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Will the Rising Tide of Tax Reform Lift All Economic Boats?

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I learned my most important lesson on taxation from my mother. My mother was a teacher and my father a chemical engineer. Every summer my mother taught summer school, but one summer she stopped, and I asked her why. She explained that she and my dad had discussed that the extra income that year would push them into a higher tax bracket, which would mean she would keep very little of her added income. So she decided the extra work wasn't worth it, a lesson that has stayed with me. Years later when I reminded her about our conversation, she remembered the decision not to work but did not recall the conversation with her budding young economist. But it was one of those "teachable moments" parents relish, even if she didn't realize it.

Little did I know that I would become fascinated with economics and mathematics, nor did I realize how the intersection of my real world experience (vicariously through my mother) and the ideas regarding the tax wedge espoused by the likes of Art Laffer and Jude Wanniski would frame my future thinking on the subject of taxation.

The incentives and disincentives inherent in any current tax system affect economic behavior. If you tax a specific economic activity, you get less of it, and if you subsidize it, you get more—it's not hard to understand. And the incentive effects from a change in the tax system are far more important than the dollar value of tax cuts or tax increases. Tax reform—which seemed like a near impossibility a year ago as Republicans bickered among themselves and failed to seek bipartisan support for tax legislation—came to fruition just before Christmas last year. The broad strokes of the Tax Reform and Jobs Act are unambiguously positive for U.S. economic growth. It is the most significant piece of tax legislation since the Reagan Administration.

Table 1 below highlights some of the simple math involved the in tax law changes in regards to a shareholder's retention of dividend payments after applying the combined tax rates on corporate and business pass-through income and individual income tax rates.

Table 1

2018 Tax Law Change Analysis

	Previous Rate	New Rate
U.S. Statutory Corporate Rate	35%	21%
Top Marginal Personal Tax Rate	40%	37%
LT Capital Gains & Dividend Tax Rate	24%	24%
Business Pass-Through Income Tax Rate	40%	30%

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Percent of Shareholder Dividends Retained After-Tax

	Previous Rate	New Rate	% Change
U.S. Profit/Qualified Dividends	49%	60%	**22%**
Pass-Through Income/Dividends	60%	70%	**17%**

*Source Information^*

Under the prior tax law's statutory corporate tax rate of 35% and the marginal tax of 23.6% on qualified corporate dividends, an investor retained approximately 49% of a corporation's pretax income distributed in the form of dividends. The fact that this amount is less than 65% (corporate after-tax retention rate) reflects the impact of the double-taxation of dividends. Because pass-through businesses are taxed only once, however, the after-tax retention rate is higher at over 60% even at the top marginal personal tax rate of 39.6%.

Due to the reductions in the corporate tax rate to 21%, in the top marginal personal bracket to 37%, and with the 20% exclusion of profits from taxation for many pass-through businesses (S Corps and Limited Liability Companies), the after-tax dividend retention rate rises by 17-22%! No wonder investors, who seek after-tax returns not pretax returns, began to bid up stock prices as the prospects for tax reform gained momentum. The financial rewards to working, saving, and investing have been boosted.

Financial markets anticipate policy changes in advance of the actual change whereas economic activity is most impacted in the year of the change. As the probability of passage rose substantially in October of 2017 when Senators Paul and Collins declared their support, the stock market began to recognize this benefit to economic growth and "retained" after-tax returns some months ago. So the market pushed up future growth expectations and also attached a higher Price/Earnings (P/E) multiple to the higher earnings. In a sense, the rising tide has already begun to lift all economic boats. How far can it go?

Market Risk for a Major Correction

Given the recent market sell off, it is appropriate to make a side note here. After going nearly two years without a significant correction of greater than 10%, the stock market peaked on January 26, 2018 and promptly dropped 10% in the next ten trading days, with two of these days suffering declines of roughly 1000 points on the Dow Jones Industrial Average. While this seemed to fulfill the market's "desire" for a correction, it was the increase in price volatility (the VIX index) that triggered the short-term panic-like market reaction.

Investors have learned (or should have learned) that financial instruments that capture and leverage volatility and returns can be dangerous to client portfolios. In the case of the VIX and VIX futures, the long period of low market volatility lulled investors in these securities into a sense of complacency. With the VIX futures curve in contango (predicting rising future volatility levels) but with VIX futures prices falling over time as volatility remained low, the opportunity presented itself to short VIX futures using leverage to produce high and presumed consistent returns with low downside risk. This is reminiscent of the market risk created by the use of "portfolio insurance," which was a major factor in the market crash of 1987.

We believe the triggering event for the market's sell off appears to be related to strong economic data that increased the prospect of rising future inflation. A higher rate of inflation would potentially pressure P/E ratios and raise stock market volatility—hence the panic to cover short positions on the VIX. Unfortunately, the VIX price was driven up so rapidly that some funds lost nearly all of their value. A significant amount of wealth was destroyed in a short period of time.

