NEWPERSPECTIVES

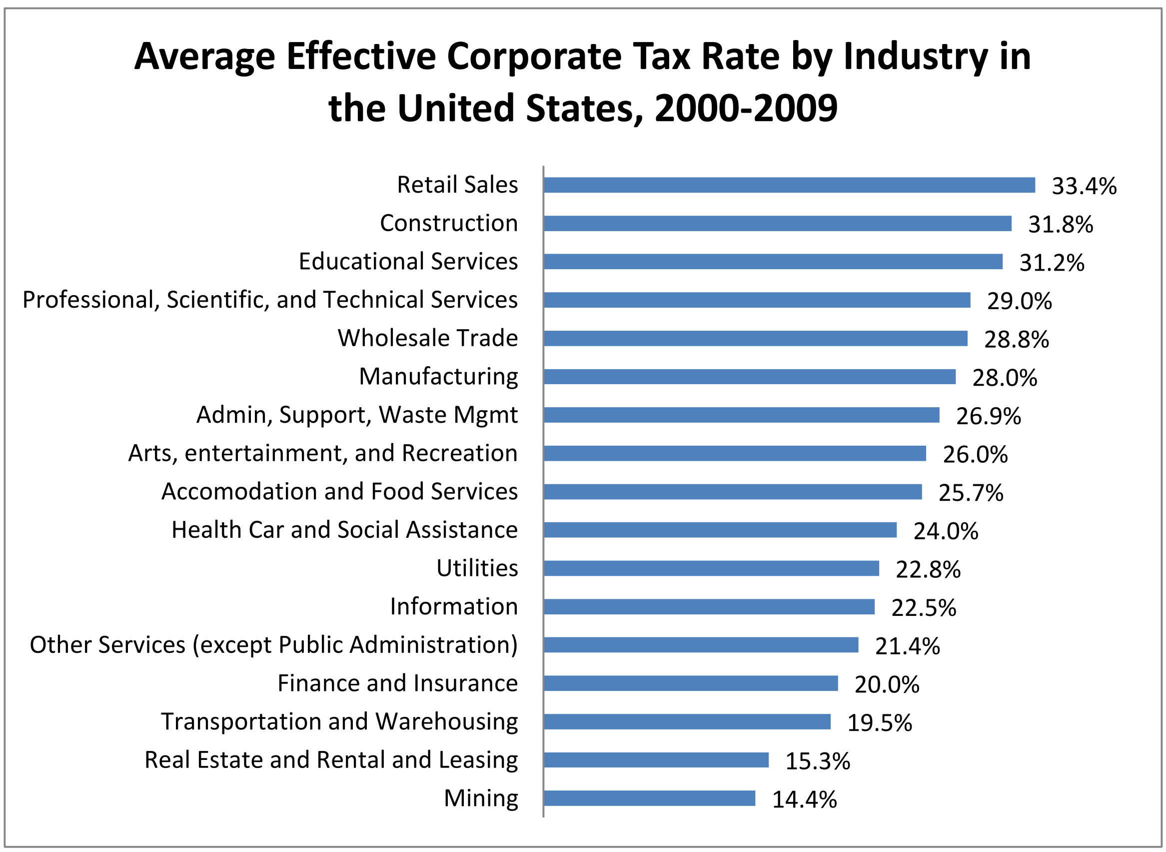
Commentary from New Century Advisors
January 2018

Tax Reform Impact on Credit Markets

- **The corporate tax rate cut puts the US in the middle of the distribution of global tax rates…fiscal stimulus coming late in the cycle.**
- **How much does it matter? Event risk potential.**
- **Potential impacts must factor into credit models.**

Tax Reform Finalized

The recently signed Tax Cut and Jobs Act officially reduced the U.S. corporate tax rate permanently from 35% to 21% in 2018. Hardly any industries in the US actually pay the 35% tax rate. As one can see from the chart blow, effective tax rates vary among industries in the US. Some reasons for lower industry tax rates include: specific industry tax credits, offshore tax sheltering, and stock option treatment. Prior to this tax cut, the average effective US corporate tax rate was 26%.



