Investment Insights

Unwrapping Tax Reform: Implications for Markets

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Highlights

- The new tax legislation is significant as it lowers individual and corporate tax rates, changes rules related to cash held overseas and corporate deductions, and helps to dismantle the Affordable Care Act, while increasing the federal debt.
- We see the legislation as a net positive for equities overall, as a combination of corporate earnings and the aggregate economy should receive a boost. Corporate bonds should also benefit.
- For municipal bonds, the changes will likely reduce the supply of new issuance, which may lead to outperformance over U.S. Treasuries in 2018.
- While significant, the legislation is only one of many factors that will drive portfolio performance in the year ahead.

After passage in Congress on December 20, the tax bill — which we refer to here as the Tax Cuts and Jobs Act (TCJA) — is expected to be signed into law by President Trump at some point in the next few days. The law is noteworthy on a number of fronts, not the least of which is its incredibly broad scope — the TCJA lowers tax rates and materially changes rules for thousands of corporations and millions of individuals. It also stands out as it increases federal debt by some $1.4 trillion over the coming decade; even with additional GDP growth stimulated by tax reform, the added debt could still easily top $1 trillion.

Further, the law helps President Trump with a second goal of the administration: dismantling the Affordable Care Act (ACA). By removing the healthcare mandate requiring people to either buy health insurance or pay a penalty, Congress was able to secure about $300 billion in revenue (through reduced government subsidies to help people afford insurance coverage). Those funds help offset tax reductions elsewhere to keep the legislation within Congressional deficit guidelines.

Finally, the law is remarkable in that it sets tax rates for individuals in part based on how they work, rather than solely on how much they earn. (Wages and salaries are taxed differently than income earned by partnerships, owners, and closely held corporations.)

We have included a list of various aspects of individual and corporate tax protocol that are changing in an appendix at the end of this note.

Some of the more noteworthy specific features of the legislation include the following:

- The corporate tax rate will fall from 35% to 21% starting in 2018.
- Multinational firms will be incentivized to bring home overseas profits at a lower tax rate, potentially adding a measure of support for the dollar.
- The individual top tax rate will fall from 39.6% to 37%.
- An exemption on the 40% estate tax will be doubled to more than $11 million per person; it will not, however, be repealed.
- State and local tax deductions will be capped at $10,000.
- The individual mandate for the Affordable Care Act will be repealed.
- FIFO, or first in, first out, was not included in the final bill, allowing individuals to continue using specific equity lots for tax planning and gifting.

The TCJA does not simplify the tax code, as Congressional members had originally intended. Indeed, the Senate's bill alone was nearly 500 pages. The large number of moving pieces in the legislation makes it challenging to confidently predict medium or longer-term implications for the economy and financial markets.

That said, looking into 2018, some aspects of the TCJA at least directionally impact our thinking, both on macroeconomic and more micro trends (sectors and securities). In this note, we specifically cover implications for U.S. equities, the dollar, municipal bonds and the broader economy, appreciating that there are other aspects of the bill we are leaving out for now but will incorporate into other research in the year ahead. (Note that our wealth planning and tax colleagues are also parsing the legislation and have their own conclusions on how it could affect our clients' tax and planning situations, as well as actions that clients may consider immediately. Please see our *Wealth Planning Insights*, "The Tax Cuts and Jobs Act: What Does It Mean for You?")

