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What's up with tax reform? The stock market seems to like it. Most Republicans seem to like it. But public opinion polls show that over half of the American population doesn't like it.

Economist Larry Summers predicts that 10,000 people per year will die due to tax reform. New York governor Andrew Cuomo calls it "a dagger at the economic heart of New York." A study by the University of Chicago found that only one of 42 economists surveyed said the tax bill would increase economic growth substantially.

Of course Republicans and their favorite economists—apparently few of whom were interviewed by the University of Chicago—have a different take on tax reform. They claim that the Tax Cuts and Jobs Act will result in more jobs, higher wages, greater business investment, faster economic growth and a flood of money flowing back to the US from American companies' $2 trillion overseas cash hoard.

"Finding Waldo" in this forest of economic hyperbole and jabbering punditry is difficult. But, as one might expect, the kernels of truth are probably found somewhere in between the prognostications of the optimists and the naysayers.

What follows is my take on the tax bill, with particular focus on what's important for investors to know in 2018.

First, some general observations. This legislation is more a straightforward tax cut than tax reform. Tax reform is usually viewed as revenue neutral, with the loss of tax revenues from the rate cuts being offset by the gain in revenues from the elimination of tax deductions and loopholes and from base broadening. This bill should cut taxes by about $1.5 trillion over the next ten years, with the cut about evenly distributed between individuals and corporations. Some of the lost tax revenues will likely be offset by gains generated from additional economic activity. Just how much growth will offset the revenue loss is, of course, the great debate between Democrats and Republicans.

An important feature of this legislation is that the tax cuts for corporations are permanent, but most of the personal tax cuts expire in 2026. Beginning in 2018, the US federal corporate tax rate will be cut from 35% to 21%, the largest corporate tax cut in history and the first cut since 1986.

For individuals, the top personal tax rate goes from 39.5% to 37%. All other personal tax rates are cut as well, with lower income earners benefiting from a near doubling in the standard deduction and a hike in the child tax credit. Between now and 2025, about 80% of Americans will get a tax cut, about 15% will see little or no change, and 5% will experience a tax increase (mostly the higher earners in high tax states like New York, New Jersey and California).

The Republican tax-overhaul plan will send about 10% of a net $1.5 trillion tax cut directly to middle-income households . . . Households that earn $20,000 to $100,000 a year in wages, dividends and benefits will get $144 billion in tax cuts in all over a decade, with most of those cuts coming in the early years of the decade and then petering out or reversing as tax cuts expire . . .

~Wall Street Journal
September 19, 2017

The average household would pay $1600 less in taxes next year, increasing after-tax incomes 2.2 percent according to the nonpartisan Tax Policy Center . . . In 2025, the last year before the individual tax cuts expire, 76 percent of households would pay about $2500 less in taxes. But by 2027, only a quarter of taxpayers would see a cut.

~ The Huffington Post
December 18, 2017

Are the personal tax cuts distributed fairly across the income spectrum? Alas, "fairness" like "beauty" is in the eye of the beholder. Many opponents of the bill say that the majority of the benefits will accrue to the highest earners. This is true: mostly because top earners in America pay the lion's share of the income taxes, so it's difficult to implement a tax cut without benefiting top earners. For example, the top one percent pay about 40% of total federal income taxes, despite generating only 20% of the taxable income. The top 50% of earners pay 97% of the total income taxes. As Congress fiddled with income taxes over the past four decades, they have steadily eliminated lower income earners from the tax rolls.

