Tax Reform: The Implications for Investors
How the Tax Cuts and Jobs Act could influence the economy and asset markets

Key Takeaways

• Corporate tax cuts should support earnings, but the impact to GDP growth may be limited due to a relatively low fiscal multiplier.

• Cyclical sectors and industries with a domestic focus may see the most gain, but specific company circumstances will likely matter most.

• The financials and consumer discretionary sectors appear best positioned to benefit from the reform, while some technology, utilities, and real estate companies may face headwinds.

• Higher-quality taxable bond issuers may benefit as well, while the most indebted borrowers could suffer.

Congress recently passed the most significant tax overhaul in decades, the Tax Cut and Jobs Act. The bill includes sweeping changes to both the personal and corporate tax codes, and fills more than 1,000 pages. How will this tax legislation affect the U.S. economy? Which asset classes and industries stand to benefit?

Fidelity experts share their insights on the reform, and what it could mean for investors.

Measuring the impact on the economy
Fidelity’s Asset Allocation Research Team (AART) estimates that the tax legislation will provide a modest positive boost to the U.S. economy over the next couple years and over the longer term. To the extent that tax relief makes businesses generally more profitable, it may be a positive for growth because some of those profits can be used for new capital spending and other growth-oriented activities. In addition, net tax cuts for individuals may increase the aggregate income of U.S. households, which should boost consumer spending.

However, the level of economic growth generated from these tax cuts may be limited due to a relatively low fiscal multiplier—the amount of growth created per dollar of tax cuts—for two main reasons:
1. The composition of the legislation is skewed toward low-multiplier beneficiaries. Tax cuts for corporate entities tend to have low multipliers because the extra cash typically does not all go to domestic capital spending (Exhibit 1, left). Instead, much gets diverted to other uses, such as share buybacks or foreign (rather than domestic) investment. Similarly, tax cuts for high-income individuals tend to be only partially spent, with a large portion going to savings. The legislation provides tax cuts on average to all income levels, but the proportion of overall tax-cut dollars going to higher-multiplier low- and middle-income individuals is not significant.

2. Multipliers tend to be larger when there is more spare capacity in the economy. An example would be when unemployment is high during recessions (Exhibit 1, right). At the current cyclical juncture, however, with tight labor markets, output closer to potential, and the Federal Reserve (Fed) hiking interest rates, the multiplier will likely be much lower.

**Overall, we estimate that the tax legislation might add about 0.3% to GDP growth in each of the next two years.** This is a net positive, and current recession risk is already low. However, the gain is not a game changer for where the U.S. stands in the business cycle. We expect the fiscal stimulus to give the Fed more confidence to keep hiking interest rates, which implies a continued progression toward a later stage of the business cycle over the next two years.

Advocates of the legislation, and some independent economists and analysts, anticipate that the corporate tax reform will materially boost U.S. investment and growth rates over the long term. One source of this optimism is the legislation’s attempt to make the corporate tax rate more competitive globally, and to

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**EXHIBIT 1: The Tax Cuts and Jobs Act is focused on lower-multiplier beneficiaries and comes at a time when there is little spare capacity in the economy—resulting in a lower fiscal multiplier.**

<table>
<thead>
<tr>
<th>Fiscal Multipliers by Tax</th>
<th>Impact of $1 Increase in Demand over Two Years</th>
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<tbody>
<tr>
<td>Corporate</td>
<td>Output below potential and Fed’s response limited</td>
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<tr>
<td>High-Income Individual</td>
<td>1.5</td>
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<tr>
<td>Low- and Middle-Income Individual</td>
<td>1.0</td>
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Fiscal multiplier: calculated as the change in gross domestic product divided by the change in the fiscal deficit, relative to a baseline. Source: Congressional Budget Office, Fidelity Investments (AART), as of Dec. 15, 2017.
reverse existing tax incentives for U.S. businesses to invest abroad rather than domestically. While these efforts should directionally be positive for U.S. investment and growth, the magnitude and timing of the boost are unclear. Many global corporations already pay much lower effective tax rates than the statutory 35% rate, and it’s too early to know exactly how the complex legislation will change incentives for corporate behavior.

