SPDR® BLOG

The Taxman Cometh: What Does Tax Reform Mean?

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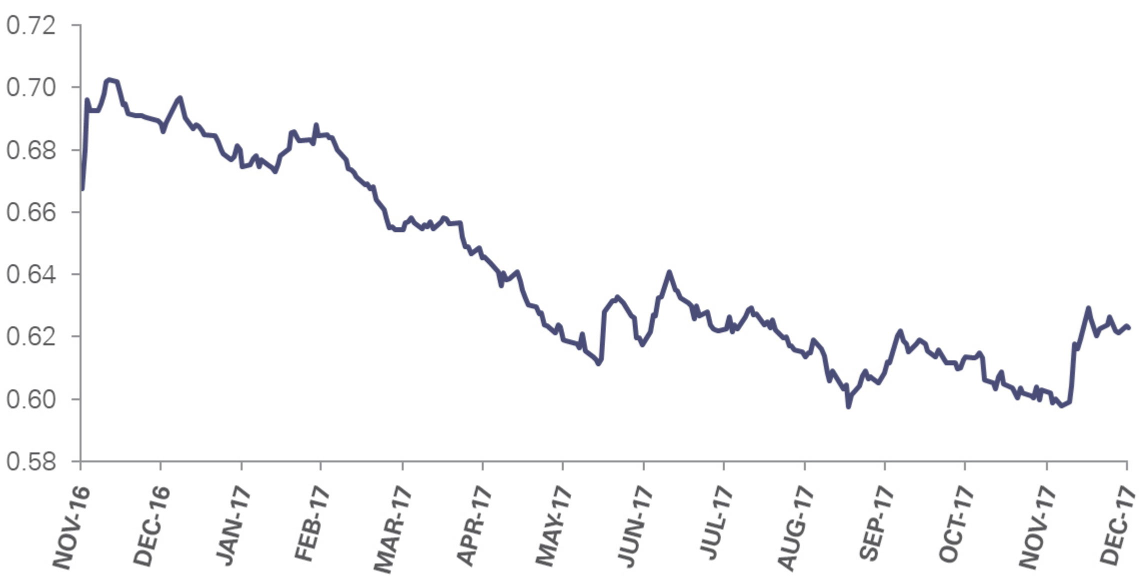
The Senate has passed the most extensive rewrite of the US tax code in more than 30 years, delivering on one of President Trump's campaign promises and securing his administration's first major legislative win. While the details of this major tax rewrite are plentiful, the most salient points outlined in the "Tax Cuts and Jobs Act" are to slash the corporate tax rate from 35% to 21% while reducing individual tax rates across six out of the seven tax brackets.[1]

The passage of the tax bill is a landmark event and a potential boon for US stocks. However, the market has been pricing in these effects over the past few weeks. As shown below, the rotation from value to growth spiked as the tax bill came into focus in November. Value stocks are largely viewed as more cyclical in nature, potentially benefiting from a boost in stimulus.

Ratio of S&P 500® Pure Value Index to S&P 500 Pure Growth Index



Source: Bloomberg Finance L.P., as of 12/20/2017. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Does the tax bill represent a sugar high?

With the tax bill signed, we will now have a chance to see if this tax legislation actually boosts the economy or represents a temporary sugar high. Questions also remain as to how much of an impact it will have on US economic growth and whether the market has already priced in any potential tax benefits.

