LPL RESEARCH

BOND MARKET PERSPECTIVES

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INVESTMENT IMPLICATIONS OF THE NEW TAX LAW: BONDS AT A GLANCE

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KEY TAKEAWAYS

The new law is intended to boost economic activity and simplify the U.S. tax code.

Given clarity on the new tax law, we are raising estimates for U.S. gross domestic product (GDP) and S&P 500 operating earnings for 2018.

After more than a year of political posturing and investor anticipation, Congress finally approved a $1.5 trillion tax cut, the most sweeping U.S. fiscal overhaul since 1986. The 2017 Tax Cuts and Jobs Act was signed into law by President Trump on December 22, 2017, meeting his pledge to deliver tax reform before Christmas. The complex 1,000-page bill features changes that are intended to spur economic activity through a reduction in both individual and corporate tax rates, and simplify the tax code by eliminating or trimming a variety of deductions and exemptions. In this week's commentaries, we look at the likely impact of the final bill on the economy, monetary policy, and the financial markets in the coming years.

As we wrote in our *Outlook 2018: Return of the Business Cycle* publication, we believe the combination of improved business fundamentals and fiscal legislation should sustain momentum in the economy and equity markets in the coming year and potentially beyond. After years of depending on the largess of monetary policymakers, investors can now focus on fiscal levers that we believe will support consumption and spur new business investment over the next few years. The law has important implications for major corporations, small businesses, and individual taxpayers [Figure 1], and may shift the trajectory for economic growth, the federal budget, monetary policy, and perhaps most critically for investors—corporate profits.

FIXED INCOME

When considering the overall environment for bond investors, the new tax law adds to our concerns previously highlighted in our *Outlook 2018*, including a less supportive Fed and a potential rise in inflationary pressures.

Investors in the U.S. Treasury market face several challenges, including a Fed that is no longer backstopping Treasury auctions, higher issuance of federal debt to support deficit spending, and the inflationary risk associated with stronger economic growth.

- Although he has not yet been confirmed, Jerome Powell, the presumed successor to Fed Chair Janet Yellen, announced plans in recent congressional testimony to raise the target for the fed funds rate at a gradual pace in 2018. Moreover, the central bank's plan to stop reinvesting proceeds of maturing securities on its balance sheet should result in "runoff" of approximately $300 billion in 2018.

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1 SUMMARY: 2017 TAX CUTS AND JOBS ACT

		Current Law	Final Bill
INDIVIDUAL	Top individual tax rate	39.6%	37% (until 2025)
	Individual tax brackets and rates	10%: $0; 15%: $18,650; 25%: $75,900; 28%: 153K; 33%: $233K; 35%: 417K; 39.6%: $471K	10%: $0; 12%: $19,051; 22%: $77,401; 24%: 165K; 32%: $315K; 35%: 400K; 37%: $600K
	Estate tax exemption	$5.5MM/person	$11MM/person
	State and local tax (SALT)	Deductible	Mostly eliminates; caps property tax/income up to $10,000
	Mortgage interest deduction	Deductible up to $1MM mortgage + $100,000 home equity	Deductible up to $750,000 of new mortgages; no home equity
	Student loan interest deduction	Deductible	No change
	Personal exemption	$4,150/person	Eliminates
	Standard deduction	$6,500 single; $13,000 married	$12,000 single; $24,000 married
	Individual alternative minimum tax (AMT)	Includes a $86,200 exemption + $164,000 phase-out	Increases exemption to $109,000 + phase-out to $1MM
	Child tax credit	$1,000/child	$2,000/child; refundable up to $1,400
	Obamacare individual mandate	Penalty of $695 or 2.5% income for no health insurance	Repeals
	Requires first in, first out (FIFO) upon sale	Flexibility to optimize tax harvesting	No change (i.e., no FIFO requirement)
	Municipal interest tax exemption	Muni interest exempt from federal taxes	No change
	Municipal private activity bonds	Tax-exempt bonds for specific public/private projects	No change
	Advanced refunding bonds	Allowable	Eliminates
	Capital gains	Long term: 0/15/20% (income dependent); short term: taxed as ordinary income	No change
CORPORATE	Corporate tax rate	35%	21% (permanent)
	Corporate tax rate starts	Not applicable	2018
	Top pass-through rate	39.6%	20% deduction for certain income until 2025 (with caveats)
	Corporate AMT	20% tax to broadly defined alternative income	Repeals
	Expensing	50% expensing through 2020	100% expensing through 2023
	Interest expense deductibility	No limit	Limits to 30% EBITDA until 2021; 30% EBIT thereafter
	Net operating losses	Allows carry backs 2 years; carry forwards up to 20 years	Eliminates carry backs; indefinite carry forwards (with caveats)
	Taxation of foreign income	Worldwide (though only taxable when repatriated)	Territorial; 100% exemption
	Deemed one-time repatriation tax	Not applicable	15.5%; 8% illiquid
	Carried interest	1-year holding period (minimum)	3-year holding period (minimum)
	Minimum taxes from income	Not applicable	10% tax on high-return income; increase to 12.5% in 2025

