual and business) contained in the Act expire at various points within the 10-year window of the legislation. However, the lower corporate rate of 21% (versus a prior top rate of 35%) is permanent, as is the shift to a territorial corporate tax system.
- In our view, corporate earnings per share (EPS) could benefit materially from the lower corporate tax rate. We estimate companies of the S&P 500 could see an incremental 8% to 10% boost to their EPS in 2018, all else remaining equal. Investors could further benefit via higher share repurchases and dividend payouts as a result of the adjusted treatment of repatriated earnings.

Individuals: From an economic perspective, we anticipate consumers will benefit under the legislation from three angles: lower paycheck withholding rates (Republican House leaders estimate new IRS withholding schedules could be available by February), the potential wealth-effect to investors from higher equity market prices and capital returns, and potentially higher tax rebates /lower tax bills when 2018 taxes are filed in early 2019.

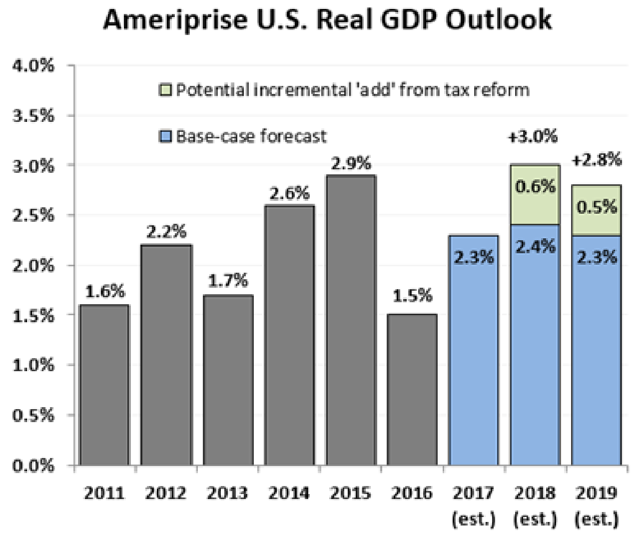
Businesses: We see reforming the corporate tax code as the primary, long-term matter of importance under this legislation. Over the past few decades, most other developed countries have enacted serious corporate tax reforms; changes that have left the U.S. code in a position of being uncompetitive. This has been most apparent over the last decade by the number of companies that have relocated their headquarters or revenue-generating intellectual property (such as patents or copyrights) to tax advantaged jurisdictions.

We anticipate the economic impact from the corporate code changes to evolve slowly. Business investment and hiring decisions are driven by the demand companies experience for their goods and services. Demand driven investment decisions often take many quarters or years to plan, prepare and implement. As such, we expect to see an acceleration of business investment spending in 2018, incremental to the gains we had previously forecast, but we anticipate the incremental increase to be modest.

Economic Impact: *Russell Price, CFA, Senior Economist*

The pace of U.S. economic activity could see a material boost as a result of the tax reform legislation. Previously, based on the House version of the bill as passed in early November, we estimated a 0.4% positive benefit for 2018. Based on the final version, we now estimate the boost for 2018 to be approximately +0.6%.

The legislation should impact economic activity via two primary avenues: higher consumer spending as a result of higher after-tax income, and higher corporate investment due to a more competitive U.S. corporate tax code and a modest expansion of previously existing business investment incentives.



Source: Actuals via U.S. Commerce Department, estimates via American Enterprise Investment Services Inc.

<u>Economic growth *could* be much higher.</u> Some researchers have pointed out that U.S. trade figures could see a significant change in consideration of the legislation's potential impact on corporate behavior as it pertains to transfer pricing. In a nutshell, transfer pricing is when a company has a patent or trademark that generates revenue and they shift ownership of such to a subsidiary in a low tax jurisdiction to lower their tax bill.

Under the new legislation, U.S. tax rates are much more competitive and it puts new taxes and impediments in place to discourage companies from doing this. How would this affect trade? If the patent (or other intangible asset) were shifted back to the U.S., the revenues associated with it would shift from being seen as an Irish export (for example) to that of a U.S. export – thus reducing the U.S. trade balance.

An analysis of the issue by economists at the University of Minnesota, and detailed in *The Wall Street Journal*, suggested that a reversal of this practice could possibly cut the U.S. trade deficit in half, thus boosting U.S. Real GDP results by 1.0% or more. A similar analysis by Deutsche Bank estimated the impact could boost GDP by 1.4%, according to the *Journal* report, and Kevin Hassett, Chairman of the President's Council of Economic Advisors, estimates the provision could boost GDP by 0.7%.