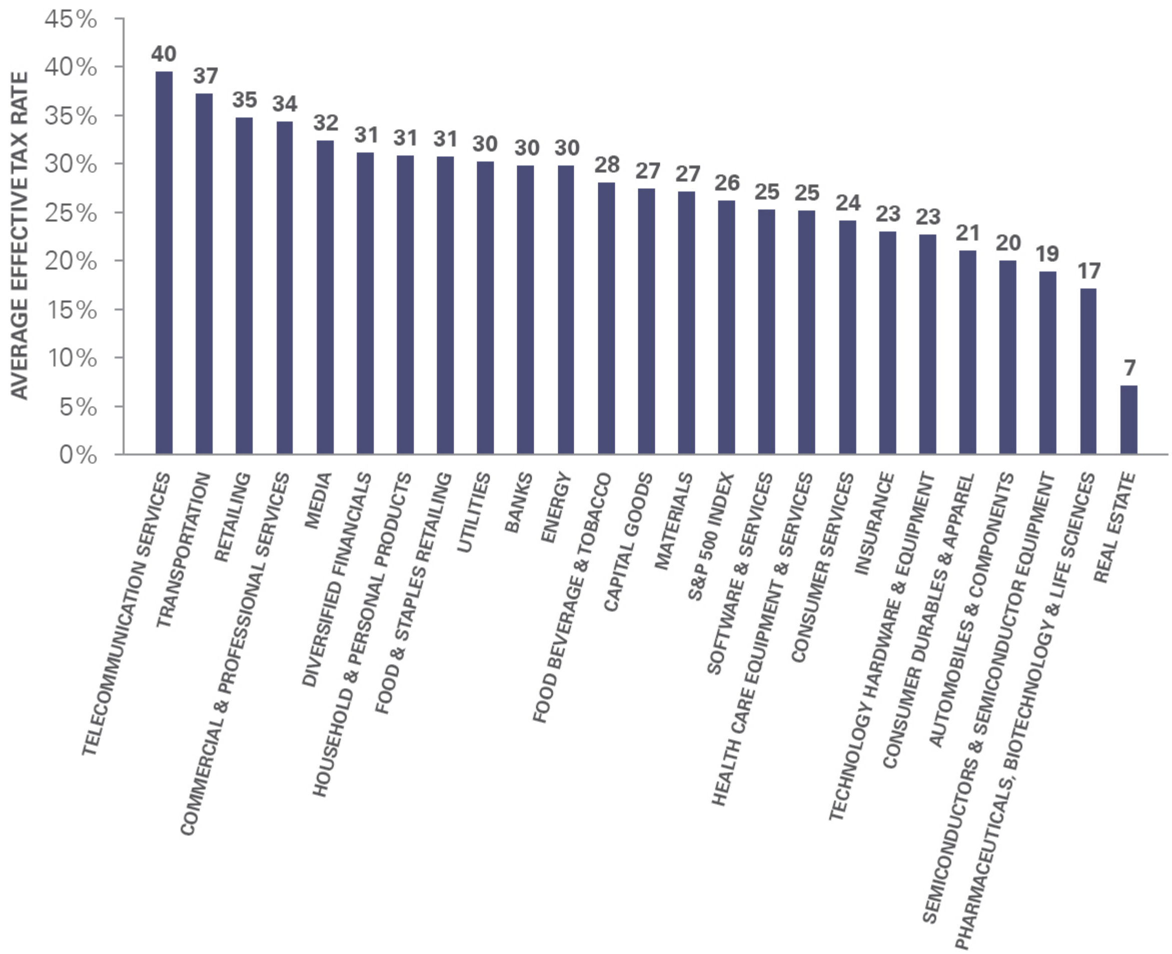
Based on the recent projections from the Federal Reserve (Fed), it does not appear the central bank expects an overall surge in economic growth. Currently, a 2.5% growth rate is projected in 2018 but lower growth of 2.1% is projected for 2019.[2] This is reinforced by Fed Chair Janet Yellen's comments that policy makers "see the plan as having a modest and mostly short-term impact."[3]

Breaking down the tax bill

While the Fed may be in the "sugar high" camp, not expecting wholescale rip-roaring growth, when it comes to the potential impact from the tax bill, these tax changes will likely have some impact on the economy and the trajectory of the US equity market, which is about to enter the ninth year of a bull market. Here's a look at three of the tax bill's biggest implications for corporations and potential beneficiaries:

1) Tax rate cut: For corporations, this is a clear positive. The 21% tax rate puts US companies on a firmer competitive footing versus other industrialized nations, which have an average corporate rate of 22.5%.[4] Segments of the market with a high effective tax rate are likely to see an increase in earnings and cash flow as the taxes companies pay out are cut. Simply put, the "T" in EBITDA now looks more like EBItDA. In light of this information, it's worth positioning toward industries that currently have *high* tax rates. Banks may warrant consideration, as they also have supportive fundamentals and additional regulatory tailwinds at their backs.