Source: Markle and Shackelford, "Cross-Country Comparisons of Corporate Income Taxes"

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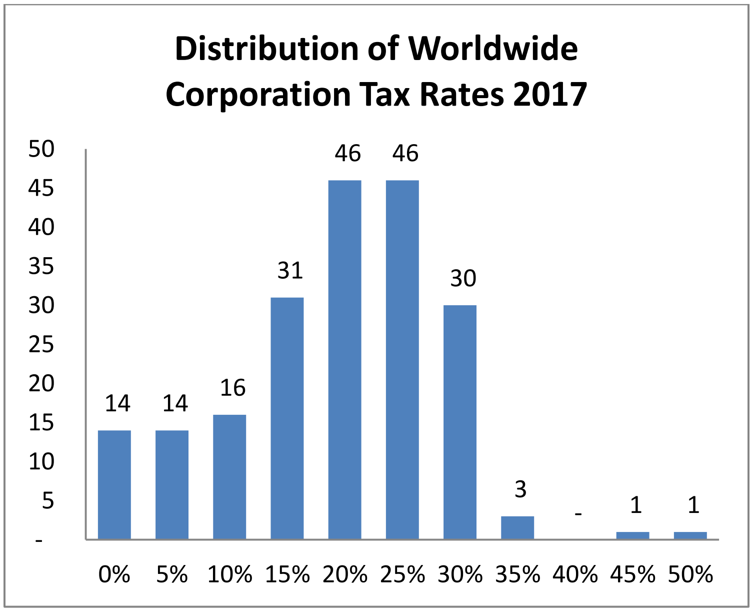
The policy architects of this tax cut argue that the US was at the high end of global tax rates, making us less competitive. The table below illustrates where the US now falls globally. With a 21% tax rate, US companies will be right in the middle of the global distribution of tax rates.



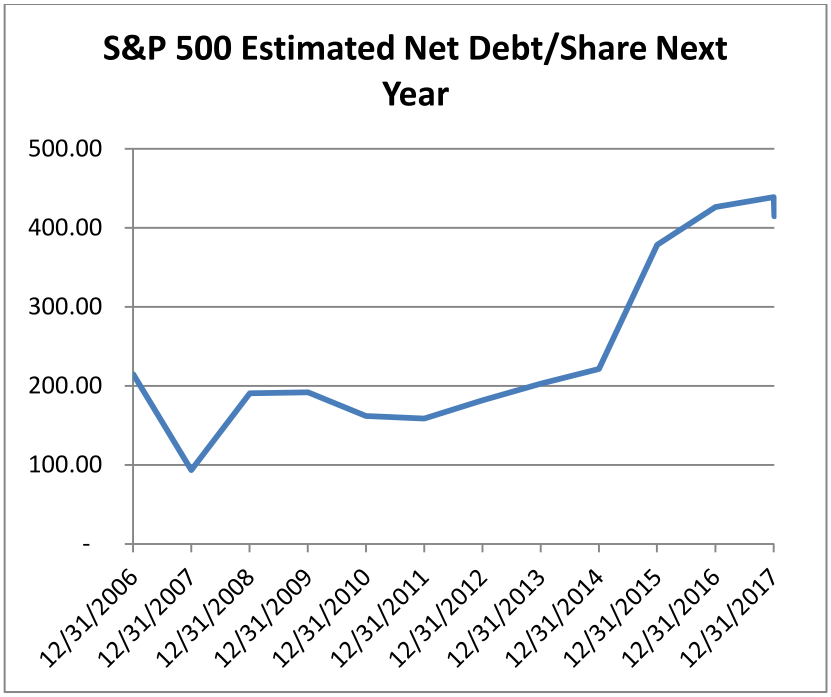
Source: Tax Foundation

The new tax plan will also allow companies to bring cash held overseas back to the US after a 15.5% tax rate has been applied, as well as to deduct foreign taxes already paid on those profits.

