MORNING BRIEFING
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Tax Reform: What's Really in this Sausage?

(1) TCJA is the sausage de jour coming out of DC's sausage factory. (2) $1.3 trillion in corporate tax windfall over next 10 years has some sizeable offsets. (3) Net interest deduction is capped. (4) It doesn't pay to have lots of debt anymore. (5) NOL deduction is also limited. (6) New rules for R&E amortization. (7) Big bonus for depreciating assets. (8) Different strokes for different folks. (9) Will the repatriated profits windfall go to buybacks, dividends, bonuses, or capital spending? Or all of the above? (10) Very interesting earnings conference calls ahead!

US Tax Reform I: Temporary Offsets. Now that we are all back from our holiday vacations, our first New Year's resolution is to make sense of what made it into the Tax Cuts and Jobs Act of 2017 (TCJA) at the end of last year. Most of the Act's provisions take effect immediately during the current tax year.

Melissa and I followed the sausage making in Congress as best we could late last year, when the differences were reconciled between the House and Senate bills in a conference committee. Signed into public law by President Donald Trump on December 22, the TCJA has been referred to as the largest tax reform effort since the 1980s. Now it's time to taste the sausage.

Let's skip over the legislation's many moving parts for now and focus first on the changes that will impact corporations most significantly. On its website, the US Senate Committee on Finance supplies helpful links including the Joint Committee on Taxation's (JCT) score of the legislation's conference report. Of course, the most substantial change to the tax code is the reduction in the statutory federal corporate tax rate from 35% to 21%.

On a static basis, the JCT expects the rate reduction to lower the corporate tax bill by $1.3 trillion over the next 10 years. That's a nice chunk of change, but it's not the complete picture. That's because the tax rate that companies actually pay may be lower, or even higher, than 21% depending on other tax adjustments. The change in the corporate tax rate is to remain in place from 2018 onward.

Interestingly, the big offsetting adjustments mostly impact the timing of tax liabilities rather than the amount of those liabilities over the long term. Here's a quick rundown of the offsetting corporate tax reforms for which the JCT estimates budget effects greater than $100 billion over the fiscal years 2018 to 2027:

(1) *Limit net interest deductions to 30% of adjusted taxable income (AGI).* Companies could deduct an unlimited amount of interest expense from their tax bill under the old tax code. Now the deduction is limited to 30% of AGI for most large companies, excluding utility and real estate companies. Offsetting the lower corporate tax rate, the JCT expects the change to increase the corporate tax bill by $253 billion over 2018 to 2027.

A 12/21 article in the *WSJ* discussed the adverse effects the new limitations could have on debt-laden companies like Dell, Tenet Healthcare, and JC Penney. In a report dated July 2017 (when Congress was still contemplating the complete elimination of interest deductibility), Moody's observed that the loss of interest deductibility would be a "blow" for speculative-grade companies. Sectors with the highest leverage, including healthcare and technology, would be "among the most exposed."

However, *Barron's* reported on 11/4 that Morgan Stanley estimates less than 4% of S&P 500 companies with an investment-grade credit rating would be affected by the cap on interest deductibility—but about one-third of the high-yield universe would be. The burden would get worse for speculative-grade companies when earnings fall or during periods of loss, when the deduction would be completely disallowed. Even so, "the amount of any business interest not allowed as a deduction for any taxable year … shall be treated as business interest paid or accrued in the succeeding taxable year," according to the conference report. That means that companies can carry it forward.

(2) *Modification of net operating loss (NOL) deduction.* Over the next 10 years, modifications to NOLs are expected to increase the corporate tax bill by $201 billion, another significant offset to the corporate rate reduction. The conference report notes that the deduction for NOLs will be limited to 80% of taxable income before any allowable NOL deduction during a tax year. Previously, NOLs could be used to offset it all. So a company with $900,000 of income in 2019 and a $1 million net operating loss from 2018 as an available offset could still end up paying tax on $180,000 of income (or 20% of $900,000) on its 2019 tax return. That's a simple calculation similar to one *Forbes* presented on 11/3, when a 90% limitation was under consideration.

Further, carrybacks, which were previously permitted for up to two prior years, are no longer permitted. Carrybacks are current-year losses that are used as an offset against prior-year profits. Carryforwards, however, will be made indefinite rather than limited to 20 years. (Carryforwards are current losses used as an offset against future-year income.)