More Earnings or More GDP Growth? Probably a Bit of Both

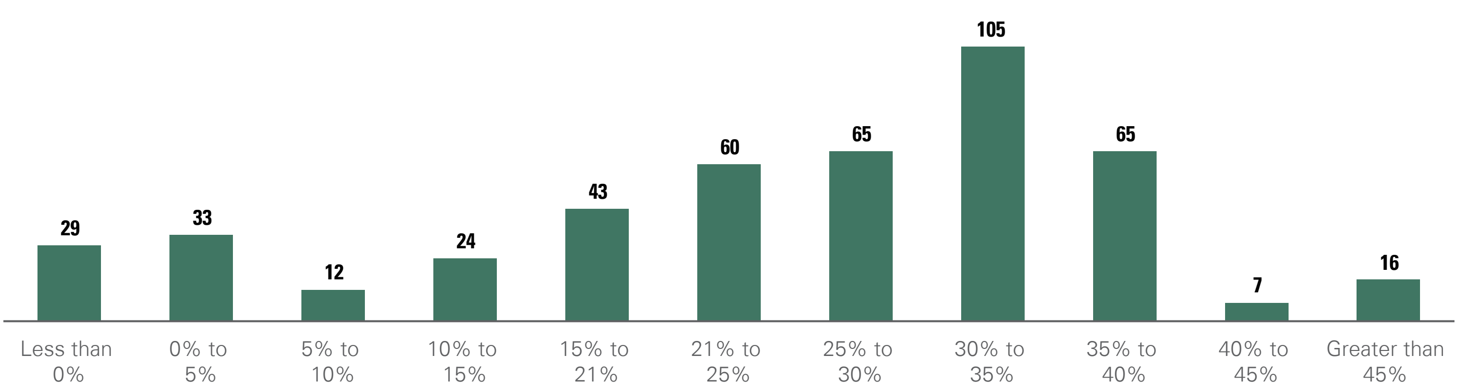
The new tax legislation is a net positive for U.S. equities overall. Before the final legislation was unveiled, consensus estimates discounted 11% earnings per share (EPS) growth for 2018. Even if some of the good news is already reflected in markets, confirmation of a 21% corporate tax rate should further lift expectations for corporate earnings. Indeed, in the coming weeks, we should see Wall Street analysts revising up estimates for companies they track, in turn supporting aggregate S&P 500 earnings estimates.

Brighter expectations will not necessarily translate into universally stronger earnings growth, however. Even if an estimated 18%–20% effective corporate tax rate for the S&P 500 under the new law is well below today's effective rate of 24%–25%, we do not think corporations' savings will all be pushed through to earnings, nor will every firm benefit equally. Consider:

- The effective tax rate change differs by equity sector and even by company; some firms will not see any material change in the tax rate from TCJA (Exhibit 1).
- How companies are structured (for instance, issuing local versus foreign-denominated debt) will impact earnings given some new limits on tax deductibility.
- Some firms will likely spend a portion of the tax-related savings, including for capital expenditures, share buybacks, or potentially higher wages.

As analysts continue to sort through the details of the TCJA from a company level, consensus estimates seem likely to evolve. (We provide

Exhibit 1: Number of Companies within the S&P 500 by Effective Tax Rate



As of most recent annual report for each company in the S&P 500. The effective tax rates are not adjusted for one-off transactions that may have resulted in abnormally low or high effective tax rates in the company's most recent fiscal year end. Results are based on data availability and includes 459 companies.

Source: FactSet

thoughts on some specific stocks that Bessemer client portfolios own in subsequent pages to offer more insight on this topic.)

What about the broader U.S. economy? Again, we see the TCJA as an overall net positive but with the devil in the many, many details. One of the potentially largest drivers of growth incorporated in the legislation is the degree to which corporations spend tax savings versus using them to boost earnings.

