Chilton Investment Services
Weekly Update
December 27th, 2017

Visit our website!

www.chiltoninvestmentservices.com

Please feel free to reach out to us. We look forward to your phone call.

Timothy W.A. Horan
CIO-Fixed Income
646-443-7748
thoran@chiltontrust.com

Gregg Manjerovic, CFA
Taxable Portfolio Manager
646-443-7768
gmanjerovic@chiltontrust.com

Debra Crovicz
Tax-exempt Portfolio Manager
646-443-7756
dcrovicz@chiltontrust.com

Stephen Stowe, CFA
Head of Credit Research
646-443-7866
sstowe@chiltontrust.com

Laura Ridolfi
Associate Portfolio Manager
646-443-7792
lridolfi@chiltontrust.com

Eamon Marley
Credit Research Analyst
646-443-7745
emarley@chiltontrust.com

Francesca Genovesi
Credit Research Analyst
646-443-7776
fgenovesi@chiltontrust.com

TAX BILL MODEST POSITIVE FOR BOND MARKETS

The tax bill recently approved by Congress and signed into law by President Trump is positive for U.S. corporations which should moderately increase GDP growth in 2018 and 2019. In the short term, much hinges on consumer behavior in response to the individual tax cuts. The longer term impact on U.S. growth will depend on whether corporations take advantage of the corporate tax rate cuts to expand investment and production capacity, or whether the cash will be utilized for shareholder payments (buybacks and dividends) and mergers & acquisitions.

Bond market impact is fairly positive. Investment-grade corporate borrowers are largely unscathed and only the most indebted high-yield borrowers will be impacted by the bill. New bond issuance could fall given alternate financing from repatriated overseas cash. Municipal bond issuance will decline sharply due to the elimination of advance-refunding transactions.

Key Corporate Tax Provisions

Corporate tax rates cut – reduced to 21% from 35%, starting in 2018

Repatriation of overseas earnings at favorable rate – earnings retained in overseas subsidiaries are repatriated at a one-time favorable rate of 15.5% tax rate on cash assets and 8% on property, plant & equipment. The tax is due over 8 years.

Interest deductibility capped – the amount of interest expense which can be deducted for tax purposes is now capped at 30% of EBITDA from 2018-2021 and 30% of EBIT thereafter.

Capital expenditure deductibility increased – capex is now 100% deductible in the year it is expended as opposed to the current 50%. This full deductibility remains in place for 5 years before phasing out by 20% each year through 2026.

Net Operating Losses less valuable– the ability to carryover and deduct net operating losses (NOL's) against future taxable income was curtailed with companies now only able to apply NOL deductions up to 80% of taxpayer's taxable income.

Corporate AMT repealed

Territorial tax system created – elimination of taxation of overseas earnings at U.S. rates. This is modified slightly by the creation of the Base Erosion Anti-abuse Tax (BEAT) which is a minimum tax on foreign earnings equal to 10%. In addition, new taxes on overseas intangible income incentive companies to locate intellectual property and other valuable intangibles in the U.S.

Winners

The primary winners of the bill are U.S. corporations while the U.S. economy and individual taxpayers receive more moderate benefits.

The reduction in the statutory corporate profit tax rate to 21% from 35% will boost corporate earnings and cash flow. In addition, U.S. multinationals should enjoy improved financial flexibility as their tax regime is converted to a territorial tax system meaning profits are taxed based on the tax rate in the jurisdiction earned, not based on the U.S. rate. The only modification to the territorial system is a 10% "base erosion tax" applied to overseas taxable income and designed to ensure a minimum level of taxation on firm's overseas profits. The territorial system effectively removes the tax incentive to indefinitely defer repatriation of foreign profits and allows multinationals freedom to utilize these proceeds as they wish. Further, the bill requires corporations to repatriate current accumulated overseas profits at a favorable rate (15.5% for cash and 8% on PP&E) which will enhance near term financial flexibility. The unknown is how companies will utilize these repatriated profits with the current consensus likely to focus more on financial uses such as share buybacks and dividend increases as opposed to capital expenditure and investment.

Broadly speaking, companies with US-focused operations will benefit most as they currently pay higher blended tax rates relative to multinationals. And companies with investment-grade credit metrics or stronger high yield names are largely unaffected by the interest deductibility cap. Banks and energy companies are expected to benefit most given that they have the highest effective tax rates. Retail and consumer-oriented firms should benefit from the increase in disposable income, not to mention their higher overall tax rates. Pharmaceutical and technology companies will gain access to overseas retained earnings. Additionally, any firms with near term capital spending needs such as transportation and telecommunications will enjoy the higher capital expenditure deductibility.

