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MARKETS BUYING INTO TAX REFORM

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KEY TAKEAWAYS

Last week's tax framework from Republican policymakers could pave the way for a budget resolution.

Although the proposal lacks details and negotiations will be difficult, we continue to believe tax reform is more likely than not.

Markets have become more optimistic in recent weeks that a deal will be reached based on several market-based barometers of policy sentiment.

Last week's tax proposal presented real progress. For much of this year we have been espousing what has felt like a minority view—that Republicans would reach some sort of tax agreement in early 2018. After last week, that view may have become the majority—even if only a slight one—as key tax policy players in Washington, D.C. put out a framework with more details. The plan is geared toward securing votes from the most conservative wing of the Republican Party and appears to have achieved its objective. Here we share some implications of that proposal and explore what some market-based barometers of tax reform show.

KEY IMPLICATIONS OF REFORM

On Wednesday, September 27, the so-called "Big Six," key Republican policymakers attempting to rewrite the tax code, released a framework for tax reform. Although the plan lacked many important details, we see a few implications:

- **Enough details for a budget agreement.** The Republican Freedom Caucus in the House wanted to see details on tax policy before voting for a 2018 budget. While a nine-page framework leaves a lot of unanswered questions, it has enough details to secure endorsement by the Freedom Caucus representatives, clearing the way for a budget resolution. Remember that without a 2018 budget agreement, there is no reconciliation for tax reform; and without reconciliation, 60 votes in the Senate would be needed for tax law changes—rather than the much more attainable 50.
- **Not enough details for this to be easy.** The nine-page framework is only a starting point for what promises to be a long and difficult negotiation. Deductions will need to be eliminated to help pay for the lower rates. Each proposed change will create winners and losers. So the path to an agreement is likely to be a bumpy one.
- **There are plenty of levers to pull in negotiations.** There are many elements of the tax code that present opportunities for negotiation and add to our (guarded) optimism. Some examples include: 1) the proposed corporate rate, which could go from 20% to 22% or 23%; 2) the number of years for full expensing of capital expenditures could be reduced; 3) state and local tax deductions could be capped rather than eliminated; 4) the highest personal tax rate could be raised; and 5) the estate tax could be scaled down rather than eliminated.

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Given these considerations, we see a path to a deal, either a tax cut or comprehensive tax reform. Republicans need a win, they are investing a lot of political capital into tax reform, there is general agreement across the party on the need for lower taxes, and there are a lot of levers to pull in negotiations. Further helping to pave the way for a deal is the use of dynamic scoring, which factors in the positive impact lower tax rates would have on growth when calculating the budget, and allowing the plan to add to the deficit.

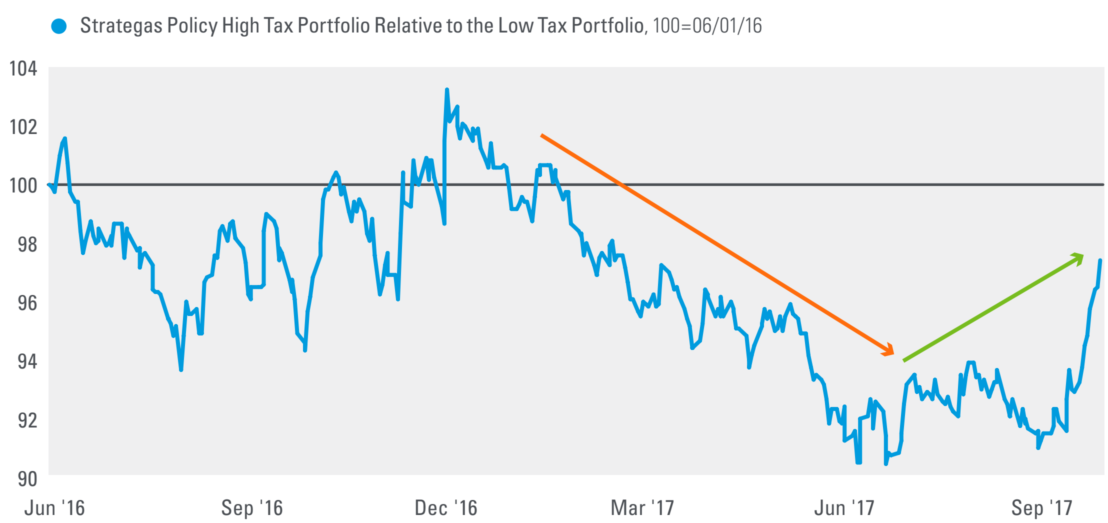
IS THE MARKET BUYING IT?

Our odds of a deal may be over 50%, but what about the market's odds? We can look at market-based measures to help gauge them; specifically, we can look at the performance of high tax rate companies relative to low tax rate companies. High tax paying companies benefit most from potential tax reform, so those stocks should outperform their low tax paying counterparts as the market's odds of tax reform rise, or vice versa.

We highlight this relationship in Figure 1, courtesy of Strategas Research Partners. The high tax portfolio underperformed during most of the first half of the year as markets expressed pessimism toward a tax deal. During that time, investors observed several failed attempts by the Trump administration to reform healthcare and strained relationships between the White House and the Republican establishment, resulting in diminished confidence in the Trump administration's ability to achieve its agenda.