We have seen a lot written about this new bill. As credit analysts, we know the first tax reform since 1986 cannot be ignored. Especially as this tax cut is coming in the ninth year since the last official recession and it is somewhat uncommon to see fiscal stimulus at this point of the business cycle.

Does It Matter?

As credit investors, there is clearly a positive side to this bill. More cash coming from an increase in after-tax profit is obviously good for investors if management teams do not plan to do anything specific with the money. The net amount of debt on the balance sheet (debt minus cash) will decrease, the risk of default will go down marginally, all other things being equal, and that should be good for bond investors as it enhances a company's ability to service debt. As one can see from the following charts, net debt for the largest companies as a whole has been increasing in recent years, which the bond market has been somewhat sanguine about, in our opinion.



Source: Bloomberg

It would be good for bond holders if any new money coming from the tax cuts will be immediately applied to debt reduction. If only it were that easy.

Save a Dollar, Spend a Dollar

The logic behind the corporate tax cuts has roots in supply-side economic theory. Supply-side economics hypothesizes an increase in after-tax profit will boost corporate savings, which should incentivize firms to invest, leading to higher productivity and more jobs (along with higher wages). This bill also provides a five-year period in which companies can immediately deduct new equipment costs, which, in theory, should also incentivize capital spending and increase employment.

The problem with economic theories is that they cannot be tested in a controlled environment. And the real world may present some head winds to this supply-side set up.

One such headwind is that we think the US economy as a whole is not particularly capital constrained. For example, credit spreads are healthy, reflecting both corporate health and the ease for companies to issue new bonds:

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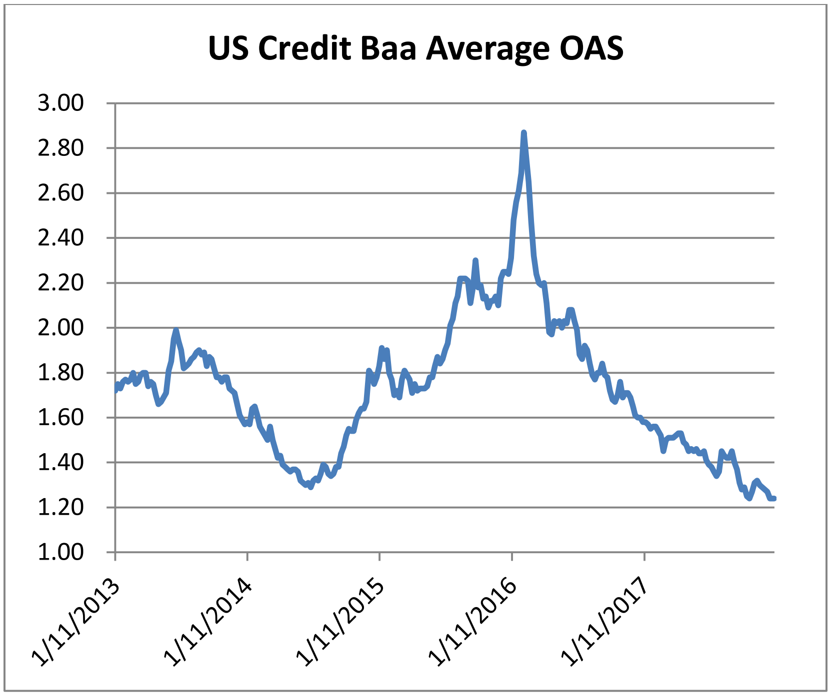
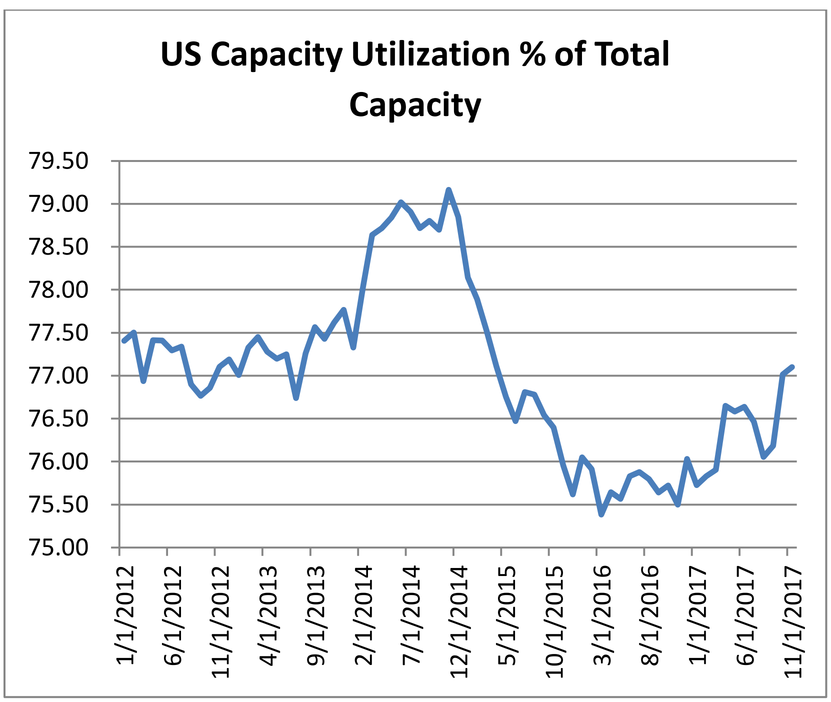