It is very important to note, however, that this change would represent a paper-only gain. In other words, although real GDP could conceivably surge to over +4% in the short-term, it would not affect actual end-demand in the economy, thus there would be no impact in labor markets, inflation or interest rates, via this issue independently.

Overall, we believe the tax reform legislation is likely to have a positive impact on near-term economic activity. However, stronger growth at a time when labor markets are already tight may add incrementally to inflation pressures. A further acceleration of inflation could entice Federal Reserve officials to hike their ultra-short interest rate targets at a faster pace than is otherwise already expected, thus offsetting some of the bill's economic benefits.

Equity Market Sector Impact: *Justin H. Burgin, Director of Equity Research*

On a sector basis, we see the new tax legislation as offering a potentially positive impact on share-holder returns from three perspectives: a lower statutory tax rate, capital returns due to the treatment of repatriated profits, and immediate expensing for domestic investment spending.

A lower statutory tax rate for U.S. corporations: The U.S. had one of the highest corporate tax rates in the world. For perspective, the U.S. had the fourth highest rate among the 202 countries evaluated by the Organization for Economic Co-operation and Development (OECD), and its top rate of 35% was well above the OECD average of 22.9%, according to the Tax Foundation, an independent non-profit group.

The tax reform legislation lowers the corporate tax rate from 35% to 21%. The 'effective' rate companies were actually paying, however, was already much lower than statutory rate of 35%, according to the Treasury Department. The lower rates were partially achieved by utilizing normal deductions and credits, but many companies also utilized such strategies as offshoring, transferring intellectual property (patents, trademarks, etc.) to low-tax jurisdictions, and /or not repatriating foreign-generated profits. As such, lowering the rate and eliminating many of these loopholes or adverse incentives should make the corporate system much more efficient and effective, while lifting the competitive position of the U.S. economy.

As seen in the data at right, certain sectors, particularly those with high overseas sales such as the Technology sector, experienced much lower effective tax rates (ETRs). In many cases, the lower rates were at least partially achieved by leaving profits overseas (thus not paying any U.S. taxes on the profits). In short, sectors that previously experienced the highest effective tax rates (i.e., Telecom and Industrials) could be well positioned to benefit from the new low rate. Nevertheless, tax considerations are but one component of a well-rounded investment thesis. Although investors should consider the impact on profitability from the new tax law changes, this should not be the only criteria used in determining sector weight allocations.

Effective Tax Rates by Sector

Technology	23.2%
Health Care	24.1%
Materials	26.1%
Energy	26.5%
Discretionary	26.9%
Financials	28.8%
Utilities	29.3%
Staples	29.5%
Industrials	30.0%
Telecom	33.2%
Real Estate	N/A

Trailing 12-month data, excludes certain companies
Source: FactSet, American Enterprise Investment Services Inc.

Freeing up foreign-held profits: Changing the treatment of repatriated earnings was a major component of the legislation where untaxed foreign-generated profits will face a one-time tax of 15.5% on liquid assets (i.e., cash) and a rate of 8% on non-liquid assets. This is an important issue for investors as U.S. companies held an estimated $2.6 trillion in untaxed profits outside the U.S. as of Q1-2017, according to the research firm, *Capital Economics*. Under the prior law, U.S. companies were required to pay U.S. taxes on foreign-generated profits (at the corporate rate of 35%), but not until the profits were brought back to the U.S. (i.e., repatriated). As such, rather than lose more than a third of their assets, companies were incentivized to keep the money overseas – much to the advantage of foreign countries when companies made investment decisions.

Ironically, the two sectors that could benefit the least from a lower statutory rate (i.e., Technology and Health Care), are also most likely to benefit from a lower tax on repatriated earnings, in our view. Specifically, based on information contained in individual company quarterly financial filings, we estimate the Technology and Health Care sectors combined account for approximately 70% of the offshore cash/equivalents for U.S. corporations. We believe repatriated cash could be used in the following ways:

- Debt Retirement: Under the "old" tax structure, Technology companies issued debt to fund share buybacks and dividend payments as the foreign held cash was unavailable without paying the repatriation tax (remember that dividends and share buybacks are required to come from domestic cash balances). With foreign cash now freely available, many of these companies will likely pay down their debts. To illustrate the growth in debt, four Technology companies with the largest offshore cash holdings cumulatively hold $301 billion in total debt (latest quarter) versus $73 billion four years ago. Note the average debt-to-asset figure for these four companies also moved higher from 16% four years ago to 34% in the most recent quarter.

