Bulletin – Trump tax bill

December 2017

It is unfortunate that the media tends to focus on the shiny things. Much hay has been made about tax cuts for the wealthy and corporations while cuts for the middle class are set to expire in 3 years.

Playing politics

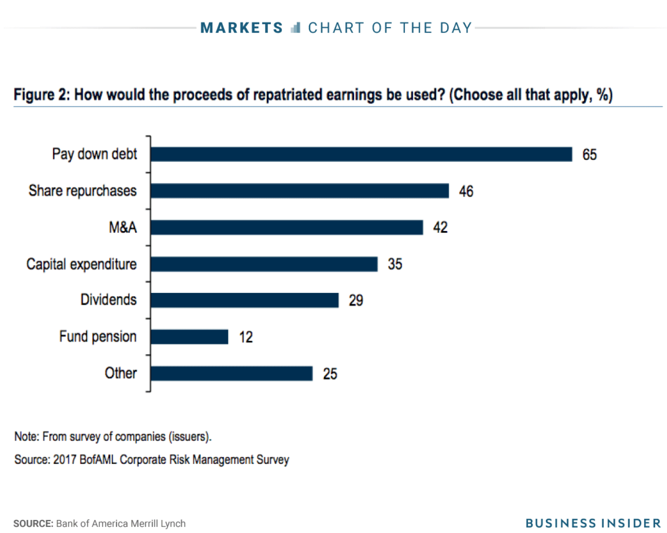
Nothing gives a stump speech more sizzle than "vote for my opponent and your tax cuts will expire", as the middle class cuts expiration coincides with the next presidential election. Here north of the border it is unlikely that the Liberals will be cutting corporate taxes with their shift to the left to try to quash the NDP, but with US corporate tax rates equivalent to Canadian marginal rates this may force their hand. These are the shiny objects.

Repatriation – the elephant in the room nobody is talking about

The actual crucible of this new US tax bill is to push corporations to repatriate profits stored abroad. They are using a carrot and stick approach; firstly they will be taxing foreign income (the stick), and they are reducing domestic taxes and introducing a retroactive 2017 repatriation holiday. The goal of which is to get US corporations to bring back profits made abroad to the US. Depending on which numbers you look at, the total amount of US corporations' foreign cash reserves are $1.5-$2.5 trillion.

What does this mean for the investor?

The majority of companies said that they would use the money to pay down debt or conduct share buybacks. Both of these add value to US large cap stocks. Almost 30% said they would put the money towards dividends.



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Let's put this into perspective. If you use the $2.5 Tn figure, and base it on corporate intentions as per the chart above, this is the kind of impact that the repatriation of all that money would have on the US economy:

Use of repatriated funds	Corporate intentions	Economic impact
Pay down debt	65%	$1.625 trillion
Share buybacks	46%	$1.15 trillion
Capital expenditure	35%	$875 billion
Dividends	25%	$625 billion

While this is an oversimplification as some companies will use these funds for multiple of these purposes, and it is based on the assumption that all the money is repatriated, as you can see the impact on the US economy of this tax bill has the potential to be absolutely huge.

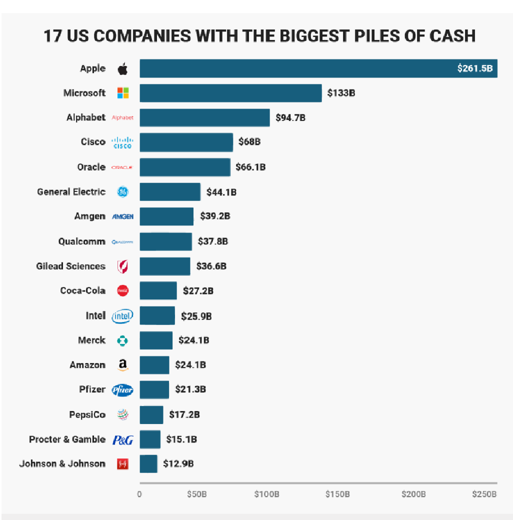
Paying down debt will help US companies wipe out interest rate risk, as despite having boatloads of cash abroad it has been cheaper with the previous tax regime to keep the money offshore and borrow locally in the US.

The US Fed is signaling measured rate increases throughout 2018 as well which will have upward pressure on the US dollar while increasing the costs of US corporate borrowing.

The Trump tax bill's repatriation has CEO's feet to the fire. They have set a very rapid deadline for companies to take advantage of these benefits (the carrot) before foreign asset taxation kicks in (the stick). They will be giving corporations a timeline in weeks, not months, quarters, or years to get on board.

Who are these companies hoarding so much cash?

Primarily tech and pharmaceuticals are hoarding overseas profits:



As you can see, some of these companies, most notably Apple, Microsoft, and Google are hoarding massive amounts of money abroad due to a tax scheme that punishes them for bringing money home. When looking at the chart to the left, you can imagine why the Trump tax plan wants to see that money come home (also a campaign promise).

This is money that has been unable to finance debt repayment, US growth, share buybacks, or capital expenditures inside their US operations.

As these numbers are so large it is sometimes difficult to wrap your head around.

If the Canadian government launched a $625 billion one time tax refund, this would be roughly double the size of the entire Canadian federal budget (C$317 billion, not including provincial budgets). This is the equivalent of if the percentage of the aforementioned companies were to release a one time special dividend. Put into that perspective, these numbers are staggering.

With regards to share buybacks, that would add about 3.5 times the value of the entire Canadian budget to US markets.

What does this mean for the Canadian investor?

For Canadians, foreign denominated equity assets (incl US) should be hedged against currency. Such a large rapid transfer of capital could have very distorting unforeseen effects on a wide variety of currencies and may be somewhat unpredictable. Such a massive injection of capital into the US will likely force the US Federal Reserve to raise rates more quickly, which may push the US dollar higher vis-à-vis the Canadian dollar. Also, as a large number of US companies have operations and subsidiaries in the US, this could cause downward pressure on the Canadian dollar. Normally if the US dollar will be strengthening, one would leave their US denominated assets unhedged and play the currency, but there are too many variables at play to remain conservative and predict the future.

Large cap US players on the chart above who may be taking advantage in whole or in part of this repatriation scheme should show significant strength and possibly special dividends. Using the example of Apple, any company receiving a $250 billion influx of cash is pretty big news, even a company as large as Apple.

The broader US economy, should corporations take the carrot instead of the stick, should receive a hefty dose of adrenaline when already flirting regularly with new record highs in markets and 17 year unemployment lows. Inflation, and therefore wage pressures, could send the US economy on a rocket ship.

If the US economy starts raging like a bull, with the repatriations FX implications and possible accelerated US Fed rate rises, this may have a positive impact for Canadian exporters with $CAD weakness exacerbated by profit withdrawal under the new tax act. However, this will be somewhat unpredictable with the hardball being played by the current US administration on trade deals like NAFTA –many of Canada’s largest exporting companies are actually subsidiaries of US companies – so Canadian investors should most definitely stick with Canadian companies with strong earnings and dividends to back their share prices.

We are in for some very interesting times ahead, most of which will be just around the corner. The cascade will depend on whether CEOs in the US use the repatriation in the new bill, or decide to stand pat and leave their money where it is.