Source: Bloomberg

Capacity utilization in the US is also not showing any signs of capital stock being fully exhausted.



Source: Bloomberg

Also, it is important to remember that we are nearly at 80% service economy, according to government data. A boost in capex may not lead directly to further reduced unemployment. We think that capex spending focused on innovative technology, like cloud computing, artificial intelligence, driverless cars, etc. could potentially eliminate jobs.

Furthermore, there seems to be limited enthusiasm for capital investment among CEOs so far. The Yale CEO Summit recently surveyed 110 senior-level executives in mid-December, just 14% said their companies will make meaningful capital investments when the tax cuts are enacted.

Potential Impacts of Financial Engineering

The decrease in the tax rate could also lead to different forms of financial engineering. For example, new cash resulting in the tax cut could be distributed to investors in the form of dividends and share buybacks.

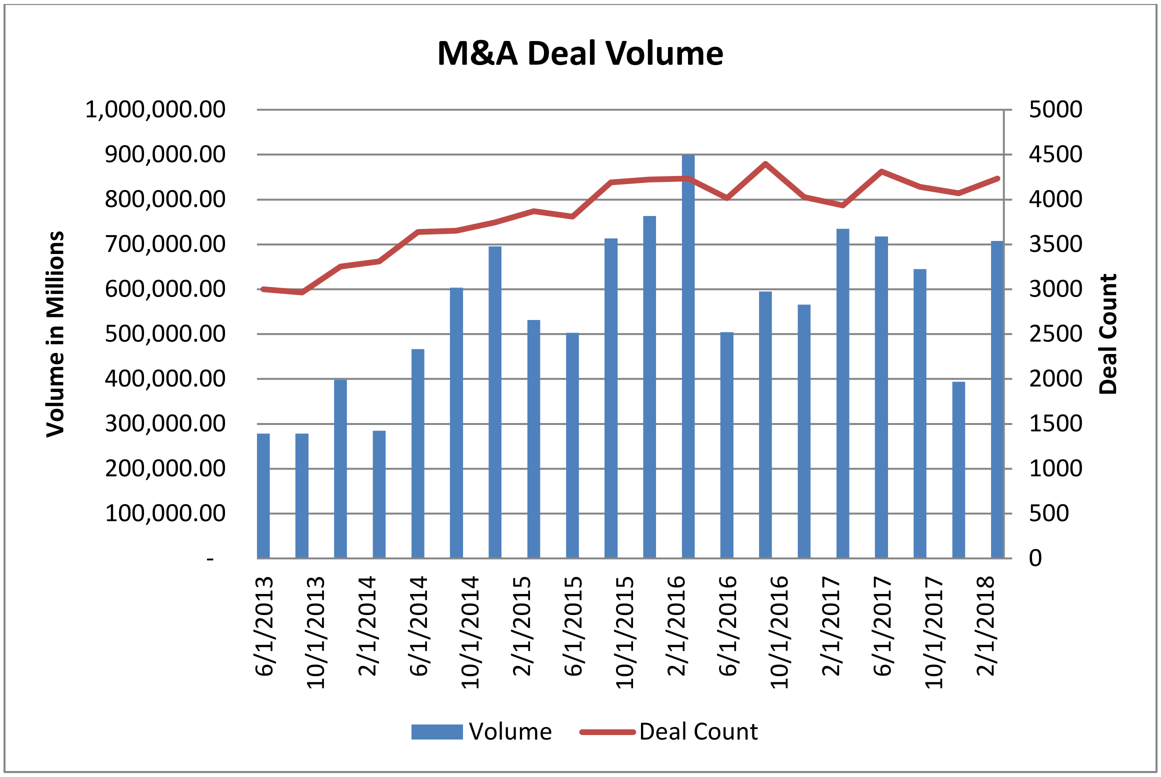
Home Depot's CFO Carole Tome recently said on a conference call: **"…we might use the tax — cash tax savings to invest in the business and then use — generated cash to back buy (back) shares, it's all fungible."**

Other companies like Coca-Cola, Cisco and Pfizer have already mentioned dividends and buybacks with the new tax windfall. But a commitment to buybacks and increased dividends has been a well-established trend so far in this business cycle.

Large multinationals hold enormous amounts of overseas cash and have been issuing debt as a tax advantaged way to pay dividends and buy back stock while avoiding US taxes. In fact, Bank of America is calling for a dramatic 17% decline in gross issuance next year, with 100-150 billion less supply attributable to the new tax legislation. (Technology is one of the largest holders of overseas cash and accounted for over 70 billion of issuance in 2017 just between Apple, Microsoft, IBM, Oracle and IBM.)