(3) *Amortization of research and experimental (R&E) expenditures.* First enacted in 1981, the R&E credit was temporarily extended 16 times before being made permanent in 2015, observed a 10/12 US Treasury analysis. Starting in 2022, according to the conference report, the full R&E credit will no longer be allowed.

Instead, the taxpayer shall charge such expenditures to a capital account to be amortized over five years (with a 15-year period imposed for certain types of expenditures). In other words, the R&E credit is not completely forgone, but spread out over time. The JCT expects the rule change to increase the corporate tax bill by $120 billion from 2022 to 2027.

Notably, the section does not apply to ascertaining the location or extent of minerals, so oil and gas companies continue to get the immediate credit. For technology companies, software development must be classified as "R&E" and amortized according to the rules. Manufacturers and pharmaceutical companies are not specifically mentioned in this section of the conference report, but they also are known for extensive R&E.

US Tax Reform II: Front-Loaded Benefits. One of our accounts forwarded a 12/18 brief on the Penn Wharton Budget Model's (PWBM) estimate of the federal corporate effective tax rate (ETR) across 19 main industrial sectors. So far, the study is one of the most helpful that Melissa and I have come across for understanding how the TCJA will impact ETRs by sector and over time. It confirmed our thinking that the macro corporate federal ETR is already significantly lower than the previous statutory rate of 35%. Under 2017 law, it averages about 23%, according to the PWBM's calculations (see our technical note below). However, there is a significant variance among industries, in a range of 18% to 33%.

Under the TCJA, the average ETR falls from 21% to 9% in 2018, according to the PWBM. However, by 2027 the ETR doubles in value to 18%, mostly due to the timing of the TCJA's provisions. For certain capital-intensive industries, the average ETR actually rises above the statutory rate in future years for the reasons discussed below. For all industries reviewed, ETRs are reduced in the long term from 2017 levels. But more than half of the effectiveness of the corporate tax cut is "undone" within 10 years, according to the PWBM. Consider the following:

(1) *Big upfront bonus depreciation*. The largest business tax break that changed under the TCJA, aside from the rate reduction, is bonus depreciation. By the JCT's account, the extension, expansion, then phase-down of bonus depreciation save corporations $86 billion over 10 years. Before the TCJA, businesses could claim a 50% first-year bonus depreciation deduction for qualified new assets placed in service in 2017. It was available for the cost of computer hardware and software, vehicles, machinery, and equipment, among other expenses, highlighted a note from The CPA Desk.

Now, under the TCJA, for qualified property placed in service between September 28, 2017 and December 31, 2022, a 100% deduction may be taken in the first year. And the deduction is expanded to include used property as opposed to only new property under the old rules. The TCJA also expands the type of property that may qualify for bonus depreciation. Starting in 2023, bonus depreciation is set to be reduced annually by 20 percentage points until it is phased out by the end of 2026. While there are nuances to the changes, that's the essence of them.

According to the PWBM, the expiration of the 100% first-year bonus depreciation provision under TCJA is one of the main reasons that ETRs are expected to rise after 2022. The PWBM brief explains: "At first glance, the higher effective rates in 2023 and 2027 seem counterintuitive. However, they reflect the fact that a portion of depreciation deductions can no longer be taken since the investments were fully expensed in prior years. … Of course, companies are better off in present value terms, since an immediate tax reduction is more valuable than a future reduction. However, much of the short-run reduction in ETR values simply reflects a shift in timing of depreciation allowances rather than an average reduction in the long run."

(2) *Higher ETR than statutory?* Capital-intensive industries—such as utilities, real estate, transportation, agriculture, and healthcare services—stand to benefit the most from full expensing. "These industries see at least a 12.8 percentage point drop in effective rate, but by 2027 these industries give back most of the ETR drop realized in 2018," according to the PWBM. For these industries, effective rates actually rise above the statutory rate for two reasons:

"First, for capital investments that were fully expensed, no future depreciation is allowed, but future book income is still net of economic depreciation in future years. Second, the limitation on net interest deductions increases taxes even though book income is net of interest payments. In fact, some industries that are relatively heavily debt financed, including agriculture, see their ETR's increase above the statutory rate even before expensing begins phasing out," noted the brief.

