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Tax reform bill likely delivers immediate stimulus for 2018

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Executive summary

The Tax Cuts and Jobs Act will broadly cut income tax rates for both corporations and individuals. When combined with other major tax reforms, the bill is expected to provide an estimated $1.4 trillion stimulus to the U.S. economy. Importantly, all of the tax cuts begin immediately in 2018, which should provide an immediate boost to the economy. The total amount of tax cuts in 2018 has been estimated at $205 billion, equal to 1 percent of the size of the U.S. economy, according to Strategas Research Partners. This would make the Tax Cuts and Jobs Act the second largest tax cut in U.S. history, second only to the Economic Recovery Tax Act of 1981.

While providing a near-term boost to the economy, we expect the future cost of the tax bill will come in the form of future interest rate hikes by the Federal Reserve (Fed) as they respond to inflationary pressures from a fiscally turbocharged economy. The near-term benefits to economic growth and corporate earnings growth should provide a lift to U.S. stocks. However, we believe that there may be a modest headwind for bond investors as bond yields rise to price in rising economic growth and inflation pressures. Therefore, we maintain our pro-risk stance, preferring global equities over bonds in portfolios, with a focus on U.S. and foreign markets, such as Japan and Europe.

Key features

Congress has passed the Tax Cuts and Jobs Act, a bill intended to lower taxes for businesses and individuals and provide immediate stimulus to the U.S. economy. Most of the provisions are scheduled to take effect January 1, 2018.

- The stimulus from the tax bill is derived from cuts to tax rates, full expensing for new equipment and a doubling of the standard individual deduction.
    - The corporate income tax rate drops to 21 percent from 35 percent.
    - The top individual tax rate drops to 37 percent from 39.6 percent.
    - Companies can deduct 100 percent of new equipment purchases for five years. This is the first time that the United States has had 100 percent expensing.
    - The standard deduction increased from $6,350 to $12,000 for individuals and from $12,700 to $24,000 for married couples.

Overall, the tax cuts will cost the federal budget an estimated $1.4 trillion over the next 10 years based on estimates from the Joint Committee on Taxation, a nonpartisan congressional committee.

A 1 percent possible lift to economic growth in 2018

Tax cuts of about $1.4 trillion should provide a modest lift to U.S. economic activity. The lift averages out to about one-half of one percent per year. However, it is likely to be “front loaded” into the early years, perhaps lifting growth by 1 percent or so next year, according to Strategas Research Partners.

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This acceleration to growth may also help lift inflation in future years, reflecting rising demand for some scarce resources and goods.

The lifts to growth and inflation should allow the Fed some room to continue to normalize interest rates. This could lead to up to four interest rate increases in 2018, instead of the three that are currently planned.

A potential 5 percent lift to 2018 corporate earnings

Corporate earnings will benefit directly from the elimination of the alternative minimum tax (AMT) and the reduction in the corporate income tax rate from 35 percent to 21 percent. However, benefits will be somewhat muted by the repatriation tax for international firms. Estimates by Strategas Research Partners are for corporate earnings to increase by an additional 5 percent to 6 percent in 2018.

However, the top line growth or revenue growth of companies will be unaffected by the tax cut directly. The real benefit to corporate growth may be from some lift to economic activity and a potential return of capital spending and investment.

Interest rates are likely to increase in 2018, as well. While the Fed is targeting three interest rate increases in 2018, based on results of the December meeting, the lift to growth, future inflation and inflation expectations could lead to additional modest increases in longer-term interest rates. The increase in U.S. government deficits could also spur further increases in rates in future years.

Prospects for better growth lead us to prefer stocks over bonds

The stock market rally over the past month indicates that the passage of the tax bill is at least not “new news” for market participants. However, in our view, the expected positive benefits to U.S. economic growth and corporate earnings should provide additional benefits over the next few months. This belief leads us to prefer a pro-growth stance in portfolios. We recommend a tilt toward stocks relative to bonds.

The lifts to growth and inflation may act as headwinds for bond investors over the next year. This is due to the likelihood of interest rates moving modestly higher.

Risks to our stance could include further political issues, including global trade constraints or a too-aggressive increase in interest rates by the Fed.

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