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VIEWS FROM THE BRICK

LATE NIGHT ON THE HILL

For many of us, the work week tends to be relatively predictable. Monday through Friday from 9-6. Maybe a few hours over here and there. Last Friday while the majority of us called it quits for the week, it seems like the U.S. Government decided to put in overtime. Luckily, the lights being on in the Capital building caught our attention and we decided a night shift was necessary too.

WHAT JUST HAPPENED?

Friday night US senators passed a tax overhaul plan in the late hours, which is setting up for the Trump administration's first legislative victory of the presidency. It was a late night on The Hill which featured a series of amendments and votes which ultimately saw a 51/49 (Republicans carry a 52/48 majority in the Senate) split in favor of the overall bill. Senator Bob Corker of Tennessee was the only Republican on the floor that did not vote 'aye' with the rest of his party members. A move to push the decision until Monday, proposed by Senate Minority Leader Chuck Schumer, was ultimately denied. The request came after the 500 page document, accompanied with hand written annotations, was distributed late in the evening with little time ahead of the final vote.

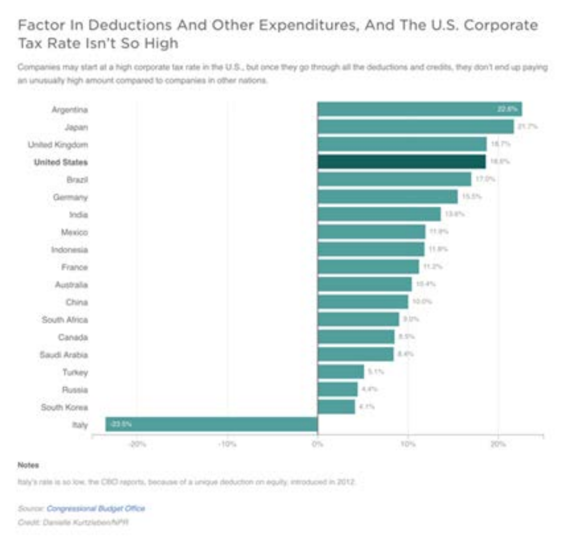
WHAT ARE THE IMPLICATIONS?

Some of the highlights from the Senate's bill have much to do with the new proposed corporate tax rate and expiration of new rates on middle income families.

- The corporate tax rate which has been signed off on (both in the House's bill as well as the Senate's) is 20%. This is a reduction from the statutory federal rate of 35% currently imposed on U.S. Companies. In reality, however, majority of corporations end up paying less than 35% today.

- The agreed upon 20% is a bit closer to what Paul Ryan's expectations were for the new system. If we can remember back to the campaign trail, the initial Trump administration expectations were for a 15% rate.

- While the idea of a slash in the federal rate from 35% to 20% looks very appealing on the surface, the effective tax rate paid by many U.S. Corporations today actually comes out to about 18.6% after deductions and credits are taken into consideration. (Source: Congressional Budget Office)



- An independent tax center (Source: Tax Policy Center) said that the bill would add $1.2 trillion to federal deficits over 10 years. While this might sound counter intuitive on paper, part of this could be attributed to the continued decline in dependency on tax revenues for economic growth as a country.

- By 2027, the Joint Committee on Taxation estimates, 84% of households will face either a tax increase or a tax cut that is smaller than $100.

- Republican leaders argue that the substantial tax cuts for business would eventually result in wage increases. Critics counter that there is little historical evidence for that claim. (i.e. Bush tax cuts 2001)

- Repatriation for corporations that have parked cash over seas estimated to be above $3 trillion would save $500 million in tax breaks. Again, the thesis here is this incentive would allow for corporations to increase investment and wages. This expectation is one that has rarely played out in other historical instances of tax holidays.

- Another bullish case for tax reform is incentive for companies to boost investment and innovation. A variable that would be in play here is the middle class. Companies need a strong middle class in order for those potential investments to make sense in the long term. Under the proposed bill, the average middle class family would eventually see a tax hike by 2025.

- Estate tax still up in the air. The Senate bill would leave the tax in place for estates over $10 million. The House Bill would increase the estate tax to $10 million each year after next, and eventually do away with the "death tax" after 6 years.

- While Tech has led much of the rally, largely driven by fundamental execution and unmatched profitability, the idea of a "tax rally" is lost on these names. Tech companies pay the 3rd lowest tax rate today, so the concept of sweeping tax overhaul doesn't exactly scream tailwind here. However, there still stands to be little evidence of negative impact on these names, so take any lagging here as an indication of rotation within the market and ultimately an opportunity (i.e. FANG immediately after the election).

- Asset heavy industries will benefit from immediate expensing of capital expenditures (capex). That's expected to benefit most notable energy and industrial companies.

- Small caps and Micro Caps should see some relief from taxation as these companies are almost always domestically concentrated.

- Some of the larger industries which are paying higher than average aggregate effective tax rates in the U.S. today include: energy, healthcare.

- An area of caution would be high yield debt issuers. Under the current tax law, corporations are able to deduct 100% of their interest payments from their taxable earnings. Both the House and Senate bills would bring this down to as little as 30%. Essentially the Senate bill would calculate this deduction using EBIT while the House bill would use EBITDA. The dropping of depreciation and amortization (DA) in the Senate bill means even higher taxes payable for corporations with balance sheets below investment grade metrics. It is estimated that 38% of the U.S. high yield market would be negatively impacted by the House's EBITDA bill (i.e. no net benefit). Under the Senate's proposal for the use of EBIT the estimation climbs to 67%. (Source: Bloomberg, Morgan Stanley)

CONCLUSION

What's the solution?

Remain balanced and positioned to benefit from the rotation within the market we've seen throughout the year. Expect some choppier waters ahead if the corporate tax reduction isn't enacted until 2019. This volatility would likely to be driven by investors trying to rerate the market based off any delayed expected impact from policy. Does that mean a steep decline? No, this could be resolved by a short term trend-less price action.

What happens next for the bill?

Are we out of the woods yet? Not quite. What's next is a conference committee will meet to iron out the details between the House and Senate proposals before it reaches the President's desk. Is this guaranteed to be a long process? No. In theory the House can agree to the Senate's bill and in which case it could be signed into law as soon as next week. But that doesn't seem likely given some substantial differences between the two bills.