(3) *Big bucks for some*. The brief observes that ETRs for manufacturing and mining decrease less than average across industries, because these industries already have low ETRs. "The benefit these industries see from a drop in the statutory rate is restricted by both the limitation of net interest deduction beginning in 2018 and the change in the treatment of research and experimentation expenses beginning in 2022. Manufacturing, in particular, accounts for almost two-thirds of research costs, which are fully deductible under current law. Under TCJA, those costs must be capitalized over a period of five years, sharply reducing the tax benefit received by manufacturers."

Nevertheless, in dollar terms, the largest beneficiary of the TCJA, according to the PWBM, is manufacturing. About $262 billion in tax savings is expected for manufacturing, or about 20% of the tax reduction for all corporations' taxes. Finance and insurance also gain nearly $250 billion.

(4) *Technical note*. The PWBM's method for calculating ETRs mirrors the one used by the US Treasury

(see here) except that the PWBM focuses on federal corporate taxes only. Like the Treasury, the PWBM "neutralizes" for NOLs by taking them out of the equation. NOL values are multiplied by the applicable statutory federal corporate rate and added back to the numerator of taxes paid. That means that in tax years that generate substantial NOLs, the effective rate would have been lower under the PWBM method if the NOLs had been included.

US Tax Reform III: Buybacks Back. As a result of the tax reform, companies will experience a domestic cash windfall from the mandatory repatriation of cash held overseas. Additionally, most companies will enjoy a significantly lower effective tax rate for some time. The important questions that we are all trying to answer are: What will companies do with the extra cash from the tax reform and will that boost earnings? The stock market? The US economy? The answer may be "yes" to all of the above, but primarily for the short term.

Typically, corporate finance textbooks dictate a few main options for putting extra cash to work, including paying it forward to employees, increasing capital spending (organically or via M&A), and returning it to shareholders or to debtholders. Of the options, several companies have advertised that they'll be engaging more heavily in all but capital spending.

It's not hard to understand why: Companies already have had access to super-cheap debt, given low interest rates, for some time now. Corporate balance sheets are not wanting for cash, so capital already is available to invest. Might tax reform be solving a capital investment funding problem that just isn't there?

In late October, Marriott's CEO summed it up at Yahoo Finance's All Markets Summit: "From our perspective, we're not cash starved, we have plenty of resources, and therefore where we've got an opportunity to invest and it makes sense for our business model, we're investing." The CEO added that with tax reform the company "probably wouldn't incrementally invest" but instead "return it to our shareholders." That's in line with what other executives are indicating. Consider the following:

(1) *Shareholder appreciation.* Recent history has proven that companies have tended to favor share buybacks in the low-interest-rate environment. Buyback enthusiasm has recently tempered, but it might just pick up again under the tax reform. Lots of promises to shareholders were found in a summary of corporate executive comments compiled by the *Washington Post's* Heather Long on 12/21. Bloomberg Intelligence analysts predict that share repurchases could increase by more than 70% on an annualized basis as a result of the tax overhaul.

Such a jump "increases the appeal of equities relative to other classes," pointed out Bloomberg Intelligence's chief equity strategist. We've been arguing for some time that buybacks have fueled the equity bull market. Major companies, including Amgen and Honeywell, have said they plan to use the corporate tax savings windfall to benefit shareholders, according to Reuters in October. Large technology companies with a significant international presence and lots of cash stashed overseas "may spearhead the growth in the rate of buybacks," observed Bloomberg.

(2) *Pay it forward.* None of the 17 companies that responded to Reuters' inquiry during October planned to boost headcount with the tax savings. But several, including AT&T, planned to pay employee bonuses in tandem with the tax overhaul—which may reflect timing more than the most significant uses of the extra cash in coming years. That's because committing to the bonus payments during 2017 may allow companies to record the expense during 2017 for tax purposes, as a 12/21 *WSJ* article discussed. "I can guarantee you [that companies] are doing everything they possibly can to accelerate deductions before the end of the year," said a North Carolina State University accounting professor specializing in corporate taxes who was quoted. Notably, the new legislation makes it more

difficult for companies to deduct over $1 million in compensation for executives.

(3) *Pay down debt*. During October, Exxon Mobil's Vice President of Investor Relations said: "The first things that are being funded are our dividends and our investment program. And if there's any cash left at that point given that the corporation does not want to hold large cash reserves, it's at that point that we will look for what the next best thing is. And maybe if we have some debt maturing, we'll pay that debt down." Indeed, some companies may be more inclined to pay down debt given the new limitations on interest expense.