- Domestic Mergers & Acquisitions (M&A): In addition to becoming more diversified, domestic acquisitions could enhance shareholder value through positive cost synergies and earnings accretion. Although total M&A has slowed yr/yr in 2017, we believe the uncertainty regarding tax reform was a contributor and thus we anticipate a rebound in the deal count for 2018.
- Share Buybacks: We believe companies could become even more aggressive in their share buyback activities. All else being equal, the same level of profits spread over fewer shares outstanding simply elevates earnings per share even with no change in existing P/E multiples.
- Dividend Increases: Although we believe significant dividend increases could be somewhat muted over the near-term, repatriated cash could support the longer-term trend for continued dividend increases. Nevertheless, the influx of cash could generate a higher number of one-time or "special" dividends as a way of returning cash to shareholders.

Immediate expensing for domestic property and equipment capital investments: This aspect has not garnered the same level of media attention as the lower statutory rate and repatriation but we believe it is still a significant consideration for equity investors. Under the new tax bill, companies can expense 100% of qualified domestic capital expenditures for the adjusted basis in the first year they are acquired. For most types of equipment, this deduction will be available for capital expenditures made over the next five years. Previously, companies were allowed a 50% bonus depreciation in the first year on capital expenditures, which then returned to a standard depreciation schedule. While the total tax paid for the capital equipment should not change over its useful life (as the new bill simply accelerates the timing of the expense), it does incentivize companies to invest sooner rather than later given the positive net present value of the benefit today versus later years. From a sector perspective, we believe this component of the tax bill should primarily benefit the Industrials and Materials sectors, with more narrowly focused positive implications for sub-sectors in the Technology sector (e.g., semiconductor capital equipment).

Fixed Income Market Impact: *Brian Erickson, CFA, Director of Fixed Income Research*

Corporate Fixed Income Securities: The collective impact on corporate fixed income investors would be three-fold, in our opinion. The first two impact corporate bond fundamentals, while the third shapes the corporate bond landscape.

First, we generally view the corporate tax cut and the reduced hurdle to on-shore foreign earnings as a credit positive, enabling greater access to cash to service and/or pay down debt. Should companies use newly available cash flow to constructively reduce indebtedness or for pragmatic growth, we believe bond investors benefit.

Second, the bill would limit interest deductibility, impacting companies with high leverage and low credit ratings to the greatest degree. Over the first few years, the interest deduction will be limited to 30% of earnings before interest, taxes, depreciation and amortization (EBITDA). A partial offset may come from the immediate, full deductibility of capital investments, that may offer an interim benefit for industries including metals & mining, paper & packaging, and aerospace and defense. These industries are the most capital intensive, typically operate with higher leverage (thus, lower ratings), and utilize assets that otherwise would be depreciated over a long period of time. Collectively, the changes may lead to higher levels of default among speculative grade companies in the next economic downturn than would have occurred without tax reform.

Third, fixed income investors may see lower levels of debt issuance over the next few years as corporations rebalance capital structures (i.e. utilize less debt borrowing) to reflect lower interest deductibility and the resulting higher cost of debt from new tax reform. Therefore, we believe lower supply and the likely support for risk assets in the wake of the new legislation may propel credit spreads to tighten from current levels.

Municipals: Municipal markets are impacted on several fronts. First, the final version of new tax legislation retained the issuance of Private Activity Bonds (PABs) often used to finance hospitals, airport improvements, and university campus projects. We believe this is a significant positive for municipalities and critical to support infrastructure financing. It also retains a meaningful source of new municipal issuance. Advance refunding, where, municipal issues are refinanced before they are callable to save issuers money, becomes uneconomical for issuers, except in very unique circumstances. We believe this provision could increase interest costs for municipal issuers, and could reduce municipal issuance over the next few years as the market transitions from advance-refunding to refunding at a designated call date. As a result, we believe a degree of scarcity may rest at the margin, reducing turnover and adding modestly to illiquidity. In addition, issuers may shift to shorter call protection and lower coupon issuance as a result, increasing the relative value of existing debt with longer call protection and 5% or better coupons.

Next, municipal markets could also see impacts from lower corporate tax rates and limited interest deductibility for corporations. Currently, 29% of municipal debt is held by banks and insurance companies according to SIMFA figures, compared to 41% held directly by individuals, and 24% through mutual funds. With the corporate tax rate falling, we believe bank and insurance buyers may have reduced appetite for tax-exempt investments. We believe reduction in bank and insurance demand could offset the elimination of pre-refunded issuance over the next few years. Further, reduced corporate participation could increase market volatility, especially during periods of outflow from mutual funds or individual municipal investors, as the steady, cross-over investor base reduce their purchases.

