Some version of tax reform is likely to emerge out of Washington during President Trump’s early months in office. Many of the ideas that have been proposed by the White House or the GOP-led Congress would have wide-ranging effects on the economy and financial markets. While there seems to be no shortage of politicized opinions in today’s partisan climate, an honest, unbiased discussion of the possible reforms can help investors set expectations for the potential impact the changes may bring to the financial markets.

Potential tax reforms could produce a tailwind for stocks

Proposed reforms could boost economic growth in the near term

Any tax reform outcome would create winners and losers among sectors and asset classes
Potential tax reforms could produce a tailwind for stocks.

- A reduction in the corporate tax rate is estimated to have a significant impact on after-tax earnings per share (EPS) for S&P 500 companies (see chart below).
  - Dropping the corporate tax rate from the current 35% to 20% (as House Speaker Paul Ryan has proposed) would result in a 7.2% increase in S&P 500 EPS, estimates Ned Davis Research.
  - A 15% corporate tax rate (as Trump had proposed as a presidential candidate) would result in a 13.9% increase in S&P 500 EPS.
- A simplification of personal tax brackets and reduction in personal income tax rates would likely bolster consumer confidence and encourage spending.
- Proposals for repatriation of deferred profits held overseas — either a one-time low-rate tax holiday or an extended period of tax breaks on these profits — could potentially fuel a new round of share buybacks and merger activity among multinational companies.

**Chart 1: After-tax income per share under proposed corporate tax reform plans**

<table>
<thead>
<tr>
<th>% change in after-tax income</th>
<th>Large companies (S&amp;P 500 Index)</th>
<th>Mid-cap companies (S&amp;P 400 Index)</th>
<th>Small-cap companies (S&amp;P 600 Index)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ryan proposal (20% tax)</td>
<td>7.2%</td>
<td>19.1%</td>
<td>35.4%</td>
</tr>
<tr>
<td>Trump proposal (15% tax)</td>
<td>13.9%</td>
<td>26.6%</td>
<td>43.9%</td>
</tr>
</tbody>
</table>

Sources: S&P Capital IQ, Ned Davis Research Group
Proposed reforms could boost economic growth in the near term.

- Lower corporate and personal tax rates would put more money in the hands of individuals and businesses, potentially boosting consumer spending and business investment.
- The overall impact on the economy from lower tax rates would be positive but modest; consumer spending has been robust in the past few years, and the unemployment rate is not likely to fall much further from current levels.
- Options to pay for tax reform are diverse, but it is more likely that the fiscal deficit will rise as a result.
  - The Border Adjustment Tax proposal would potentially offset some of the loss of revenue from corporate and personal tax cuts, and could fall more heavily on companies that sell a large portion of imported goods in the U.S. or manufacture some or all of their products overseas (see illustration below).
  - Ending the deductibility of interest expenses would also help pay for some of the tax reduction proposals, making leverage and debt issuance less attractive for companies.

Chart 2: How a proposed Border Adjustment Tax may affect manufacturers and retailers
Any tax reform outcome would create winners and losers among sectors and asset classes.

- Financial companies, many of which currently pay the highest corporate tax rates among S&P 500 firms, would be among the biggest beneficiaries of a corporate tax reduction, according to an analysis by Strategas Research Partners.
- Whatever form a repatriation proposal takes, technology companies stand to benefit the most because they have the lion’s share of overseas cash among S&P 500 companies.
- In the proposals to pay for tax reforms, retailers and consumer goods companies would have the most to lose from a border adjustment tax, as they are the largest importers of goods, but small-cap companies could potentially benefit because they do more of their business domestically.
- Ending the deductibility of interest payments would fall hardest on energy and telecom firms, both of which would likely see a significant impact on earnings from higher costs to service existing and new debt issues.

Chart 3: Possible winners and losers from proposed tax reforms

<table>
<thead>
<tr>
<th>Possible winners</th>
<th>Possible losers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial stocks — If corporate tax rates are lowered</td>
<td>Retailers — If border adjustment tax is implemented</td>
</tr>
<tr>
<td>Technology stocks — If overseas profits can be repatriated at lower tax rates</td>
<td>Consumer goods stocks — A BAT could have its biggest impact on earnings for this sector</td>
</tr>
<tr>
<td>Small-cap stocks — Domestic business would be less impacted by a border adjustment tax</td>
<td>Energy &amp; telecom stocks — If interest expense deductibility is phased out</td>
</tr>
</tbody>
</table>
Key takeaways

Washington is “open for business” as much as it has been in recent years, but few expect it will be business-as-usual with President Trump in office. After a year when the unexpected became reality, it’s foolish to regard any legislative proposal as improbable or unlikely. For investors, that requires an honest and unbiased assessment of the potential impacts of all reform ideas emerging from the White House or Congress. There remains a great deal of political wrangling yet to be done over what tax reform will look like, so pay attention to the final outcome rather than the ongoing rhetoric.

- Review the tax reform proposals with an unbiased eye, focusing on the details of the changes and not the accompanying political pronouncements.
- Maintain balance in your portfolio allocation as winners and losers are sorted out in the final tax reform changes.
- Keep a long-term time horizon when investing and avoid snap investment decisions based on political and legislative developments.

For more help or information, contact your financial advisor.