ClearBridge Investments

How the Tax Bill Will Shape 2018

January 5, 2018

Key Takeaways

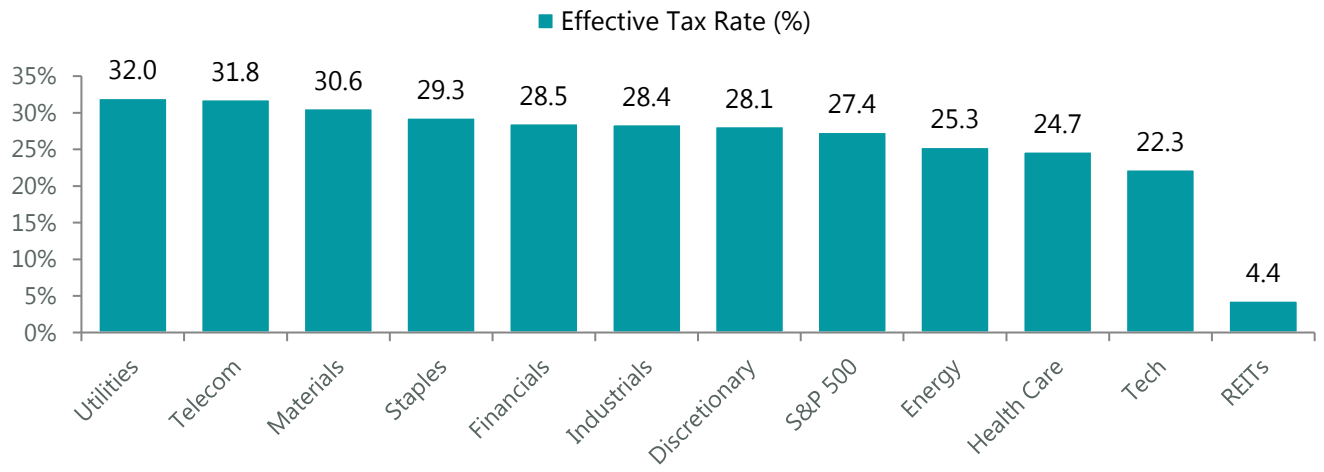
- We expect a pickup in capex as corporate managers aim to fully expense investments in 2018 under the tax bill.
- Repatriation of overseas cash could help boost shareholder-friendly activities like M&A, share buybacks and dividend increases in the health care and information technology sectors.
- 2018 policy making likely will be dominated by the upcoming mid-term elections.

A Penny Saved Is a Penny Spent?

The $1.5 trillion tax package will help the U.S. become more competitive with the rest of the world. Despite substantial rhetoric about tax reform from D.C., the market had not priced in its potential benefits until December. More specifically, as it became more likely that a bill would pass in very late November, a shift in market leadership began, with the highest-tax-paying companies and sectors outpacing lower payers. As Exhibit 1 shows, when you consider effective tax rates across sectors, not all tax benefits will be equal.

Tax reform gives corporate managers the visibility needed to make long-term decisions about operations. Many managers have held off investments in order to be able to fully expense these costs in the new year. As such, we expect a pickup in capex into the high single digits. The most recent ISM Manufacturing New Orders Index, which printed at 69.4 for December, appears to confirm an impending pickup in capital spending. This is a very strong number: any reading above 50 is expansionary. Importantly, 100% expensing for investment has never before been combined with an overseas tax holiday in the U.S. This combination should fuel a pickup in economic activity. Further, new equipment could help boost productivity, which would further lift the economy, as GDP growth is a function of population growth and productivity. While population growth has been relatively stable, productivity growth has been lackluster since the financial crisis. Improving productivity would mark a departure from the recent trend, and could help push GDP above the sluggish 2% pace it has experienced since 2010. Additionally, rising capex typically occurs later in the economic cycle, as the bite from high wage growth eats into corporate margins. Investment in capex has historically been a way to help maintain margins by boosting labor productivity. Accordingly, companies that provide productivity-enhancing services should have a tailwind for the next couple of years.

Exhibit 1: Not All Tax Rates Are Equal



Source: ClearBridge Investments. January 5, 2018.

The tax reform bill includes a provision that will force companies to bring overseas capital back to the U.S. at favorable rates. Many consider the actual amount in liquid assets to be close to $1 trillion. As that money comes home, it can be used for capex as discussed above, or it can be used for shareholder-friendly activities like M&A, share buybacks and dividend increases. The two sectors that could see an outsized boost from these operations are health care and information technology. Per Strategas, approximately 20% of the market value of the S&P 500 health care sector is unremitted foreign earnings, while information technology is at 18%. These percentages are much higher than most other sectors in the index and represent outsized opportunities for repatriation benefits.

Mid-Term Elections Could Spur Bipartisanship

Looking forward, 2018 likely will be dominated by one day: November 6, the date of the mid-term elections. Since 1938, the party holding the presidency has lost congressional and Senate seats in all but two and four mid-term elections, respectively. Additionally, in the few years where the incumbent party added congressional seats, presidential approval ratings exceeded 60% (President Trump's approval ratings, for comparison, are below 40%). It appears that Republicans are facing an increasingly uphill battle to retain control of the House, and possibly even the Senate.

Against this backdrop, the coming year could see bipartisan issues like infrastructure spending and drug pricing move to the forefront as the Republicans attempt to co-opt Democratic influence. Republicans will need Democrats to pass any substantial legislation in 2018, and the upcoming spending debate should provide real insight into how the year will evolve. Democrats want to reinstate the Deferred Action for Childhood Arrivals immigration policy, increased disaster relief funding and budget sequestration relief with a dollar for dollar military/domestic programs spending increase. The Republicans, meanwhile, want stricter immigration control and sequestration relief specifically to boost defense outlays. At the same time, President Trump continues to want his wall. Democrats seem to have both the momentum and the leverage, but will need to restrain their party's propensity to overreach. Republicans, controlling the House, Senate and the presidency, cannot allow the government to shut down, though it is not clear if the president agrees with this strategy. Ultimately there will be a compromise, but the winners and losers from it are not yet obvious. Nor is it obvious a shutdown will be avoided. The drop-dead date is January 19.

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