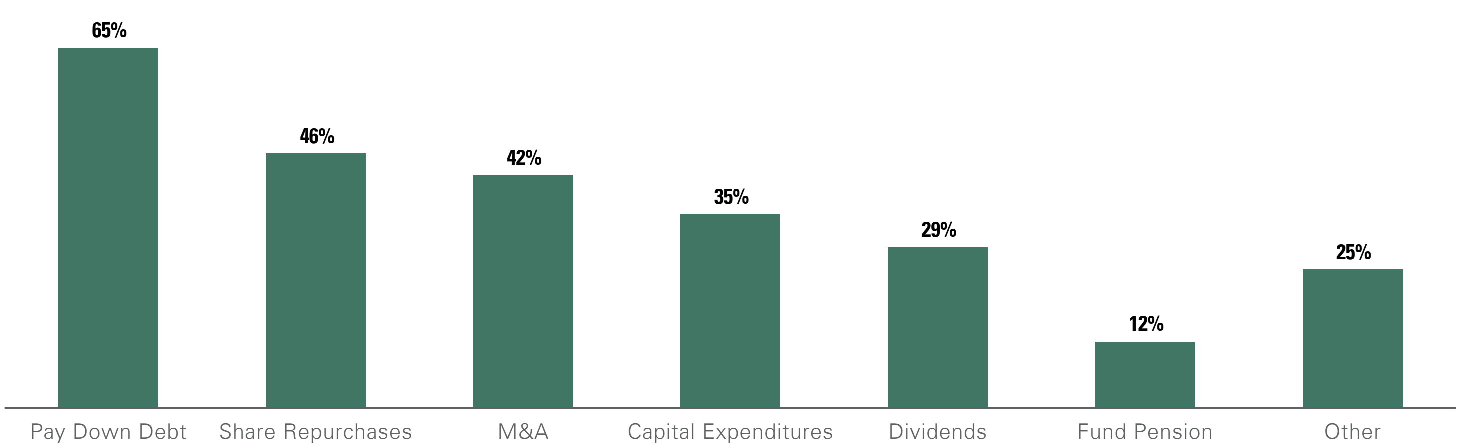
The scenario likely to generate the highest amount of growth is one where firms decide to spend tax savings on capital expenditures (or capex) to improve their companies. Capex can generate new business for other sectors of the economy, which can have a virtuous-cycle effect on the overall economy as a result.

Conversely, if the companies decide to use the funds for corporate actions such as debt-paydowns or share repurchases, this will have far less of an overall effect on growth longer-term (though it may still help growth short-term via an equity-led wealth effect). A survey of 300 American CEOs conducted earlier this year by Bank of America Merrill Lynch Global Research suggests capex may take a back seat to balance sheets in the year ahead — helping equities near-term but growth relatively less over the medium-term. Asked what they would do with cash raised from a corporate repatriation, fewer than 40% of CEO respondents indicated that they would use those funds for capital expenditures, as shown in Exhibit 2.

With all these factors in mind, we believe that at least a 25-basis-point (0.25%) increase per year in U.S. GDP is reasonable. Again, though, our forecast is highly dependent on how much overseas cash is repatriated by corporations, and what they then choose to do with those funds as well as how overall tax-related savings are utilized. The degree to which consumption ramps up as tax savings trickle through — both to individual consumers and to small businesses — is difficult to gauge but in sum should also support economic growth. We will also need to see how immediate depreciation of capex feeds into the economy; while we would expect this change to support growth, its magnitude remains unclear. To put all this in perspective, as of mid-December, with some of the tax-change plans incorporated, economists' consensus forecast for U.S. GDP was 2.6% for 2018, up from 2.3% in 2017.

A final thought for GDP growth ties back to monetary policy. While the Federal Reserve has incorporated some measure of tax reform and fiscal stimulus into its economic forecast, any upside surprise in growth or inflation expectations is likely to be met with more rate hikes from the Fed.

Exhibit 2: Survey of 300 American CEOs on Plans for Repatriated Cash



Source: Bank of American Merrill Lynch Global Research

Modestly tighter monetary policy may serve to partially cancel out some of the potential economic growth. We note, however, that the Fed has hiked five times now, and financial conditions continue to loosen, so the impact from higher interest rates to growth is less than crystal clear.

Repatriation: Leaving No U.S. Dollar Behind

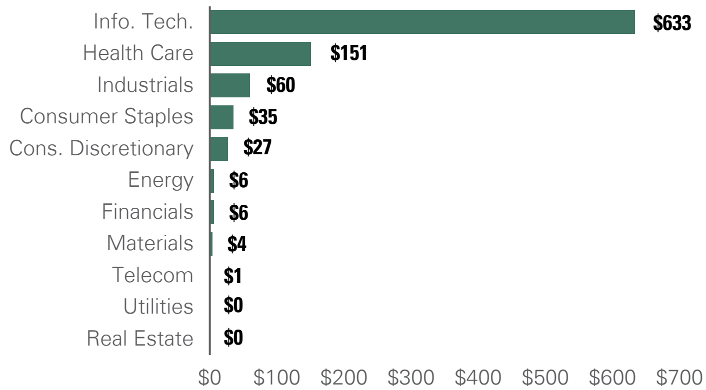
An important element of the TCJA relates to provisions for repatriating earnings that U.S. companies have generated abroad. While disclosure of foreign untaxed earnings is not uniform, there is approximately $2.9 trillion in earnings reinvested overseas held by U.S. firms (the bulk of which is represented by S&P 500 firms). Roughly $920 billion of the total is held as untaxed overseas cash, while the remaining $1.6 trillion is non-cash untaxed overseas earnings. U.S. corporate tax rates at 35% have been high relative to other developed countries, prompting companies to favor lower-tax jurisdictions, such as Ireland or Switzerland with 12.5% and 8.5% tax rates, respectively.