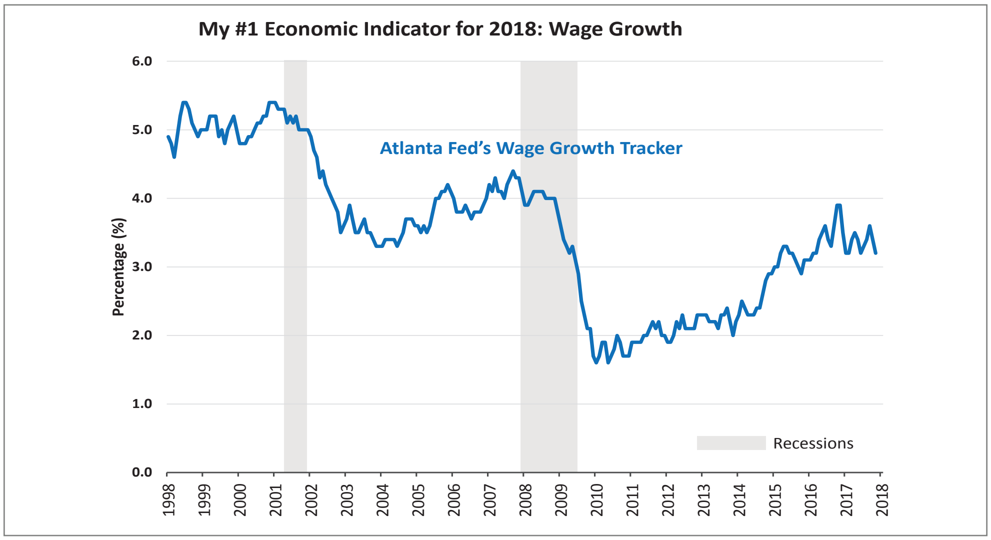
From an investor point of view, there are six key conclusions that can be gleaned from these tax cuts.

1. **US economic growth will be significantly enhanced in 2018 and 2019.** I don't buy the argument that this legislation is likely to have a negligible effect on US economic growth. It constitutes a significant dose of fiscal stimulus. Not only does it cut tax rates for both corporations and individuals, it also provides a five-year window for companies to fully expense their investments in capital equipment. A boost, if not a boom, in capital investment spending is likely to follow. What's more, many companies have recently announced $1000 bonuses for their employees. Soon, most employees will see a bump in take home pay due to lower withholding. I think 3% plus economic growth can continue at least through 2018. The tax cuts will increase the deficit and thereby push up interest rates, which will eventually slow the economy. But that likely won't become a problem in the next year or so.

2. **The international competitiveness of American manufacturers will improve.** Prior to this legislation, the US had the highest corporate tax rate among major developed world economies. High US corporate taxes have been a major impediment to manufacturers located in the US. Currently, the world average corporate rate is about 29%. Adding in 4% for state and local taxes, the new US corporate tax rate will be about 25%. This lower tax rate will reduce, but not eliminate, corporate desires to take advantage of tax havens such as Ireland, Bermuda and the Cayman Islands. Most importantly, it will substantially improve the US manufacturers' competitive position in world markets. (At least until foreign countries begin to match our tax cuts.)

3. **Corporate earnings will jump in 2018.** Earnings will be about 10% higher in 2018 just because of the tax bill. However, as corporations adjust to the new legislation, there will be "noise" in 4th quarter 2017 and 1st quarter 2018 earnings when some companies take write-downs to adjust to the new tax code. Using the S&P 500® index as a benchmark, 2017 earnings are estimated to be about $130. Prior to the tax cut, 2018 earnings were expected to advance about 5 to 7%. Since the bill's passage, analysts have been scrambling to raise their 2018 estimates to about $155, a gain of about 19% over 2017. Using the S&P 500 close of $2674 at year-end, the stock market sells at 20.5 times 2017 earnings, but for 2018 earnings it sells at a more reasonable 17.2 times.

4. **The tax bill's corporate benefits will vary.** The tax bill will benefit companies and economic sectors with a large US base of business. As such, smaller capitalization companies will benefit more than the larger multinationals, which usually have higher foreign sales. Among economic sectors, Consumer



Source: Federal Reserve Bank of Atlanta

The shortage of qualified workers reached a record high in December, and the number of small business owners who made plans to raise compensation was the second highest in history. . . "Finding qualified workers is now the second biggest concern for small business owners," said NFIB Chief Economist Bill Dunkelberg. "Taxes occupied the top spot all of last year, but that may drop as the recently enacted tax reform law takes effect. The worker shortage could very well become the number-one problem for small businesses."

~ NFIB Jobs Report
National Federation of Independent Business
January 4, 2018

Discretionary (retailers), Telecom Services, Industrials and Regional Banks are expected to be major beneficiaries. The sectors benefiting the least should be Energy, Technology and Materials, because of their relatively high foreign sales content. Despite their domestic orientation, most Utilities are also unlikely to benefit because their earnings power is heavily regulated.