Source: LPL Research, Joint Committee on Taxation, Senate Finance Committee, House Ways and Means Committee, PIMCO 12/26/17

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- The U.S. Treasury will need to increase issuance of debt in order to make up for the potential initial loss in tax revenue as the economy adjusts to the new dynamic. Though only time will tell what the additional tax revenue from the supply-side benefits of the legislation will be, the immediate need to fund U.S. government activities and programs is likely to result in further deficit spending, which has historically resulted in bond investors demanding higher yields (by paying lower prices) for the extra risk of increased Treasury issuance.
- Improved consumer demand and business investment could fuel increased economic activity, supporting GDP growth and corporate profits. Yet this growth is typically associated with higher costs, rising wages, and inflationary pressures, which can diminish the value of fixed income investments.

We believe these dynamics will combine to pressure bond prices in the next few years. For 2018, we maintain our estimated range of 2.75% to 3.25% for the benchmark 10-year Treasury yield.*

While global investors may continue to find relative value in the benchmark 10-year Treasury, supporting demand and putting some downward pressure on rates, we suspect the degree of dollar strength will ultimately determine whether this trade persists, as global investors must consider the currency impact on dollar-denominated investments. Even with recent dollar weakness, any move near a 3.0% yield for the 10-year Treasury will likely attract global interest, in our opinion, potentially limiting the risk of a move above our target range.

Nevertheless, we think investors should be mindful of some risk to the upside for rates. While the yield curve (the difference between long-term and short-term rates) has not seen any real steepening due to the new law as it worked its way through Congress, the yield curve response was delayed following the 2003 Bush tax cuts [Figure 2]. If the Fed should hike rates three times in 2018, current spreads would put the 10-year Treasury yield near the upper end of our range. Our base case is for only slight yield curve steepening given the likelihood of foreign buying, but bond investors should be prepared to ride out a larger move.

Muni Bonds

Investors in the municipal bond market should also expect to confront some challenges, and some benefits, from the new fiscal dynamics. Uncertainty during negotiations over the new law resulted in heightened volatility in the Bloomberg Barclays Municipal Bond Index these past few months. Specifically, investors were concerned about the tax-free status of private activity bonds (PAB) and advance refunding bonds, along with the potential impact of lower tax rates. The new tax bill allows for the tax-free treatment of PABs, but not for advance refunding bonds issued after December 31, 2017.

We believe the dynamic tension between the forces of supply and demand will be on full display for the tax-advantaged bond market in the coming years. Since the tax reform discussions pulled issuance forward into 2017, we could see a slowdown in municipal issuance next year, easing supply concerns. The lower individual tax rates may limit demand from top income earners, but the changes to state and local tax (SALT) deductions may actually increase demand in some high-tax states.

*As noted in our *Outlook 2018: Return of the Business Cycle*, we forecast flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index, based on our expectations for a gradual pickup in interest rates across the yield curve. We also expect the 10-year Treasury yield to end 2018 in the 2.75 – 3.25% range, based on our expectations for a modest pickup in growth and inflation.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in