A handful of companies make up the majority of unremitted earnings and untaxed overseas cash within the S&P, including Apple, Microsoft, Cisco, Johnson & Johnson, General Electric, and Oracle. Other notable companies that disclose, such as Exxon, Pfizer, and IBM, have large permanently reinvested overseas earnings.

Most companies impacted by this legislative change are in the healthcare space, especially pharmaceutical and biotechnology industries, as well as information technology (Exhibit 3). Unlike other sectors, pharmaceutical and information technology companies' value add is more intellectual-property intensive, enabling them to more easily use lower-tax jurisdictions. They often hold their foreign earnings in liquid instruments denominated in U.S. dollars. In contrast, companies in other sectors reportedly use the majority of their foreign profits to fund offshore operations. For instance, in General Electric's most recent annual report (fiscal year 2016), the company stated that "Most of these [non-U.S.] earnings have been reinvested in active non-U.S. business operations, and we do not intend to repatriate these earnings to fund U.S. operations."

The new tax code requires that companies account for and pay taxes on all accrued earnings since 1986, albeit at lower rates than was previously the case. Cash and cash equivalents will be taxed at a rate of 15.5%, and all other earnings will be

Exhibit 3: S&P 500 Overseas Cash by Sector — Billions



Cash level is based on 2016 10-Ks.

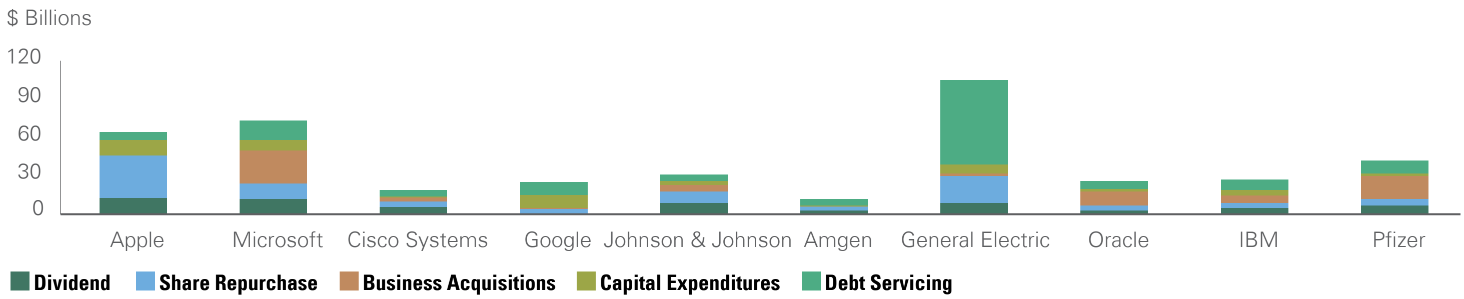
Source: Bloomberg, Goldman Sachs

taxed at a rate of 8%. Companies can elect to pay their net tax liability in eight installments or all at once. In comparison to the 2004 tax holiday (2004 Homeland Investment Act), all untaxed foreign earnings will now be taxed, but companies will not be required to repatriate the earnings.

We see repatriation, while a high-profile part of the TCJA, as having only modest market and economic impacts. We expect companies, particularly information technology, pharmaceutical, and biotechnology firms, to repatriate some cash holdings to fund both cash to shareholders (stock buybacks and dividends) and growth investments (capex, R&D, and cash M&A). In Exhibit 4, we include how some companies with large overseas unremitted earnings and untaxed cash balances used cash according to each company's most recent annual report. Given increasingly high stock market valuations, we would not expect a sizeable share of remitted earnings to fund stock buybacks.