In terms of economic impact, the bill is front-loaded and expected to provide a stronger near term fiscal stimulus, fading out over the medium term. The most immediate boost is due to lower personal tax rates with individuals estimated to receive an average tax cut of $1,610 in 2018[i]. In terms of economic impact, Morgan Stanley estimates a 2018 impact equivalent to 0.7-1% of GDP and with total fiscal stimulus (including disaster relief and higher defense spending) estimated to boost GDP by 0.5% in 2018[ii]. This could raise U.S. economic growth towards a range of 3-3.5%. Over the medium term, the bill is designed to stimulate corporate investment by allowing 100% expensing of new PP&E in the year spent. This 100% expensing is allowed for 5 years but begins to phase out thereafter over the next 5 years. This highlights one of the notable features of this bill is - its temporary nature. The average effective tax rate will dip to 9% in 2018 (from 21% currently) but gradually rise again to 19% in 2027 as many of the bill's provisions phase out[iii].

<u>Losers</u>

The bill is estimated to reduce Federal tax revenue by $1.8-2.0 trillion over next 10 years[iv]. In the near term, Morgan Stanley projects the bill will push the budget deficit to -4.2% of GDP in Fiscal 2018 and -4.9% in Fiscal 2019 (versus -3.5% in FY17)[v]. Federal debt / GDP is projected to rise to 98% in 2027 versus current projection of 91%[vi]. Unknown is the amount of additional GDP growth which will materialize due to supply-side effects, thereby providing some level of offset for this higher debt.

In general, firms with large overseas segments and lower effective tax rates will benefit less, technology companies being the most prominent example. The tax bill also repeals the Affordable Care Act's individual health insurance mandate, meaning the number of uninsured individuals could rise, pressuring hospital margins.

Highly leveraged companies will see higher tax bills as a result of the interest expense deductibility cap. Specifically, interest expense is deductible up to 30% of a firm's EBITDA[1] over the next 4 years. Following this period, the formula becomes more restrictive, limiting interest deductibility to 30% of EBIT[2]. This is expected to result in tax increases for the most highly-

[1] Earnings Before Interest Taxes Depreciation & Amortization
[2] Earnings Before Interest & Taxes

leveraged issuers, typically those rated in the triple-C rating category. This impact will be partially mitigated by the lower statutory tax rate and the increased deductibility of capital expenditures. Longer term, it could also provide leveraged companies incentive to reduce debt.

Corporate bond market supply is expected to fall as overseas cash repatriation will provide an alternative source of financing to debt. In addition, demand for short term corporate bonds may weaken as overseas cash hoards were believed to be a major buyer of short-dated credit. One offset to this reduction in supply is an expected increase in new debt issuance from higher M&A activity as the uncertainty around taxation has been lifted.

Municipal Market Impact

Key Municipal Bond Provisions

Advance Refunding Bonds eliminated – refunding of tax-exempt bonds 90 days or more from their maturity date can no longer be accomplished by utilizing tax-exempt bonds. However, Private Activity Bonds (hospitals, airports, stadiums, etc.) maintained their tax-exempt status.

State and Local Tax (SALT) deduction reduced – state and local tax deductions are limited to $10,000 which applies to property tax as well as state income or sales tax

Mortgage deduction reduced – mortgage interest is now deductible on loans up to $750,000, down from $1,000,000.

Alternative Minimum Tax (AMT) was reduced in scope – with a narrowing of eligibility criteria, the Tax Policy Center now estimates that roughly 200,000 households will now pay AMT versus over 4 million previously.

Impact on the municipal bond market is expected to be mixed. Prices should find support from expected lower issuance due to the elimination of advance-refunding ability with Barclays predicting a 35% decline in 2018 supply[vii]. Conversely, demand could weaken from banks and insurance companies whose reduction in statutory tax rates will reduce the appeal of tax exempt investments. Collectively, banks and insurance companies held 29% of municipal debt outstanding, largely in the intermediate range (10 to 17 years)[viii]. Offsetting this decline in institutional demand could be higher retail demand from residents of high tax states for whom State and Local tax (SALT) deductions are now capped at $10,000 and whose mortgage interest deductibility is now allowed only on loans up to $750,000, down from $1,000,000. In terms of municipal credit quality, local government property taxes could face pressure over the medium term if the reduced levels of SALT and mortgage interest deductions reduce housing values, particularly in high-tax jurisdictions. Finally, Puerto Rico's economy will take a hit from the new taxes on foreign intangible income as manufacturers on the island are considered "foreign" under U.S. tax law.

[i] "Distributional Analysis of the Conference Agreement for the Tax Cuts and Jobs Act", Tax Policy Center, December 18, 2017
[ii] "A Wrap on Tax", Morgan Stanley, December 20, 2017

[iii] "The Tax Cuts and Jobs Act, as Reported by Conference Committee (12/15/17): Tax Effects By Industry", Penn Wharton Budget Model, December 18, 2017
[iv] "The Tax Cuts and Jobs Act, as Reported by Conference Committee (12/15/17): Static and Dynamic Effects on the Budget and the Economy", Penn Wharton Budget Model, December 18, 2017
[v] "A Wrap on Tax", Morgan Stanley, December 20, 2017
[vi] "Lawmakers Are Getting Closer to Bringing Back Trillion-Dollar Deficits", Committee for a Responsible Federal Budget, December 20, 2017
[vii] "Tax Bill – No Real Surprises", Barclays, December 19, 2017
[viii] "Muni Market's Trusted Buyers Could Disappear After Tax Cuts", Bloomberg, December 20, 2017