Market Commentary

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Potential impact of tax reform

It's no secret that being able to enact a new tax law by year-end is a clear priority for President Trump. Congressional leaders have agreed to compromise legislation and the bill is heading towards the floor voting process. At this time, final details remain unsettled, but there are several observations that can be made.

In the fixed income world, corporate and tax-exempt bonds in particular continue to see consistent interest from a diverse investor base. Both sectors face a potential scarcity in issuance levels as a result of the tax bill which may actually have the effect of driving up bond prices. From an equity perspective, the stock market has responded positively to news surrounding tax reform, building on the momentum that started with the presidential election and expectations for tax cuts. Key beneficiaries to a cut in the corporate tax would be small-cap companies who often face substantial tax liabilities, though large caps will also benefit from a more favorable tax treatment. Possible risks to the U.S. economy include an uptick in inflation, a growing federal deficit and policy missteps by the Federal Reserve (Fed) as a result of the stimulus provided by the tax cuts. The first two risks would result in higher interest rates, while the third could bring the current economic expansion to an end.

Market reaction

In our opinion, markets have largely reacted positively to the proposed legislation. The stock market has continued to rally, led by the Down Jones Industrial Average breaching 24,000 for the first time on 11/30/17. In addition, interest rates have edged up, with the 10-year U.S. Treasury currently yielding 2.41%.[1]

Below, we consider the potential impact of the pending tax reform from an asset class perspective.

Fixed income

Municipals: The near-term outlook appears positive for tax exempt bonds, driven in large part by the possibility of lower issuance for this sector due to two features of the House bill. First, private activity bonds (for example, securities issued by hospitals and universities) stand to lose their tax exempt status. Second, municipalities may no longer be able to "advance refund" their debt in the tax exempt market.[2] Combined, these two sources account for roughly 40% of the muni market's issuance. Such a reduction in supply would, in our opinion, increase demand for the remaining muni inventory. At the moment, however, there has been a huge spike in issuance heading into the end of 2017, creating a potential buying opportunity. Longer term, we would expect a negative impact on the credit quality of general obligation bonds as the elimination of the state and local tax deduction would decrease the financial flexibility of state and local governments.

Investment grade corporates: In our opinion, corporates look like winners in this scenario. One reason for our optimism is that corporations, by potentially losing their ability to treat the interest they pay on their borrowings as an expense, are likely to issue less overall debt. That dynamic suggests a lower level of supply and tighter spreads versus U.S. Treasurys which, in turn, should increase the value (and attractiveness) of existing bonds. Also, a reduction in the corporate tax rate to 21% will translate to increased profitability of companies, potentially increasing their creditworthiness. Having said that, within corporates, *telecommunications* companies face the highest effective tax rates *(see Exhibit 1, next page)* so they would clearly benefit if the corporate rate was slashed. *Financial* firms would benefit for the same reason, as well as typically outperforming in a rising interest rate environment.

(continued)

[1] *As of 11/30/17.*

[2] *"Advance refund" means that after year-end, if a municipality wanted to refinance any outstanding debt more than 90 days prior to its maturity, it would have to do so in the taxable market.*

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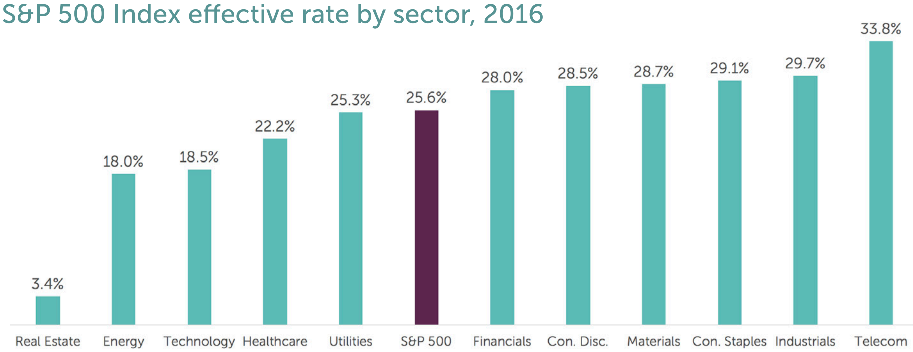
Exhibit 1: Tax rates can vary dramatically by sector

S&P 500 Index effective rate by sector, 2016



Source: Standard & Poor's, J.P. Morgan Asset Management

High yield: The tax bill is a mixed bag for high yield issuers. On the one hand, like investment grade issuers, they will benefit from a reduction in the corporate tax rate. The bill, however, potentially limits the amount of interest expense that a corporation could deduct to 30% of its income, versus 100% currently. This would be a negative for highly leveraged companies because their effective cost of debt would increase. Within the overall category, we see CCC-rated issuers as having the most significant exposure under such a scenario.

Equity

It is no surprise that the tax bill will most dramatically impact firms operating within the United States. In general, a lower tax rate will increase the profitability of companies. *Small-cap* companies, in particular, are likely to experience a nice bounce in performance due to the proposed drop in the corporate tax rate as they usually face high effective tax rates. However, this doesn't mean we should overlook large-cap stocks. Even though many of these companies already enjoy relatively low tax rates given their multinational status and their ability to locate the most beneficial tax treatments around the globe, a potential cut in taxes of foreign earnings held in cash (possibly to as low as 10%) could incentivize many of them to repatriate billions of their overseas profits.

Risks

With that background, there are a number of risks that investors should be aware of if a tax reform bill is passed. These include the following:

- A pick up in economic growth could spark inflationary concerns.
- An increase in the federal deficit would likely lead to a higher issuance of U.S. Treasurys, leading to lower price levels and higher yields for these securities.
- Higher interest rates might cause the Fed to increase the pace of its rate hikes.
- The Fed could make a policy mistake by raising interest rates too much.

Summary

Signing a tax-overhaul law appears to be on the top of the president's wish list for the coming holiday. If we assume his "gift" arrives, what would its likely impact be? For fixed income investors, corporates and municipals have been experiencing solid demand from both domestic and foreign investors. We expect this positive dynamic to continue, despite a potential increase in interest rates. For equity investors, we see the current stock market rally continuing based on the positive impact of the tax bill, which enhances the already constructive earnings and economic environment.

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