Meanwhile, from a foreign-exchange perspective, most unremitted foreign holdings today are already in U.S. dollars or are hedged back to the dollar. That, plus the open-ended period in which firms can repatriate, suggest to us that the tax-code change should result in only modest dollar appreciation. We also see any impact on corporate bonds as modest. There might be a slight decrease in bond supply by a select number of companies with large overseas cash balances (e.g., Apple, Microsoft, Amgen, Gilead, PepsiCo, and Intel, all of which issued debt each year from 2015 to 2017 and have overseas cash balances greater than $5 billion).

Exhibit 4: Companies' Use of Cash in Past Fiscal Year



As of each company's most recent annual report. Reflects companies with large overseas cash holdings and/or permanently reinvested foreign earnings.
Source: FactSet

TCJA Means Something Different to Each Company

Given the complicated nature of the new tax legislation, we thought it might help illuminate some of the issues to provide a peek into the situations of individual Bessemer portfolio holdings. The following examples are from the Large Cap Core and Small and Mid Cap Core separately managed accounts and reflect the perspective of the respective portfolio managers.

Discover: Discover Financial Services is expected to benefit from both the lower corporate tax rate and overall stimulus to consumers. Specifically, Discover has an effective tax rate of 33%, meaning the lower corporate tax rate of 21% will likely have a meaningful impact on the company's tax bill in future years. Similarly, Discover lends to prime customers, who, as a whole, are expected to have more after-tax disposable income in the year(s) ahead.

Apple: The net effect of tax reform for Apple is positive given its sizeable overseas cash, and Apple's positioning is positive outside of the tax angle as well. Apple has the largest amount of overseas cash and cash-equivalent holdings of any company within the S&P 500, amounting to $252 billion, or a quarter of its market cap as of September 30. Apple has not publicly announced if it plans to pay off its impending tax bill in installments or all at once. Over the past several years, Apple has used the majority of its cash to repurchase stock, followed by dividend payments and capital expenditures. It is likely that Apple will repatriate at least some of its cash currently held overseas.

Nike: The tax reform is likely a net neutral for Nike, with some nuances. Approximately 59% of Nike's total revenue is generated outside of U.S. The company, to a large degree, has used overseas revenues for permanent foreign reinvestment, and it will now need to pay taxes on these earnings. According to its 2017 annual report, dated May 31, Nike has around $12.2 billion, or around 12% of its current market cap of $106 billion, in indefinitely reinvested earnings, which will now be subject to taxation — but accounting for offsetting credits, Nike's taxable exposure is closer to one-third of this level. The company primarily has used cash to fund share repurchases followed by dividend distributions and capital expenditures over the past few years. Repatriation may be the more relevant angle for Nike as its effective corporate tax rates in most years has not been meaningfully different than the new rate.

Dentsply Sirona: Dentsply Sirona, a worldwide manufacturer and distributor of dental supplies, is expected to be a beneficiary of the new depreciation policy (see Appendix for more details on depreciation policy). More specifically, Dentsply will likely experience a boost in sales as demand for its products increases because its consumers will purchase more of its equipment due to the increase in bonus depreciation. The company also will be marginally affected by deemed repatriation with a tax liability equal to 15.5% or 8% of $599 million in cumulative foreign earnings as of December 31, 2016 (the amount might be lower after accounting for foreign tax credits). Dentsply had an effective rate of 18.9% for fiscal year 2016 after accounting for a one-off event that materially lowered its rate to 2.2%, so it will likely not reap significant benefits from a materially lower corporate rate.

Wyndham Worldwide Corp.: Wyndham will benefit from a significant reduction in its corporate tax rate, which is currently at 35%, due to its high share of revenue generated in the U.S. at around 75%. The new lower corporate tax rate of 21% will result in a noteworthy enhancement in earnings power. The company, however, will likely be subject to additional taxes next year through deemed repatriation as the company mentions that it has accumulated foreign earnings that it has not paid U.S. taxes on in its 2016 annual report.