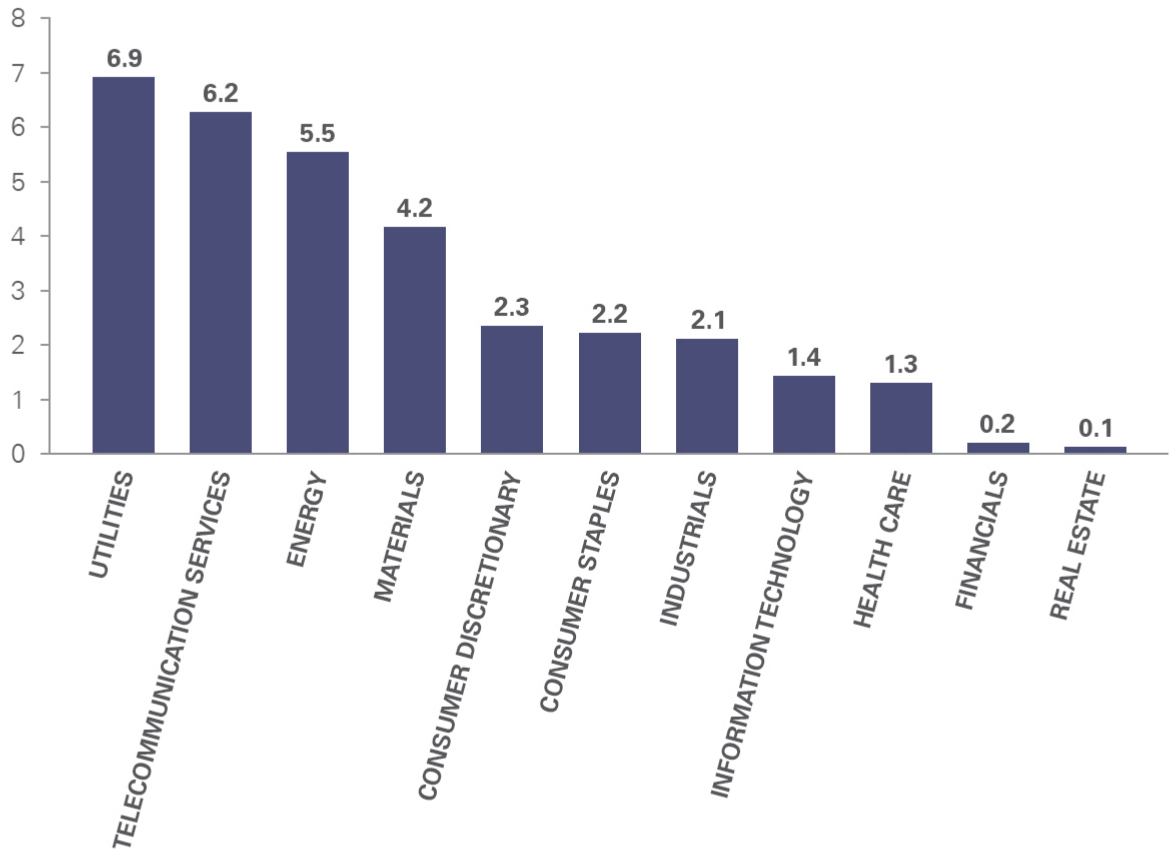
S&P 500 Company Average Effective Tax Rate by GICS Industry Group



Source: Bloomberg Finance L.P., as of 11/30/2017. The information above is rounded to the nearest whole number. Characteristics are as of the date indicated and should not be relied upon thereafter.

2) Capital Expenditures (capex): The tax bill includes the benefit of business-capital expensing, allowing businesses to immediately write off the full cost of new buildings and equipment. The aim is to stimulate growth and investment; however, it will be phased out after five years. If companies are not able to deliver meaningful growth from their investment, this part of the tax reform bill may end up being simply a sugar high, rather than a sustained driver of growth. However, based on factor analysis from Bloomberg Finance L.P., firms with a high amount of capex compared to assets (capex/assets) registered some of their best performance in November—a potential sign the market is expecting a brighter future for capital intensive firms.[5] From a sector perspective, the energy and materials sectors have a high amount of capex /assets, as shown below. They also have supportive fundamentals given that 42% and 47% of their revenue, respectively, is generated overseas.[6] But this potential trend can't be viewed in a vaccum, however, as utilities and telecom stocks may be impaired if interest rates rise because they are rate sensitive sectors.

Capital Expenditures to Assets



Source: FactSet, as of 12/20/2017. Characteristics are as of the date indicated and should not be relied upon thereafter.