5. **Repatriation of corporate cash held overseas won't meet investor expectations.** Many analysts predict a flood of cash being repatriated from the $2 trillion corporate cash hoard held overseas. This presumed flood will enable corporations to pay increased dividends, buyback stock, retire debt and fund additional capital investment. It might even increase the value of the US dollar. The optimists often base their prediction on what happened in 2004, when legislation opened up a window of opportunity to bring overseas cash back at a low 5.5% rate. The new tax bill should cause overseas corporate cash to flow back to the US, but it won't be a flood—more likely a steady trickle. The new tax bill treats cash repatriation differently than the 2004 legislation. It taxes all unrepatriated foreign earnings at 15.5% over a period of eight years, whether the company brings cash back to the US or not. There is no window of opportunity to spur companies to take immediate action.

6. **Debt-laden companies are likely to suffer, with negative implications for the junk bond market.** Historically, companies have been able to deduct from their taxes all interest payments on debt. In 2021, the amount of interest expense companies can deduct will be limited to 30% of EBITDA—earnings before interest, taxes, depreciation and amortization. This rule stays in effect until 2025, then the interest deduction becomes even more onerous. As a result, the new rule will restrain credit availability to lower quality companies as well as make them more vulnerable to any rise in interest rates.

There is a lot to like in the new tax bill. But, with all major legislation, there will be unintended consequences. The one I worry about is inflation. The Tax Cut and Jobs Act of 2017 applies a powerful dose of fiscal stimulus to our economy which is already doing well. The US unemployment rate is a low 4.1%, with an increasing number of businesses citing shortages of skilled labor.

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The recent string of natural catastrophes will lead to across-the-board increases in insurance prices, according to Swiss Re's chief financial officer. Prices for specialist insurance and reinsurance has been falling for years, but hopes are rising that the estimated $100bn in claims from hurricanes Harvey, Irma and Maria, combined with earthquakes in Mexico, will reverse the trend, allowing the industry to put up prices again.

~Financial Times
November 3, 2017

Drug makers have imposed price rises of several times the rate of inflation on more than a thousand products in the US, a New Year move that risks a political backlash at a time of intense scrutiny on healthcare costs.

~ Financial Times
January 5, 2017

Indicator	Commentary	Current Reading
1 **Short-term vs. long-term interest rates**	When short-term interest rates rise to meet or exceed long-term rates, monetary policy is usually tight enough to eventually cause a recession.	**Fed funds rate is below 10-year T note, but gap is narrowing**
2 **High-quality vs. low-quality bond yields**	A widening gap between junk bond yields and Treasuries indicates deteriorating credit market conditions.	**Credit Spreads are still narrow**
3 **Wage inflation**	When wages rise at a 4% annual rate, it is difficult for the Fed to keep core inflation near its 2% goal. So the Fed usually tightens policy aggressively.	**Wage growth is 3% and beginning to accelerate**
4 **S&P 500 P/E ratio**	Price/earnings ratios over 20 times makes stocks vulnerable to rising interest rates and inflation.	**P/E is 20.5 times**
5 **The leading economic indicators**	The Conference Board's LEI has peaked and turned down in advance of each recession since 1960.	**Strong uptrend**

Data as of December 31, 2017.

So far, inflation pressures in the US have been benign—a big benefit to stock and bond prices. The Consumer Price Index (CPI) is running at 2.2%, up from 1.6% last summer due to higher energy prices. Core CPI (CPI excluding food and energy) has flatlined at a low 1.7% since last spring. As US economic activity continues to improve, there is a growing possibility that the markets could experience an inflation scare, which causes the Fed to raise interest rates more aggressively.

My favorite early warning indicator of inflation is the trend in wages and salaries as measured by the Atlanta Fed's wage tracker on page three. When wage growth gets to 4% or more, the Fed tends to become more serious about raising interest rates. As the chart on wage growth shows, the uptrend stalled in 2017. That's the key reason that core inflation remained steady throughout last year.

The table above shows five indicators I monitor to gauge the health of the equity market. When two or three turn red, I get worried about the outlook for stocks. Currently, only one, the S&P 500 price/earnings ratio, is flashing a negative signal.

My big concern is that inflation pressures are lurking right below the surface of US economic activity. If they breakout, interest rates could spike and credit conditions could quickly deteriorate. So for those optimists raging about the tax bill's beneficial impact on our economy, be careful what you wish for.