Overall, this doesn’t change our view of asset-allocation positioning dramatically. We still believe that the global corporate and economic backdrop is constructive and that the financial markets will enter 2018 with positive momentum, but a maturing U.S. business cycle implies smaller cyclical asset-allocation tilts.

Implications for investment categories
Sweeping tax legislation creates potential impact across asset classes and their underlying sectors and industries. We asked our investment professionals to identify the key areas of the markets that are likely to be affected.

A potential boost for U.S. equities, but the impact will vary by sector and by company
The one clear implication is that lower corporate taxes mean potentially higher corporate earnings, which tend to boost U.S. equities generally. This immediately makes the U.S. stock market less expensive on a price-to-future earnings basis, though rising stock prices in recent months have likely priced in at least some of this anticipated earnings growth already.

Moreover, this tax overhaul will likely prolong the corporate earnings recovery, which is broadly constructive for equities. Both corporate tax reform and profit recoveries have historically tended to support the outperformance of cyclical sectors relative to defensive sectors.

For this reform, the sectors with the highest average effective tax rates and the greatest proportion of domestic earnings stand to benefit the most, while the sectors with the lowest effective tax rates and heavy overseas earnings may actually see negative effects. Because their profits tend to be more U.S.-based, the financials and consumer discretionary sectors appear best-positioned to benefit from the

Provisions of the act that may affect investments
• The corporate tax rate is lowered from 35% to 21%.
• The alternative minimum tax (AMT) for corporations is repealed.
• Accumulated foreign earnings of U.S. companies are mandatorily repatriated, at a one-time rate. Going forward, most foreign profits will be considered under a territorial tax system, reducing the tax incentive to defer repatriation.
• Business deductions for debt interest payments are capped at a percentage of earnings, putting a limit on the tax benefits of carrying debt.
• Businesses may immediately deduct expenses for certain capital expenditures, rather than depreciating gradually for up to 20 years. (This benefit is currently set to phase out gradually starting in 2022.)
• For personal taxpayers, income tax rates are lower (subject to modified income brackets), the state and local tax deduction (SALT) is capped at $10,000, and the mortgage interest deduction applies only to mortgages up to $750,000.
• Specific new tax provisions affecting the health care delivery, pharmaceutical, and life insurance industries will likely have impact that needs to be studied at the company level.
• One type of municipal bond—advance refunding bonds—will no longer provide tax-exempt interest.
reform. Technology, utilities, and real estate are the sectors likely to benefit least. Importantly, individual companies within each sector may fare better or worse than their peers, depending on their circumstances.

**U.S. corporate bond quality—and rates—may rise**
To the extent that tax reform benefits the bottom line of U.S. companies that issue debt, their credit quality may improve. The repatriation of cash from foreign earnings may shift the capital structure of multinational corporations, allowing them to issue less debt to raise U.S. operating cash. The limit on deductibility of debt interest payments will generally hit only the most highly levered companies (those issuing high yield debt), but may increase credit risk at the very lowest end of the credit spectrum.

To the extent that the act stimulates the economy as anticipated, the Fed may be encouraged to raise rates faster, which will influence government, corporate, and municipal rates. However, the Fed’s economic projections have accounted for moderately higher economic growth due to tax cuts, with no change as of yet to their policy rate projections. Actively managed bond funds may be best positioned to take advantage of shifts in the fixed income market as issuance volumes, issuer credit quality, and rates change.

**How the new tax code could affect various equity and bond categories**

**Equity Sectors**

**Financials**
- Several industries in the sector stand to benefit from the lower corporate tax rate due to their limited overseas exposure, including consumer finance, regional banks, U.S. wealth management and brokerage firms, and some exchanges.
- Because financials tend to be commoditized businesses and, in some cases, subject to regulated pricing, these benefits may be competed away over time.
- In contrast, life insurance and reinsurance companies may stand to benefit least due to provisions in the act, and some could even see their taxes rise.

**Consumer discretionary and consumer staples**
- The average tax rate for companies in the consumer sectors is well above 21%, with consumer discretionary and specialty and multiline retail companies, specifically, at the higher end of the range. The new corporate rate should meaningfully reduce their tax obligations.
- To the extent that the U.S. consumer benefits from tax reform and an improving economy, consumer companies stand to gain from increased spending.

