Market insights

Tax reform is here: Should investors reform their portfolios?

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Going into 2017, all eyes were on politics: from the new U.S. administration to Brexit negotiations and European elections. The equity markets seemed to coast through many of these mile markers. However, the political development that got many investors the most excited was the growing likelihood that U.S. tax reform just might become a reality. Here we are, with a tax reform package being signed into law that fundamentally changes the corporate and individual income tax code. What are the implications for investors' portfolios? Here are my thoughts on variables ranging from how companies may react to the bill, to how tax reform might affect equity valuations and Treasury yields. We'll also feature insights from five Wells Fargo Asset Management portfolio managers.

Economic growth

All pieces of legislation are massive and that is especially true of tax reform legislation. It will likely have many knock-on effects felt for many years, so it is hard to forecast exactly how tax reform will affect every part of the market. The long-term effects are the areas of the widest disagreement among economists: some say the tax bill will only provide short-term stimulus, while others say it will have longer-lasting effects. At its most recent policy meeting, the Federal Open Market Committee (FOMC) ratcheted up its projection for 2018 Gross Domestic Product (GDP) growth by 0.4 percentage points, probably in no small part because the FOMC saw the increased likelihood that tax reform would soon pass. The Joint Committee on Taxation estimated that tax reform could boost GDP growth by an average of 0.1 to 0.2 percentage points per year, over 10 years. Some say these are overly optimistic estimates, while others say they are overly pessimistic. The truth may be somewhere in between.

Equity valuations

Perhaps tax reform can change investor perceptions of equity valuations. People have been worried about elevated valuations all year, if not longer. Here's how cutting the top marginal corporate tax rate from 35% to 21% would influence earnings per share (EPS) for domestic income:

- 35% tax rate: $1 in earnings before taxes (EBT) is $0.65
- 21% tax rate: $1 in EBT is $0.79
- The result: a 22% increase in EPS, by moving up from $0.65 to $0.79

That is a significant one-off jump in earnings, even if it does not affect the long-term growth rate of earnings. As a result, worries about "sky high valuations" should likely subside. This affects smaller-cap stocks more than larger-cap stocks as small caps tend to be more domestically-oriented than large-caps.

Company reactions

Switching from a worldwide to a territorial corporate tax system could also have important domestic growth implications. Companies with accumulated overseas profits will have to pay a tax on those earnings, whether they bring the money back to the U.S. or not. That could encourage them to loosen the purse strings, investing in property, plants, and equipment; paying out special dividends; restructuring their balance sheets to pay off debt; or engaging in a shopping spree through acquisition activity.

- Investing in property, plants, and equipment would tend to benefit those firms that sell the plants and equipment
- Paying out dividends puts more money in the pockets of investors, which can be spent or invested
- Merger and acquisition activity may unleash some acquisitiveness in the small and mid-cap areas
- Restructuring balance sheets to pay down debt should improve the credit quality of these firms

Treasury yields

For yields, limiting interest deductibility to 30% of EBITDA (earnings before interest, taxes, depreciation, and amortization) and then after a few years to 30% of EBIT (earnings before interest and taxes) may affect some firms, but that's a small subset of firms. Full expensing of investments in plants and equipment could encourage investment spending—that's what it's designed to do—but although the nation's capital stock is old, capacity utilization is merely close to average. And we're seeing that average level because firms still aren't predominantly maximizing their existing resources for the production of goods—there's still some slack. Any incremental investment could be long-term deflationary, and serve the purpose of seed corn for future productivity growth. Lower inflation risks with upside risks to growth could ultimately put upward pressure on Treasury yields, but it's a process that will likely take time.

Insights from our portfolio managers

- **Watch for a boost to confidence and consider stocks of companies that may be attractive acquisition targets.** "I believe the tax bill will create a greater sense of confidence in corporate America. We are already sensing it from the conversations we are having with management teams. And repatriation as well as tax cuts will create a surge of consolidation over the next couple of years."—Ann Miletti, Portfolio Manager, Wells Fargo Asset Management PMV (Private Market Value) Equity Team

- **Watch for competitive pressures, while considering stocks of companies that can protect their margins.** "One of the interesting twists I've heard being debated by some is whether tax reform will ultimately be deflationary. The argument is that lower taxes will boost after-tax cash flow margins and companies will compete those away, as they try to grab market share. That competition in this scenario will manifest in lower prices. My take is this is more likely in competitive commodity-like industries."—Tom Ognar, Portfolio Manager, Wells Fargo Asset Management Heritage Growth Equity Team

- **Watch for any "sell the news" action and consider waiting in a small cap position.** "From our bottom-up work in small caps, we think the market has failed to adequately price in the value of tax reform. It's a little strange, because normally I would say 'sell the news' on something that was so well telegraphed, but perhaps seasonality—and a desire to avoid introducing risk into equity portfolios this late in the year—has left the door open for the market to reprice small cap companies after this news."—Jim Tringas, Portfolio Manager, Wells Fargo Asset Management Special Global Equity Team

- **Watch for changes in the credit environment and consider areas with the best tax-adjusted returns.** "People inherently think that tax cuts are a negative for municipal valuations. The market showed recently that the supply side of the equation also affects valuations as forecasts for less supply in 2018 helped support prices today. Ultimately, the level and direction of rates and credit environment will be the primary drivers of valuations. Investors will need to look at their current and projected tax rates and make allocation decisions based on the best tax-adjusted income at that time, projected changes to relative valuations between muni bonds and other fixed income classes, and their desire for diversification."—Gabe Diederich, Portfolio Manager, Wells Fargo Asset Management Tax-Exempt Fixed Income Team

- **Watch for a big jump higher in corporate profits when considering corporate fixed income or Treasuries.** "My perspective is that we will see after-tax corporate profits rise as a direct result of the cut in the statutory rate, though not all firms will benefit equally and some could be hurt by the limitation on interest deductibility. At the margin, corporations will be incentivized to de-lever balance sheets, to some degree. Higher deficits resulting from the net reduction in tax collections will result in more Treasury issuance, which could lead to higher rates, all else being equal. At a very broad-brush level, the tax reform legislation should be good for corporates and not so good for Treasuries."—Jay Mueller, Portfolio Manager, Wells Fargo Asset Management Fixed Income Team

Final thoughts

While tax reform will bring about big changes, it should not reform the way people look at their portfolios. Tax reform may create more opportunities on the margin, in cyclical areas tied to consumer spending and investment spending. It could also disproportionately benefit smaller firms and those firms that could become targets for acquisitions. However, if investors have started with a well-balanced portfolio designed to align with their long-term goals, that foundation should still serve investors well, no matter what the tax code looks like.

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