(4) *Increase capital spending.* Anecdotally, Gary Cohn asked a room of CEOs in November to raise their hands if they planned to increase investment upon tax reform. Very few hands went up, and Cohn looked surprised, reported the *Washington Post*.

Some companies, however, have signaled that they see room for additional investment. For example, during November, CVS Health's CFO said: "To the degree that we have [tax] relief, there's a lot of investments that we think we can make within our business model that can more rapidly expand our business model across the country and deliver better care and higher quality and lower cost. So we would look to take the benefit of that and invest it clearly."

The comments captured above were all made late last year, before tax reform was official. Now that it is, and corporate earnings season is underway, we will be listening closely to earnings calls for indications of solid corporate plans for the extra cash.

CALENDARS

US. Tues: NFIB Small Business Optimism Index 107.9, Job Openings 6.038m. **Wed:** Export & Import Prices 0.4%/0.3%, Wholesale Trade Inventories 0.7%, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone Unemployment Rate 8.7%, Germany Industrial Production 1.8%m/m/4.0%y/y, Germany Trade Balance (euros) 21.2b, Japan Consumer Confidence Index 45. **Wed:** China New Yuan Loans 1000b, China Aggregate Financing 1500b, China CPI & PPI 1.0%/4.8% y/y, China M2 9.2% y/y, UK Headline & Manufacturing Industrial Production 1.8%/2.8% y/y, UK NIESR GDP Estimate 0.5%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to yet another record high last week for all three indexes as more analysts incorporated the lower tax rate into their models. LargeCap's forward earnings was higher for a 24th straight week; MidCap's was higher for a 20th week; and SmallCap's has risen in 18 of the past 24 weeks. Momentum remains strong, as the yearly change in forward earnings is up from six-year lows in early 2016 and should accelerate in 2018. In the latest week, the rate of change in LargeCap's forward earnings surged to a six-year high of 11.6% y/y from 11.0%, which compares to a six-year low of -1.8% in October 2015; MidCap's jumped to a six-year high of 17.1% from 16.6%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a five-month high of 12.0% from 11.3%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. Consensus growth rates expected for 2018 improved w/w for all three indexes. Here are the latest consensus earnings growth rates for 2017 and 2018: LargeCap 11.4% and 12.6%, MidCap 10.5% and 15.6%, and SmallCap 5.4% and 21.6%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios surged higher for the three indexes last week. LargeCap's weekly forward P/E rose to a 14-year high of 18.5 from 18.2. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the tech bubble's record high of 25.7 in July 1999. SMidCap's P/E had stalled for most of 2017 following the post-election meltup, but has been rising again recently. MidCap's forward P/E rose to 18.5 from 18.3, and is barely above LargeCap's P/E again after being below in mid-December for only the third time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in late February, when the Energy sector's earnings were depressed, and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's edged up to 20.0 from 19.9, which compares to a 51-week high of 20.2 at the beginning of December and a 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and just 0.9ppt below SmallCap's record-high P/E of 20.9 in April 2002. Prices remain near record highs for all three indexes, but their "E"s still remain low as the bottom-up consensus awaits management guidance about the impact of the lower corporate tax rate. Looking at their daily forward price/sales (P/S) ratios, valuations last week were mostly steady for the three indexes: LargeCap's P/S of 2.11 on Friday was at a record high, MidCap's 1.36 remains below its record high of 1.39 in March 2017, and SmallCap's 1.05 is down from 1.08 in March 2017 and its record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the Q4 earnings season getting underway this week, earnings revisions activity paused last week. The S&P 500's Q4-2017 EPS forecast was steady w/w at $34.84, and is down only 0.4% from $34.98 at the end of Q3. That decline marks the smallest decrease in a quarterly forecast since Q1-2011. The $34.84 estimate represents a forecasted pro forma earnings gain for Q4-2017 of 11.9%, down from 12.0% a week earlier, and compares to Q3-2017's blended estimate/actual of 8.5%, Q2's 12.3%, and Q1's 15.3% (which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy). Since the end of Q3, Q4 estimates are higher for three sectors, lower for seven, and steady for one. Energy's Q4 forecast has jumped 24.1%, followed by the forecasts for Tech (up 2.4%), Utilities (2.4), and Telecom (0.0). Materials' Q4-2017 forecast has fallen 9.6% for the worst decline, followed by forecasts for Industrials (-8.9), Consumer Discretionary (-5.2), Real Estate (-5.1), Financials (-2.8), Health Care (-2.3), and Consumer Staples (-1.0). The S&P 500's Q4-2017 forecasted earnings gain of 11.9% y/y would be its sixth straight gain after four declines. Nine of the 11 sectors are expected to record positive y/y earnings growth in Q4-2017, and four are expected to beat the S&P 500's forecasted y/y earnings gain of 11.9%. That's because analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago. That's better than Q3-2017, when eight sectors rose y/y, but down from Q2-2017, when all 11 sectors rose y/y for the first time since Q3-2011. The latest forecasted Q4-2017 earnings growth rates vs their blended Q3-2017 growth rates: Energy (135.4% in Q4 vs 162.6% in Q3), Materials (25.0, 7.0), Tech (15.7, 24.2), Financials (12.9, -7.3), S&P 500 (11.9, 8.5), Consumer Staples (8.9, 4.7), Utilities (8.8, -4.6), Consumer Discretionary (5.8, 3.9), Health Care (4.6, 8.3), Industrials (3.8, 3.1), Real Estate (-1.3, 3.8), and Telecom (-2.0, -2.8). On an ex-Energy basis, S&P 500 earnings are expected to rise 9.4% y/y in Q4, up from 6.1% in Q3 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016) but down from gains of 9.6% in Q2 and 11.0% in Q1.