**Health care**
- Overall, the impact on the health care sector is likely to be relatively modest, with possibly mixed results for different industries due to specific provisions. As an example, U.S. health care services companies will likely benefit from the lower corporate tax rate.
- U.S. health care services companies will likely benefit from the lower corporate tax rate.
- The impact on HMOs could be more significant if the “health insurer fee”—a non-deductible fee paid for by the industry—is delayed, as it could be a windfall for profits in 2018.
- Repatriation may have an impact, with more than $1T of cash and unremitted earnings likely to be repatriated within the sector.
- A new tax on internal goods that cross international borders and a reduction to the orphan drug tax credit may be negative for the sector, but the overall rate reduction is likely to offset the upward pressure in other parts of the act.
Technology

- In general, the technology sector may only see a minimal benefit from the lower corporate tax rate; many companies already have very low tax rates due to deferring U.S. taxes on profits in low- or no-tax countries—a practice that will no longer be effective.
- However, the technology sector is likely to be one of the biggest participants in repatriation of past foreign profits, allowing them to put “trapped” overseas cash to work in various ways.

Utilities

- For regulated utilities, tax expenses largely pass through to customers, so consumers will gain from lower corporate rates but the utilities themselves will not, and earnings growth may lag that of other industries.
- Highly leveraged parent companies of regulated utilities will get less of a tax deduction from ongoing interest expense, due to the lower corporate rate.
- These factors combine to lower cash flow, potentially hurting the credit rating of many utilities and encouraging them to be more aggressive about financing new projects by issuing new equity.
- Within the sector, parent companies with more non-regulated components—such as deregulated power generation, natural gas infrastructure, or renewable energy plants—may see greater benefits from the lower corporate rate.

Real estate

- The final bill suggests a more benign impact on the real estate sector than earlier proposed versions.
- Many limitations on corporate deductions, including those for depreciation and interest, appear to exempt real estate investment trusts (REITs), which lessens the potential negative impact of the reform.
- The limitations on state and local tax and mortgage interest deductions could hurt REITs with exposure to high-tax, high-property-value states, but the longer-term impact will depend on whether corporations opt to move headquarters and pools of labor to lower-tax markets.

Market capitalization considerations

- Tax reform has historically favored U.S. companies with smaller market capitalizations, because smaller companies tend to be more focused on domestic business and therefore benefit more from local economic growth.
- Similarly, small-cap and mid-cap companies may have been paying higher tax rates than large-cap competitors with more multinational business opportunities. The mandatory repatriation of foreign earnings may level the playing field, while the repeal of the corporate AMT could benefit less mature companies that are still investing heavily in growth.

Bond sectors

Investment grade corporate bonds

- Typically, investment grade issuers have relatively low debt burdens, and will not be affected by the cap on interest rate deductions.
- Lower corporate rates and the temporary ability to immediately expense capital investments may generally improve corporate earnings, increasing credit quality.
- Many companies have been using debt to finance U.S. cash needs while avoiding repatriation of foreign earnings. The one-time repatriation and territorial tax system may reduce issuance from cash-rich companies, which could shift the proportions of sectors within the investment grade bond indexes. For
example, technology companies now make up almost 9% of the corporate bond index, despite high cash balances at the top companies. However, corporate bond supply could continue to be supported by generally low interest rate levels, refinancing needs, and merger-and-acquisition funding.

• Demand for investment grade corporate bonds should remain generally supported by constructive economic fundamentals, demographic demand, and ongoing asset allocation needs.

High yield bonds
• Investors have a wide range of circumstances to consider when analyzing high yield bond issuers. For example, companies generating earnings may benefit from the lower statutory rate, and companies with net operating losses may benefit from the elimination of the AMT. However, companies carrying deferred tax assets from net operating losses may need to write those down due to the new lower rate, weakening their balance sheets.
• The cap on interest deductibility will affect many high yield issuers, penalizing the most highly leveraged companies.
• At the high-quality end of the high yield credit spectrum, the benefits from a lower rate and the immediate deductibility of capital expenses are more likely to outweigh the negatives. But at the other end, credit risk for the most highly leveraged companies during a downturn may increase.
• The interest deduction cap will also discourage leveraged buyouts and other highly leveraging transactions.
• Over time, the result may be a smaller, higher-quality high yield market, with less default risk.