Laboratory Corporation of America Holdings: Around 80% of LabCorp's pretax income is generated in the U.S., meaning that it is well positioned to reap the benefits of the lower corporate tax rate effective next year. More specifically, LabCorp had an effective tax rate of 33.7% in fiscal year 2016 (historically the rate has been even higher since it only recently expanded overseas). The lower rate of 21% will result in an increase in earnings power. Like most multinational corporations, LabCorp will also be affected by deemed repatriation with a tax liability on its unremitted foreign earnings.

Fixed Income: Beware of Poor Credits

In the municipal bond market, the loss of exemption for refunding bonds will likely reduce the supply of new issuance by upwards of 20%. This is a large portion of the market simply to close down, and it offsets the slightly negative effects of lower corporate rates for financial and property/casualty insurance companies, which are large muni buyers. Bessemer's portfolio team expects the drop-off in supply to cause muni outperformance relative to U.S. Treasuries in 2018. During 2017, they held U.S. Treasuries in many portfolios as a relative-value strategy because munis were expensive (this is called a "crossover trade" in bond lingo), but in Q4, they began unwinding these Treasury holdings in favor of munis. They will continue to monitor the relationship between municipal and Treasury yields.

High-tax states, hurt by issuance restrictions and challenged by the abolishment of the SALT deduction, are likely to push part of the funding burden down to local municipalities. The team also believes that the burden on more highly taxed localities may increase as it becomes more difficult to push through higher levies. Therefore, higher-quality cities, towns, and counties are likely to withstand this trend, while lower-quality, inefficiently managed municipalities are likely to suffer. As a result, the higher-quality bias should be helpful to clients' portfolio returns in this environment.

The U.S. Treasury bond market is likely to be relatively calm since economic growth is merely good (not excessive), and inflation, for a variety of reasons, has not budged from comfortably low levels. The tax plan is unlikely to cause excesses in the real economy that would prompt the Fed to tighten beyond market expectations, and if there is any significant inflation, it is more likely to be in financial-asset prices. The Treasury is likely to issue more debt as a result of Congress' deficit spending — which normally would push yields upward — but the Treasury's move to reduce the duration of its issuance should help offset this effect. The team expects the yield curve to continue flattening with short-term yields rising more than longer-term yields, and clients' portfolios are positioned accordingly with lower-than-normal exposure in the one- to five-year portion of the yield curve. This is called a "barbell" strategy.

Corporate bond issuers will have to deal with a reduction in the deductibility of interest expense (on debt), but — with the exception of the lowest-quality high-yield issuers — the reduction in the corporate tax rate will more than offset this loss. As a result, the tax plan is credit-positive, and the portfolio team plans to maintain the large overweight in investment-grade corporate credit — for longer at this stage of the economic cycle than if no tax bill had been passed. One dynamic to note is that, with interest deductibility geared off EBITDA, in an economic downturn, falling EBITDA will make less interest deductible, thereby raising a struggling high-yield issuer's tax liability at the worst possible time. Within Strategic Opportunities, where the portfolio has historically held high-yield debt, exposure to high-yield debt is very small, as even before the tax reform process heated up, the portfolio team viewed the upside as limited with yields having compressed significantly over the past 18 months.

Conclusion: More Unwrapping to Come, but Base Case Remains Constructive on U.S. Equities

We appreciate that this legislation will impact corners of the financial markets, and broader economies, in ways we may not yet have clarity around. Over the coming days, weeks, and months, our investment department will continue to analyze and discuss the TCJA to ensure that we are uncovering opportunities and managing against risks.