US ECONOMIC INDICATORS

Merchandise Trade (*link*): Trade data for the first two months of Q4 suggest trade was a drag on GDP growth last quarter, after contributing positively during the first three quarters of last year. The real merchandise trade deficit widened to -$66.7 billion in November—the largest since March 2015, deteriorating steadily from June's -$60.8 billion gap. The deficit averaged -$66.1 billion in the two months through November, compared to an average monthly deficit of -$62.0 billion during Q3. November's report was a strong one, as growth in real exports and imports exceeded 2.0%, with both jumping to new record highs. Gains in both were widespread. Real exports of autos (7.6%), capital goods ex autos (5.7), consumer goods ex autos (4.2), and food (2.7) all posted robust gains; exports of industrial supplies & materials (-2.3) was the outlier. The gain in real imports was led by consumer goods ex autos (4.8), capital goods ex autos (2.9), and autos (1.2), with imports of food (0.9) and industrial supplies & materials (0.8) fractionally higher.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales (*link*): November retail sales rebounded to a new record high. Sales jumped 1.5%, more than reversing October's 1.1% drop, climbing 2.8% y/y. November's strength was widespread, led by gains in spending on non-food products (2.3%), food, drinks & tobacco (1.2), and automotive fuel (0.3); that was the first gain in the latter since June. Available data for three of the Big Four economies show sales in Germany (2.3) posted its biggest gain in over a year, climbing to a new record high; sales in Spain and France rebounded 1.3% and 1.2%, respectively, after contracting in October. Along with Germany, the biggest sales increases during the month were recorded in Portugal (3.9), Slovenia (2.8), and Croatia (2.1); only Estonia (-0.2) posted a decline.

Germany Manufacturing Orders (*link*): November factory orders fell for the first time in four months, though the Economy Ministry said the dip was largely due to fluctuations in bulk orders, and the overall trend remains upward. Billings slipped 0.4% after soaring 6.2% the prior three months to a new record high. Both domestic (-0.4%) and foreign orders (-0.5) posted declines, as a 1.2% drop in orders from outside the Eurozone more than offset a 0.7% gain in billings from within the Eurozone. Yearly growth rates show Germany is in the midst of an economic boom. Total orders expanded 8.7% y/y, led by a double-digit gain of 10.6% in foreign orders—with orders from both outside the Eurozone (11.4% y/y) and within the Eurozone (9.4) soaring; domestic orders were a solid 6.2% above a year ago. Robust growth is widespread across industry groupings. Intermediate goods orders jumped 9.5% y/y, with foreign and domestic order up 13.1% and 6.2%, respectively; capital goods' billings expanded 8.5%, with foreign and domestic orders 10.0% and 5.8% above a year ago. Within consumer goods, durable goods billings are soaring, up 18.1% y/y—with growth in both foreign (22.0 y/y) and domestic (12.7) orders in double digits; demand for nondurable goods is more modest, with total, domestic, and foreign demand up 4.4%, 8.9%, and 1.4% y/y, respectively.

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