Municipal bonds
• Tax uncertainty increased the supply of municipal securities in Q4, because many borrowers hurried to issue bonds ahead of potential changes. This additional supply is expected to result in decreased issuance in early 2018.
• With lower corporate tax rates and no corporate AMT, the benefits of tax-exempt bonds for corporate holders may be diminished moving forward, and therefore, demand from U.S. insurance companies and banks that purchase municipal debt may decrease.
• Private activity bonds and “stadium bonds” will still have tax-advantaged status. This decision will preserve the ability for issuers such as hospitals, universities, and airports to issue tax-exempt bonds, encourage ongoing investment in infrastructure projects, and maintain an important source of tax-exempt bond supply.
• Effective in 2018, issuers will not be allowed to advance refund their debt with tax-exempt bonds. Issuers advance refund bonds to pay off higher-interest debt with new debt. This will likely reduce the supply of municipal debt in future years, though to differing degrees each year.

Mortgage-backed securities
• The $750,000 limitation on mortgage interest deductions may lower home prices and reduce very large mortgages, but the majority of the mortgage-backed securities (MBSs) market is made up of mortgages well below that limit.
• However, the two government-sponsored mortgage agencies (Fannie Mae and Freddy Mac) have large deferred tax assets that will have to be written down due to lower rates. Although their MBSs are protected by an agreement with the federal government, we expect this action to spur a political call for more reform in the years to come.
Money market funds

- With lower corporate and personal income taxes, yields on municipal money market funds will need to move higher to stay competitive with taxable funds on an after-tax basis.
- Municipal money market fund managers may need to contend with lower municipal supply in early 2018.
- Corporate repatriation of foreign cash may lead to higher balances in government money market funds overall, but increased issuance of U.S. Treasuries should be able to accommodate the additional investments.

Conclusion

There are pitfalls associated with making investment decisions based on a single variable, such as tax reform. Many drivers, including business fundamentals, valuations, and dominant economic trends can influence the performance of equities and bonds. Nevertheless, sweeping tax reform can create potential investment opportunities and in-depth analysis may help identify the industries and companies that will benefit most.

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Investing involves risk, including risk of loss.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

Because of its narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies. Sector investing is also subject to the additional risks associated with its particular industry. The consumer discretionary industries can be significantly affected by the performance of the overall economy, interest rates, competition, consumer confidence and spending, and changes in demographics and consumer tastes. The financials industries are subject to extensive government regulation, can be subject to relatively rapid change due to increasingly blurred distinctions between service segments, and can be significantly affected by availability and cost of capital funds, changes in interest rates, the rate of corporate and consumer debt defaults, and price competition. The health care industries are subject to government regulation and reimbursement rates, as well as government approval of products and services, which could have a significant effect on price and availability, and can be significantly affected by rapid obsolescence and patent expirations. The technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic condition. A REIT issues securities that trade like stock on the major exchanges, and invests in real estate directly, either through properties or mortgages. A REIT is required to invest at least 75% of total assets in real estate and distribute 90% of its taxable income to investors. Illiquidity is an inherent risk associated with investing in real estate and REITs. There is no guarantee the issuer of a REIT will maintain the secondary market for its shares, and redemptions may be at a price which is more or less than the original price paid. Changes in real estate values or economic downturns can have a significant negative effect on issuers in the real estate industry. The utilities industries can be significantly affected by government regulation, financing difficulties, supply and demand for services or fuel, and natural resource conservation.

The securities of smaller, less well-known companies can be more volatile than those of larger companies.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rates rise, bond prices usually fall, and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Lower-quality debt securities generally offer higher yields but also involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

The municipal market can be affected by adverse tax, legislative, or political changes, and by the financial condition of the issuers of municipal securities. Interest income generated by municipal bonds is generally expected to be exempt from federal income taxes and, if the bonds are held by an investor resident in the state of issuance, from state and local income taxes. Such interest income may be subject to federal and/or state alternative minimum taxes. Investing in municipal bonds for the purpose of generating tax-exempt income may not be appropriate for investors in all tax brackets. Generally, tax-exempt municipal securities are not appropriate holdings for tax-advantaged accounts such as IRAs and 401(k)s.

You could lose money by investing in a money market fund. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Before investing, always read a money market fund's prospectus for policies specific to that fund.

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