3) Overseas profits: Being able to repatriate overseas income held as cash at a tax rate of 15.5% instead of 35.5% may spur further investment in areas such as equipment and research and development (R&D). It could also encourage mergers and acquisitions (M&A), or return of capital to shareholders in the form of buybacks. Technology and health care companies are leaders in terms of the amount of cash held overseas,[7] and tech firms have the highest percentage of revenue derived from foreign sources.[8] M&A could be a boon for smaller, less established biotech firms. The biotech industry is rife with M&A activity, and it also has attractive valuations. Biotech stocks are trading at more than 20% below the 15-year median based on historical and forward price-to-earnings ratios.[9]

Monitoring the longer-term impact of the tax bill

Looking ahead, the full impacts of tax reform will likely manifest themselves in earnings reports over the coming quarters. But remember: Tax reform is not the last policy issue that markets will have to deal with this year. A debt ceiling debate and budget discussions still loom, which could also have an impact on the market. To examine how the market is treating the impact of lower tax rates, we believe the value-to-growth trade will act as a key indicator. If tax reform is able to generate sustained stimulus, value shares will likely outpace growth as the bull market finds another gear higher in this cyclical trade.

Stay tuned to SPDR Blog where I'll continue to cover repercussions of the recent Tax reform and other Market Alerts.

[1]"Senate Passes U.S. Tax Overhaul Putting GOP on Brink of Big Win", Bloomberg Finance L.P., as of 12/20/2017
[2]Federal Reserve, as of 12/13/2017
[3]"Yellen Isn't Buying Trump's Tax Cut Talk of an Economic Miracle," Bloomberg Finance L.P., as of 12/13/2017
[4]"Senate Passes U.S. Tax Overhaul Putting GOP on Brink of Big Win", Bloomberg Finance L.P., as of 12/20/2017
[5]Bloomberg CapEx/Assets LTM Factor, as of 12/20/2017
[6]FactSet, as of 12/20/2017
[7]"US companies are hoarding $2.5 trillion in cash overseas," CNBC.com, as of 8/2016
[8]FactSet, as of 12/20/2017
[9]Factset, as of 11/30/2017

Definitions

Capital Expenditure (Capex)
Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

EBITDA
Net income with interest, taxes, depreciation, and amortization added back to it. EBITDA can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

Global Industry Classification Standard (GICS)
A financial-industry guide for classifying industries that is used by investors around the world. The GICS structure consists of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries, and Standard & Poor's (S&P) has categorized all major public companies into the GICS framework.

Price-to-Earnings Multiples, or P/E Ratio
A valuation metric using the ratio of the company's current stock price versus its earnings per share.

S&P 500 Pure Growth Index
A style-concentrated index designed to track the performance of stocks that exhibit the strongest growth characteristics by using a style-attractiveness-weighting scheme.

S&P 500 Index
The S&P 500, or the Standard & Poor's 500, is an index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and

their weightings are determined by S&P Dow Jones Indices.

S&P 500 Pure Value Index

The S&P 500 Pure Value index is a style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style-attractiveness-weighting scheme. The Pure Style index series identifies approximately one quarter of the parent index's market capitalization as Pure Growth and one quarter as Pure Value. There are no overlapping stocks, and these indices do not have the size bias induced by market capitalization weighting. Rather, stocks are weighted in proportion to their relative style attractiveness.

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Diversification does not ensure a profit or guarantee against loss.

Forecasted asset class returns are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Foreign investments involve greater risks than US investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

The use of leverage, as part of the investment process, can multiply market movements into greater changes in an investment's value, thus resulting in increased volatility of returns.

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Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

Passive management and the creation/redemption process can help minimize capital gains distributions.

Commodity funds may be subject to greater volatility than investments in traditional securities. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors, such as weather, disease, embargoes, and international economic and political developments.

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Actively managed ETFs do not seek to replicate the performance of a specified index.

ETFs typically invest by sampling an index, holding a range of securities that, in the aggregate, approximates the full Index in terms of key risk factors and other characteristics. This may cause the fund to experience tracking errors relative to performance of the index.

There are risks associated with investing in Real Assets and the Real Assets sector, including real estate, precious metals and natural resources. Investments can be significantly affected by events relating to these industries.

Risks associated with investing in the natural resources sector include large price volatility due to non-diversification and concentration in natural resources companies.

Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

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Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

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