Bessemer equity mandates increased exposure to both emerging markets and Europe in the first half of the year as the outlook there improved, but the mandates maintained overweight exposure to the U.S. versus benchmarks throughout 2017. Part of the thinking in maintaining higher exposure to the U.S. was our base-case assumption that, at some point, tax reform would be passed and would include provisions supportive for U.S. corporations. Our best guess was that reform would happen in early 2018, so the outcome is a bit more supportive than anticipated in that regard, though there are many nuances in the details as we have discussed in this note. We believe the regional weighting tilted to the U.S. is appropriate both for the current scenario of tax reform being realized, which can boost the relative prospects for the U.S. dollar and U.S. companies, and also for a scenario in which volatility increases, as the U.S. markets and U.S. dollar tend to outperform due in part to "safe haven" flows as risk aversion rises. Please see *A Closer Look*, "The Dollar Under President Trump Revisited," for more details on these views.

While significant, the TCJA is only one among many factors that will drive portfolio performance in the year ahead. As we discussed in our *Quarterly Investment Perspective*, "Goldilocks or the Three Bears," we are constructive on cyclical assets in the year ahead but acknowledge a number of material risks including a potentially sharp rise in inflation and Fed response, an unexpected China slowdown, and/or a political/geopolitical shock.

Special thanks to many members of the investment department for their contributions.

Appendix: Key Changes to Individual Taxes

	Current Tax Law	Tax Law Effective in 2018/2019
Tax Brackets	• Seven	• Seven, lower overall
Alternative Minimum Tax	• Tax calculation applicable to high-income earners	• Increases exemption, meaning AMT applies to fewer individuals
Standard Deductions and Personal Exemptions	• Standard deduction ($6,500 singles/$13,000 couples) • Personal exemption of $4,150 per taxpayer and dependent	• Standard deduction ($12,000 singles/$24,000 couples) • Eliminates personal exemption
Family Tax Credits	• Child tax credit of $1,000 with refundable portion of 15% of earnings over $3,000 • Family tax credits phase out starting at $75K for singles and $110K for couples	• Child tax credit of $2,000 with refundable portion up to $1,400 • Family tax credits phase out starting at $200K for singles and $400K for couples
Education Savings Plans	• 529 college savings account for college tuition	• Expands 529 college savings accounts to K-12 private school tuition
State and Location Tax Deduction	• Income or sales and property taxes are deductible	• Caps all state and local tax deductions at $10K
Mortgage Interest Deduction	• Deduct interest payments on up to $1M of debt	• Deduct interest payments on up to $750K of debt
Overall Limit on Itemized Deductions	• Income-based reduction to itemized deductions beginning at $266,700 for singles and $320,000 for couples	• Reduction suspended
Estate Tax	• Top rate of 40% on estates greater than $5.6M	• Increases threshold to estates over $11.2M
Pass-Through Income	• Taxed at individual rates	• 20% deduction, phasing out starting at $315K of income for couples
Individual Mandate	• Penalty for not having health insurance	• Penalty amount of $0 starting in 2019

Key Changes to Corporate Taxes

	Current Tax Law	Tax Law Effective in 2018
Corporate Tax Rate	• Statutory tax rate of 35% plus alternative minimum tax	• Statutory tax rate of 21% • Elimination of alternative minimum tax
Repatriation of Accumulated Foreign Earnings	• Taxed at the U.S. corporate rate of 35% when repatriated	• Deemed repatriation on all currently deferred foreign earnings since 1986 at a rate of 15.5% on cash and cash equivalents or 8% for all others to be paid at once or in eight year installments; no requirement to repatriate earnings
Territorial System	• Worldwide system with tax deferral and credits for taxes paid abroad	• Global intangible low-taxed income (GILTI) tax and foreign-derived intangible income (FDII) deduction; effectively provides an effective tax rate of 13.125% on income generated by foreign intangible assets (e.g., intellectual property, patents, copyrights, etc.)
Interest Deduction	• Generally 100% net interest deductibility	• Caps net interest deduction at 30% of EBITDA for first four years and then 30% of EBIT thereafter
Bonus Depreciation	• 50% bonus depreciation of all equipment acquired and put into service in 2017 and phased down to 40% in 2018 and 30% in 2019	• 100% bonus depreciation through 2022 and then to 50% through 2026
Section 179 Expensing	• Expensing cap of $500K	• Expensing cap of $1M

Changes to individual taxes expire 12/31/2025 with the exception of the individual mandate; changes to corporate taxes are permanent.

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