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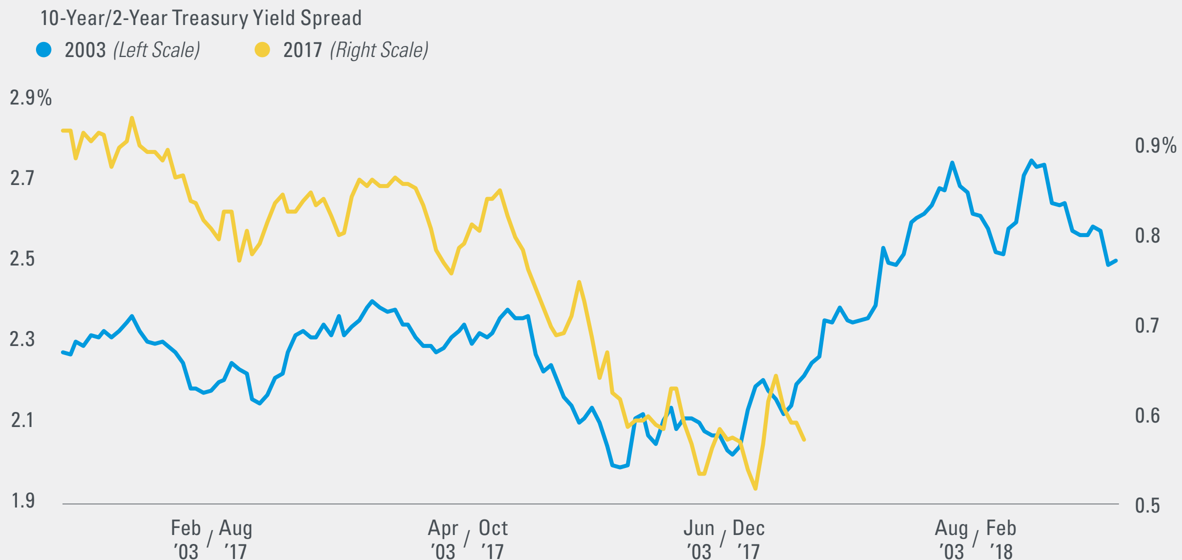
Corporate Debt

Investors in corporate debt must get comfortable with the changes in interest deductibility. The full deductibility of corporate interest is now limited to 30% of earnings before interest, taxes, depreciation, and amortization ("EBITDA"). While limits on the deductibility of interest expense is a negative for corporate debt, some of that can be offset by the positives of lower overall corporate tax rates, the full expensing of capital expenditures, and other provisions within the bill.

- The impact of the deductibility provision is more negative for firms with increased leverage as there is larger relative loss from the deductibility limitation. Firms with the lowest quality debt are likely to feel the impact more severely than those companies with higher quality debt.
- The tax bill may slightly reduce issuance for corporate debt in the coming year, though it was forecast to be lower anyway, due to the record investment-grade issuance in 2017.
- Firms that repatriate cash may use some funds to buy back corporate paper to lower their debt levels, further reducing supply as demand for yield is expected to persist.

We believe demand for both investment-grade and high-yield corporate debt should remain robust amid the near historically low yields on government debt globally. We continue to favor higher-quality investment-grade corporate debt for suitable investors, and we encourage those investors who pursue high-yield bonds, which do offer added yield, to monitor overall portfolio risk levels. Fixed income exposure within a diversified portfolio can continue to play an important role, providing the potential for liquidity, yield, and smoothing out volatility during periods of weakness in the equity markets.

2 YIELD SPREAD RESPONSE TO TAX CUTS WAS INITIALLY MUTED IN 2003 TOO



Source: LPL Research, Strategas Research Partners 12/26/17

The 2003 tax cuts were signed into law by President Bush on May 28, 2003.

Performance is historical and no guarantee of future results.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread (yield advantage), the greater the difference between the yields offered by each instrument.

CONCLUSION

It's been our view since the election that the combination of a Republican president with a Republican Congress had a high chance of passing some form of tax relief, whether it be in the form of tax cuts or more comprehensive tax reform. Early legislative setbacks led us to push back our timeline, but we remained confident that a tax bill would find its way to the president's desk. While the accelerated legislative process that led to the president being able to sign the bill into law on December 22, 2017 was a surprise to us, it does not substantially change our views.

The biggest impact of the accelerated timeline is decreased uncertainty, allowing individuals and businesses the opportunity to begin planning around the changes and pulling forward the new law's impact. As a result, we have upgraded our economic growth path to 2.75–3.0%, maintained our bond market view though we see greater risk to the upside for rates, and upgraded our S&P 500 target to align with our view of the law's expected impact on corporate earnings. Our upgraded S&P 500 target keeps our broad return expectations for 2018 at approximately 10% including dividends. While the new law should help provide fiscal support for the economy as monetary support is withdrawn and helps decrease the chance of recession in 2018 and even in 2019, we still expect to see market volatility increase from the extraordinarily low levels that persisted in 2017. But nevertheless, for markets and the economy, we believe the new law provides a firmer launching point as we enter the new year. ■

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Please see the *Outlook 2018: Return of the Business Cycle* publication for additional description and disclosure.

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All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

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Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

DEFINITION

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

INDEX DESCRIPTION

The Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indexes are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

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