As a whole, earnings estimates for large US companies are expected to increase in 2018 (without the tax cut), so money spent on buybacks does not necessarily have to come at the expense of bondholders. Furthermore, this anticipation of less issuance may already be priced into the current market, as a potential shortage of bonds in 2018. Though, it could potentially be a negative for some specific industries in the corporate bond market. As leverage is increasing among corporate balance sheets, a decrease in earnings coinciding with allocating more capital toward shareholders would most likely widen bond spreads.

Another issue for the corporate bond market coming from this tax rate cut is event risk coming via LBOs. Deal volume was muted in 2017 despite reasonably decent economic backdrop in 2017.



Source: Bloomberg

This could not last for long. With stocks hitting record highs, and after-tax income increasing year-over-year, leverage buyout models may be the new shiny toy for bankers and executives cannot resist. Typically LBOs are not a good for credit spreads.

Conclusion: We Don't Really Know the Impact

At some point in the near future will we look back at this tax bill as a turning point in the business, credit and economic cycle? Will we all become supply-side devotees? It is very possible this tax cut will add to the certainty that bond spreads are already projecting. But, the timing of the cut and specific actions from management teams may cause some nervousness in the bond market at the corporate and industry level. Frankly, we just don't know how to weigh this corporate tax cut. But, it will be a factor when we discuss the bigger drivers of credit spreads: issuance, earnings, technicals and other specific global macro trends.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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