This dynamic has changed recently. After showing some signs of life at the end of June, the high tax stocks took off in late August and rallied throughout September, even as the latest attempt at healthcare reform fell short. Interestingly, the market began to show confidence that a tax deal would get done even before last week's framework opened the door for a budget resolution.

1 STOCKS BEST POSITIONED TO BENEFIT FROM TAX REFORM HAVE BEEN RALLYING



Source: LPL Research, Strategas Research Partners 09/29/17

Performance of stocks with high tax rates relative to stocks with low tax rates. A rising line indicates that the market is favoring stocks with high tax rates. A falling line indicates that the market is favoring stocks with low tax rates. Past performance is no guarantee of future results.

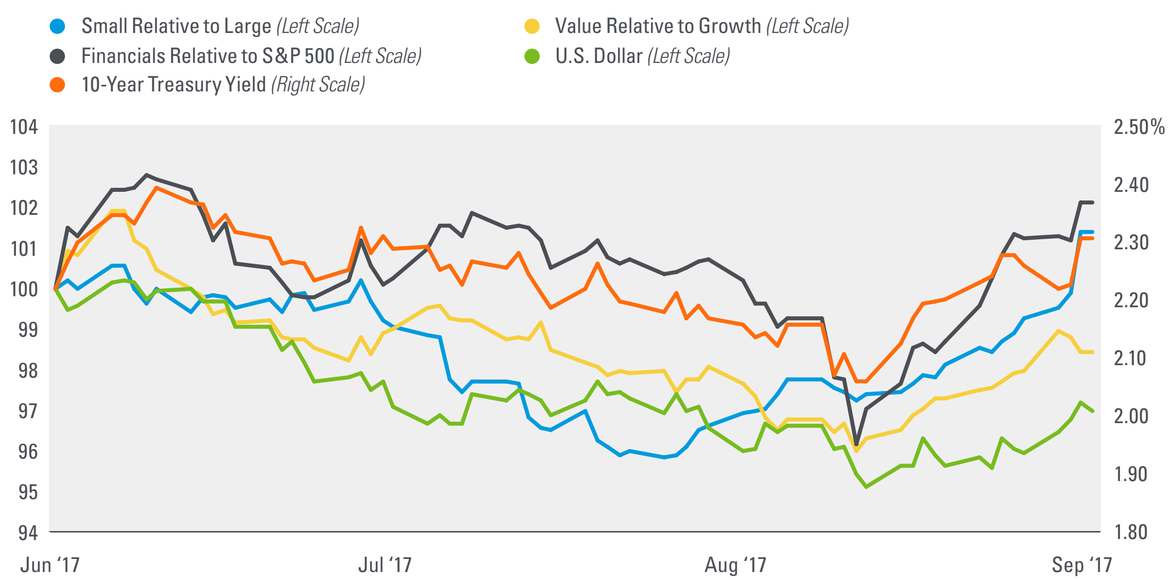
We can look at other barometers of the market's sentiment toward a tax deal, shown in Figure 2. These so-called "Trump trades" all started turning higher about one month ago, confirming the message from Figure 1:

- **Small cap stocks.** Like high tax stocks, small caps tend to be more domestic, pay higher taxes, and therefore tend to be bigger beneficiaries of tax reform (read more in the *Weekly Market Commentary,* "Is Policy Skepticism Creating a Small Cap Opportunity?").
- **Financials sector.** Pro-growth policy tends to put upward pressure on interest rates and steepen the yield curve, while financials are more domestic and pay higher taxes.
- **Value style.** Financials benefit from pro-growth policy and higher interest rates, favoring the value style.
- **Interest rates.** More growth and more inflation tend to push interest rates higher.
- **U.S. dollar.** The Trump administration's U.S.-focused trade policy and potential upward pressure on interest rates are generally bullish for the U.S. dollar.

CONCLUSION

Last week's tax framework from Republican policymakers could pave the way for a budget resolution that would then enable tax reform to potentially be achieved. Although the proposal lacks details and negotiations could be difficult, we continue to believe tax reform is more likely than not. There are plenty of levers to pull in negotiations, Republicans are more unified on tax policy than on healthcare, and some budget maneuvering will help grease the wheels. Market-based barometers of policy sentiment are supportive. Stay tuned. ■

2 OTHER BAROMETERS OF PRO-GROWTH POLICY STARTED TURNING HIGHER A MONTH AGO



Source: LPL Research 09/29/17

Indexes used include: Russell 3000 Growth and Value, Russell 2000–Small Caps, Russell 1000–Large Caps, S&P 500 GICS Financials, and DXY US Dollar Index.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small cap market may adversely affect the value of these investments.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year, and 30-year U.S. Treasury debt.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Dollar Spot Index (BBDXY) tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar.

The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index.

The Russell 1000 Index measures the performance of the large cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Russell 3000 Growth Index measures the performance of those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 companies considered undervalued relative to comparable companies.

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