Although these events were a jolt to the market and another wake-up call that “easy money” and “programmed strategies” can be highly dangerous to your wealth, the favorable underpinnings of the economy and the market have not changed. When the VIX shorts “lost their shorts” and had to cover or close, the downside pressure on the stock markets came to an end.

While we do not believe the “VIX Panic” presents lasting risk to the stock market, we believe the greater potential risk involves international trade disputes or “trade wars,” with dangerous misperceptions about the ease of “winning a trade war” as our President recently tweeted. While the Executive Branch has authority to impose trade sanctions or tariffs, the question is will this negate the gains to economic growth and valuation created by the Tax Reform and Jobs Act and actions to reduce the burden of regulation or will it just reduce the beneficial impact? Our belief is that the impact would most likely be the latter, not the former. Rather than creating a worldwide recession, severe trade actions might “steel” back 0.50%-0.75% of the GDP acceleration that might otherwise occur.

Historical Perspective on Trade Bills and Tax Law Changes

Certainly, changes in monetary policy, technology, and regulations, as well as wars, have had a significant impact on economic growth and financial market returns. This analysis, however, compares the results of some periods of past tax changes and the impact they had on economic growth and stock market performance. After President Hoover signed the Smoot-Hawley Tariff Act in 1930, triggering a trade war in retaliation that worsened the Great Depression, he compounded his error by raising tax rates in 1932 as reflected in Table 2 below. He approved the increase in the top personal marginal tax rate by 38 percentage points to 63% in one fell swoop! No wonder stocks struggled to recover during the 1930s as the after-tax reward for investing in the economy and stocks plunged 52%!

Table 2

The Difficult Decades!
Hoover/Roosevelt/Ike Tax Laws - Impact on Retained Dividends

President	Tax Legislation		Top Personal Marginal Tax Rate	Corporate Tax Rate	Dividends Retains After-Tax Return
Hoover	**Revenue Act of 1932**	Previous	25%	12%	**66%**
		New	63%	14%	32%
		Change	**38%**	**2%**	**-52%**
Roosevelt	**Revenue Acts of 1935/36 with Surtax**	Previous	63%	14%	32%
		New	79%	26%	16%
		Change	**16%**	**12%**	**-51%**
Truman & Eisenhower	**Revenue Acts of 1950/54 with Surtax**	Previous	79%	38%	13%
		New	91%	52%	**4%**
		Change	**12%**	**14%**	**-67%**

*Source Information^*

But the damage to economic incentives and stock market returns didn't end there as further tax rate increases came during the Roosevelt Administration (along with massive increases in regulatory burdens). And yet, as if it completely ignored the lessons from prior administrations, the Truman and Eisenhower administrations successively boosted the top tax bracket on personal income to 91% and on the corporate tax rate to 52%. Only the massive post war period of reconstruction finally offset the tax and regulatory burdens of what could be called "the Difficult Decades" that cumulatively took the reward from corporate dividends (after-tax) from 66% down to a "lowly" **4% retention rate**!

It should come as no surprise, then, that the U.S. was ripe for promises by the Kennedy Administration to "get the country moving again" with tax cuts that passed Congress in 1964 after his death but which were well anticipated by 1963. The reduction in the top marginal personal tax bracket from 91% to 70% and the corporate tax rate from 52% to 48% triggered the booming economy and stock market during the next four years. Off such a low base for reward, the incentives to work, save and invest exploded by 260%, leading to rapid economic growth, along with the investment and stock market boom of the mid-1960s, which during the three years from 1963 to 1965 amounted to 17.1% annualized return for the S&P 500.

But these benefits didn't last as the poor economic policies of the Johnson, Nixon and Carter Administrations (particularly Nixon's price controls) put the economy into a period of Stagflation leading up to Ronald Reagan's election in 1980. As with the Kennedy tax cuts, the Reagan cuts followed a similar pattern. The top marginal bracket was cut from Kennedy's 70% level to 50% in 1983 (after a phase-in) and then to 28% by 1988. Table 3 below highlights these changes.

