February 2017 Investment Publications Highlights

Death and Tax Reform

Savita Subramanian, et al., *Equity Strategy Focus Point*, Bank of America Merrill Lynch, January 29, 2017

The authors analyze possible impacts of corporate tax reform on US corporate earnings based on likely White House and Congressional plans. According to their analysis, US corporate tax reform could boost S&P 500 earnings per share (EPS) by anywhere from $0.50 to $10.00.

Although President Trump has repeatedly stated that corporate tax reform is a priority, the details of what might be included in a reform bill are still unknown. The authors use House Speaker Paul Ryan's "Blueprint" proposal as a starting point for their analysis, and also discuss the potential impacts of other proposals. The analysis focuses on four main reform topics: reducing the US statutory corporate tax rate, adjusting taxes on overseas profits for US companies, implementing a border adjustment tax (BAT), and removing the interest expense deduction for corporate debt.

If the US statutory corporate tax rate were reduced from 35% to 20%, the analysis predicts a 12% boost to 2018 S&P 500 EPS; however, any benefit to the bottom line likely would be passed on to consumers in the form of lower prices over the long term. Different sectors would be impacted to varying degrees—financial and consumer discretionary companies would likely gain the most, while real estate and information technology stand to benefit the least. Some of these benefits would be offset by other tax reform impacts.

Under both the Blueprint and the White House plans, a new mandatory tax on overseas profits would be implemented. The Blueprint rate (8.75%) is slightly less than the White House rate (10%) but, according to the analysis, the difference in impact would be negligible. Both plans would see S&P 500 companies bring back over $1 trillion in overseas earnings. While this one-time event is likely to result in a $4 boost to EPS due to stock buybacks, the tax itself could pose an $8–$9 hit. The authors also note the repatriation could put upward pressure on bank funding costs.

The BAT would have a mixed impact on S&P 500 companies; net importers would be likely to suffer, net exporters would stand to benefit, and purely domestic companies would be unaffected. For the index as a whole, the authors estimate a 20% BAT would cost 2018 EPS $5–$6, but almost 80% of the impact would be limited to the consumer discretionary and consumer staples sectors.

According to the authors, if the tax deduction for corporate debt were removed as part of the comprehensive plan, $4–$5 could be shaved off 2018 EPS. However, this assumes current debt is grandfathered in, which is not certain. Companies with higher leverage would be most negatively impacted, as well as companies with depressed earnings, such as those in the metals & mining or energy sectors. Ending the tax deduction for corporate debt could also negatively impact demand for investment-grade credit and dampen leverage buyout activity.

While there would certainly be winners if US corporate tax reform happens, the authors note that the likelihood for entire industries to be hurt could derail reform efforts as currently envisioned.

US Border Tax Adjustment: Implications for Inflation, the Fed and Rates

Matthew Luzzetti and Aditya Bhave, *Economics Special Report*, Deutsche Bank Research, February 6, 2017

The BAT—one of the potential features of the Trump administration's proposed corporate tax reform—would impact the US economy substantially, potentially causing a temporary spike in inflation, the Federal Reserve to be more dovish initially, and rates to sell off.

The potential BAT proposal will exempt US firms' export revenues but tax US firms' imported goods at a new corporate tax rate. As a result, the BAT will tend to benefit firms that rely more on foreign revenues, as opposed to firms that import goods to be used in the production process.

The increase in import prices will likely lead to a temporary, but sharp, increase in inflation. The magnitude of the BAT's impact on inflation will be driven primarily by the timing and extent of US dollar appreciation. All else equal, increasing import costs and export incentives will increase demand for US dollars. A rapidly appreciating dollar would limit the rise in inflation, but studies have found that frictions—such as existing trade contracts—prevent currency appreciation from perfectly offsetting a rise in inflation. Imperfect currency adjustments, along with the imperfect pass-through of a change in tax rates to the price of goods, suggests that the BAT will cause a rapid, albeit mostly temporary, increase in inflation.

A key concern for markets is how the Fed will respond to a temporary shock to inflation. Based on previous shocks, the authors believe the Fed's initial response will be dovish, anticipating only a short-term rise in inflation. The shift in Fed policy in response to the injection of uncertainty and tighter financial conditions accompanying the BAT will likely be bearish for US interest rates. However, the BAT's impact on the slope of the yield curve is less certain. A short-term spike in inflation would likely steepen the curve, but a sustained increase in inflation expectations would increase the risk of the Fed overshooting its inflation target. In this scenario, the Fed would likely respond by being more hawkish, which would in turn flatten the yield curve. Regardless of the Fed's monetary policy position, the faster the dollar appreciates in response to the BAT, the steeper the yield curve.

Trump's Tax Twist on Trade

Adrian Mowat et al., Asia Pacific Equity Research, J.P. Morgan, January 9, 2017

The authors analyze the risks of the Trump administration's proposed BAT policy on Asian exporting countries. To mitigate portfolio risks related to exposures to these countries, the author highlights a potential derivative strategy.

The authors believe investors should take the possibility of a BAT seriously, for several reasons: the new administration's need to offset the impact of lowering the corporate tax rate, the administration's high-profile statements on US manufacturers' investments in Mexico, and the number of administration officials that have embraced protectionist policies. But, based on the recent rally in many Asian exporters' share prices since the election, the authors doubt that investors are pricing in the potential risks properly.

The authors argue that foreign company products that can easily be replaced by US manufacturers may, in fact, be less vulnerable because spare US production capacity would need to be used to manufacture such products, making it unavailable for other manufactured goods. The authors believe the new administration will likely prefer to increase production in current industries to ensure they are not replaced by non-US-based manufacturing.

Across Asian exporting countries, certain areas could experience weakness. In India, IT companies that rely on India-based developers and health care companies that supply competitively priced generic drugs may be at risk, as their US subsidiaries will no longer be able to offset the cost of work done in India against taxable income. In South Korea, large companies like Hyundai, Kia, LG, and Samsung would face difficulty in pricing their products relative to US manufacturers. In China, no major US exporters are acutely at risk, but rising trade tensions between the two countries are a concern.

To reduce portfolio risks related to the BAT, the authors highlight the J.P. Morgan Asia Trump Policy Short Basket. It comprises the 30 most liquid stocks that could be negatively impacted by Trump's trade policies. The authors suggest investors looking to hedge portfolio risks consider gaining exposure to this basket. ■

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