Further, we believe two changes to individual tax deductions could soften million-dollar home purchases, especially in high tax states. The reduced ceiling on deductible mortgage interest to mortgage balances $750,000 or less, down from $1,000,000 today, may lead to less appetite for million-dollar homes as buyers trim target price ranges to retain the full deductibility. The impact may be more prominent in high tax states given the $10,000 cap on state and local taxes deductibility, as combined sales taxes and property taxes from high priced homes may exceed the cap even before state income taxes are considered. As a result, municipal credit quality in some affluent areas could see pressure from softer property values over the next few years.

In conclusion, the impact from individual income tax changes are likely to be limited. Individual tax brackets are little changed, leaving tax-exempt demand from individual investors in high tax brackets steady. “Overall, we believe the impact on municipalities may be negative for high tax areas in the near-term, and that municipal bond markets remain an attractive asset class for most investors. The one caveat would be that we anticipate more pricing volatility for the segment and a greater dependence on flows from retail investors.

Summary:

Overall, we take a favorable view of the tax reform bill’s potential implications for the economy and equity markets. Most importantly, we believe the plan makes some necessary changes to the corporate code that could benefit the competitive position of the U.S. economy over the long-term. We are cautious, however, of adding stimulus to the U.S. economy at a time when the labor market is already tight and getting tighter, and growth and inflation seem to be in balance. We could be adding $1.5 trillion to the U.S. debt with some of the benefit potentially lost to inflation, interest expense and /or a stronger dollar.

This space intentionally left blank.

The content in this report is authored by American Enterprise Investment Services Inc. ("AEIS") and distributed by Ameriprise Financial Services, Inc. ("AFSI") to financial advisors and clients of AFSI. AEIS and AFSI are affiliates and subsidiaries of Ameriprise Financial, Inc. Both AEIS and AFSI are member firms registered with FINRA and are subject to the objectivity safeguards and disclosure requirements relating to research analysts and the publication and distribution of reports. The "Important Disclosures" below relate to the AEIS research analyst(s) that prepared this publication.

Each of AEIS and AFSI have implemented policies and procedures reasonably designed to ensure that its employees involved in the preparation, content and distribution of research reports, including dually registered employees, do not influence the objectivity or timing of the publication of research report content. All research policies, coverage decisions, compensation, hiring and other personnel decisions with respect to research analysts are made by AEIS, which is operationally independent of AFSI.

IMPORTANT DISCLOSURES

As of September 30, 2017

The views expressed regarding the company(ies) and/or sector(s) featured in this publication reflect the personal views of the research analyst(s) authoring the publication. Further, no part of research analyst compensation is directly or indirectly related to the specific recommendations or views contained in this publication.

INDEX DEFINITIONS

An index is a statistical composite that is not managed. It is not possible to invest directly in an index.

Definitions of individual indices mentioned in this report are available on our website at ameriprise.com/legal/disclosures/ in the **Additional Ameriprise research disclosures** section, or through your Ameriprise financial advisor.

DISCLAIMER SECTION

Except for the historical information contained herein, certain matters in this report are forward-looking statements or projections that are dependent upon certain risks and uncertainties, including but not limited to, such factors and considerations as general market volatility, global economic and geopolitical impacts, fiscal and monetary policy, liquidity, the level of interest rates, historical sector performance relationships as they relate to the business and economic cycle, consumer preferences, foreign currency exchange rates, litigation risk, competitive positioning, the ability to successfully integrate acquisitions, the ability to develop and commercialize new products and services, legislative risks, the pricing environment for products and services, and compliance with various local, state, and federal health care laws. See latest third party research reports and updates for risks pertaining to a particular security.

This summary is based upon financial information and statistical data obtained from sources deemed reliable, but in no way is warranted by Ameriprise Financial, Inc. as to accuracy or completeness. This is not a solicitation by Ameriprise Financial Services, Inc. of any order to buy or sell securities. This summary is based exclusively on an analysis of general current market conditions, rather than the suitability of a specific proposed securities transaction. We will not advise you as to any change in figures or our views.

Past performance is not a guarantee of future results.

Investment products are not federally or FDIC-insured, are not deposits or obligations of, or guaranteed by any financial institution, and involve investment risks including possible loss of principal and fluctuation in value.

AFSI and its affiliates do not offer tax or legal advice. Consumers should consult with their tax advisor or attorney regarding their specific situation.

Ameriprise Financial Services, Inc. Member FINRA and SIPC.