Table 3

The Booming Decades!
Kennedy & Reagan Tax Laws - Impact on Retained Dividends

President	Tax Legislation		Top Personal Marginal Tax Rate	Corporate Tax Rate	Dividends Retains After-Tax Return
Kennedy	**Tax Reduction Act of 1964**	Previous	91%	52%	**4%**
	(After Kennedy's death)	New	70%	48%	16%
		Change	**-21%**	**-4%**	**261%**
Reagan	**Economic Recovery Tax Act 1981**	Previous	70%	46%	16%
	Phased in over 3 years	New	50%	46%	27%
	Called Kemp-Roth Tax Cut	**Change**	**-20%**	**0%**	**67%**
Reagan	**Tax Reform Act of 1986**	Previous	50%	46%	27%
	Includes changes in 1988	New	28%	34%	**48%**
		Change	**-22%**	**-12%**	**76%**

*Source Information^*

It may seem surprising that the economic and stock market booms of the 1960s and the 1980s (with greater than 4.5% real GDP growth rates using Bureau of Economic Analysis data for each of the four year periods starting in 1964 and 1983) occurred when the after-tax reward from corporate dividend payments recovered to only 48% compared with the 66% before the Hoover tax increases of 1932. *Yet that is the impact of changes in incentives.* The after-tax returns on corporations that paid dividends rose 1200% from the paltry 4% rate in 1963 to the 48% rate at the end of the Reagan presidency! The stock market boom was even greater and lasted longer during the Reagan years than the Kennedy years, as the S&P 500's annual return averaged 19.5% for the five years ended 1986.

One could look at these particular events and conclude that changed tax incentives result in huge negative or positive economic and stock market impacts and that trade wars only have negative impacts on the world economy.

How Much Might the Rising Economic Tide Lift All Boats [Stock Market Valuations]?

The impact of the Tax Reform and Jobs Act on individual economic sectors and industries will be the topic of a future client newsletter, but we think the broader effects on the economic and financial markets should be felt relatively quickly because the changes passed in December are not phased-in. Instead they apply immediately to 2018 incentives. One of the flaws of the Economic Recovery Act of 1981 was the fact that the reduction in tax rates was phased-in over three years, causing economic growth to be delayed until the full benefit of the Reagan tax cuts was felt in 1983. This "phase-in" problem was repeated by the Bush Administration in the Economic Growth and Tax Relief Act of 2001. The economic recovery was delayed for the phase-in period, which ended in 2003 with legislation that accelerated the changes. The Trump Administration and Congress considered phasing in the corporate tax cut but in the end, wisely made the changes apply to 2018.

While it still takes some time for businesses to rev up their activities under the new incentives, separate from other impacts (such as bad trade policies), we believe one could reasonably expect real GDP growth in the U.S. to accelerate from the 2% level that persisted from the end of the Great Recession to 3% or more, much of which will come from more rapid business formation (in part due to the reduction in the burden of regulations), continued high level of hiring, and accelerated fixed investment with foreign profit repatriation and 100% tax expensing. Even if inflation rises only modestly, our research suggests the overall U.S. economy may see *nominal* GDP growth accelerate by 1-1.5 percentage points from the 2% real GDP, 2% inflation levels of the prior 8 years. This is a rough aggregate measure of the rise in the growth rate of corporate domestic revenues that, even with rising discount rates, could still see P/E ratios rise with faster S&P 500 earnings growth over the next 3-5 years.

Furthermore, we believe S&P 500 earnings should see a one-time shift up after-tax margins due to the reduction in statutory and effective tax rates on domestic earnings. While the lightening of the burden of taxation raises A/T margins, the potential increase will be somewhat reduced as companies "invest" some of the tax savings in raising compensation to retain employees, undertaking more marketing or R&D expenses, or lowering prices to stay competitive. So whereas a 40% reduction in the statutory tax rate on domestic pretax profits would produce a 22% increase in after-tax profits (and net profit margins), in our view, S&P 500 normal earning power should be boosted by 7-10% along with another 7-10% in normalized P/E ratios due to the tax rate changes.

But given the near 22% rise in the S&P 500 in 2017, has all of that "good news" already been discounted? Probably not. The prospects for tax reform didn't gain traction until the end of last summer. It would, however, be reasonable to believe that much of the S&P's gains in the 4th quarter and January of 2018 (the combined amount of which equated to nearly a

13% rate of return) were a result of the new optimism about profits and valuation. So, perhaps half of the upward adjustment has been accounted for.

Naturally there will be relative winners and losers by industry from the tax changes, and the further caveat is that the negative impact of trade wars could "sink" those "steel" boats even while the tide would otherwise be rising. By SKBA's estimates, mid-teens returns on stocks could be achieved over the next five years if trade disputes are resolved, whereas mid-single digit returns or less would be more likely if the U.S. stirs up a serious trade battle that would destroy many incentives to invest in the U.S.^^

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^Sources for corporate and individual marginal tax rates include: U.S. Department of Treasury Office of Tax Analysis papers, Wall Street Journal "Guide to the New World of Taxes", Legislink.org through Wikipedia for specific historical tax legislation.

^^Not a promise of future returns and is estimated by SKBA's multi-scenario forecasting process. The analysis and opinions expressed in this report by Andrew W. Bischel, CFA are subject to change without notice.

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