T. Rowe Price®
INVEST WITH CONFIDENCE

PRICE POINT
December 2017

Timely intelligence and analysis for our clients.

U.S. Tax Reform
INVESTMENT IMPLICATIONS ARE MIXED

KEY POINTS

- The U.S. tax reform measure will create both opportunities and challenges for investors, but many other factors must be considered in making investment decisions.
- The fiscal stimulus from tax cuts may produce only a moderate rise in economic growth in 2018 and dissipate after that.
- The tax changes favor industries and companies that derive all or a large percentage of earnings in the U.S. and pay high tax rates currently.
- Tax cuts and other provisions could result in less issuance of corporate and municipal debt and improvement in overall creditworthiness.
- Investors should maintain a well-diversified portfolio and be mindful that changes in taxes are not likely to solely determine investment outcomes.

The new U.S. tax overhaul is likely to have widely varying impacts on companies, with some reaping considerable tax advantages compared with others. Meanwhile, companies or even entire investment sectors that appear to be relatively disadvantaged could fare better than expected.

T. Rowe Price investment professionals caution that investors have, in some cases, bid up prices in anticipation of the tax benefits. Broad characterizations of so-called winners and losers from the legislation may also be off the mark. Above all, the tax measure does nothing to diminish the importance of careful security selection and strategic investment decisions.

IMPLICATIONS FOR THE ECONOMY

With the economy eight years into an expansion and operating at full employment, the fiscal stimulus of the tax cuts is likely to have a fairly modest impact on growth next year. Chief U.S. Economist Alan Levenson had expected the nation's gross domestic product (GDP) to grow roughly 2% to 2.25% next year. He says the tax cuts could add

> “You need to be very, very selective because stock valuations, even with tax reform, are still elevated.”
>
> **—DAVID GIROUX, PORTFOLIO MANAGER**

another quarter point to growth in 2018, but that the impact dissipates after that. “It’s just too late in the business cycle to get a real boom out of this,” he says.

Mr. Levenson notes that the Joint Committee on Taxation, Congress’s official scorekeeper, is a bit more optimistic, projecting the economy’s growth rate could rise by an average of three-tenths of one percent a year over the next decade.

With inflation remaining subdued at about 2% annually and job growth slowing, Mr. Levenson does not expect the tax stimulus to significantly alter the Fed’s plan for three rate hikes totaling 75 basis points in the federal funds rate in 2018.

“We could see some overheating at the margin and rates moving higher than expected, but I’m skeptical about inflation rising,” Mr. Levenson says. “And with the European Central Bank and the Bank of Japan still extending their balance sheets, there is so much liquidity that I don’t see long-term rates moving much higher.”

While the economy may not reach the 3% annualized levels forecast by the Trump administration over the coming years, Mr. Levenson says the stimulus “does at least dispel the risk of recession next year.”

Growth Stock Portfolio Manager Joe Fath also does not expect a huge economic impact, but he says: “It gives you more confidence that the expansion can continue for some time. We were probably in the seventh or eighth inning of the cycle. Now, there is a higher probability that we go into extra innings.”

IMPLICATIONS FOR EQUITIES

Capital Appreciation Portfolio Manager David Giroux estimates that the lower corporate tax rate alone could provide a one-time boost in S&P 500 earnings of 6% to 8% on average in 2018, in addition to the expected gain of 5% without the stimulus. That would produce double-digit earnings growth. Many companies with high effective tax rates would see bigger increases. Such earnings growth would reduce the price/earnings ratio of the S&P 500 from 19 to 18 times earnings—still high on a historical basis, Mr. Giroux adds.

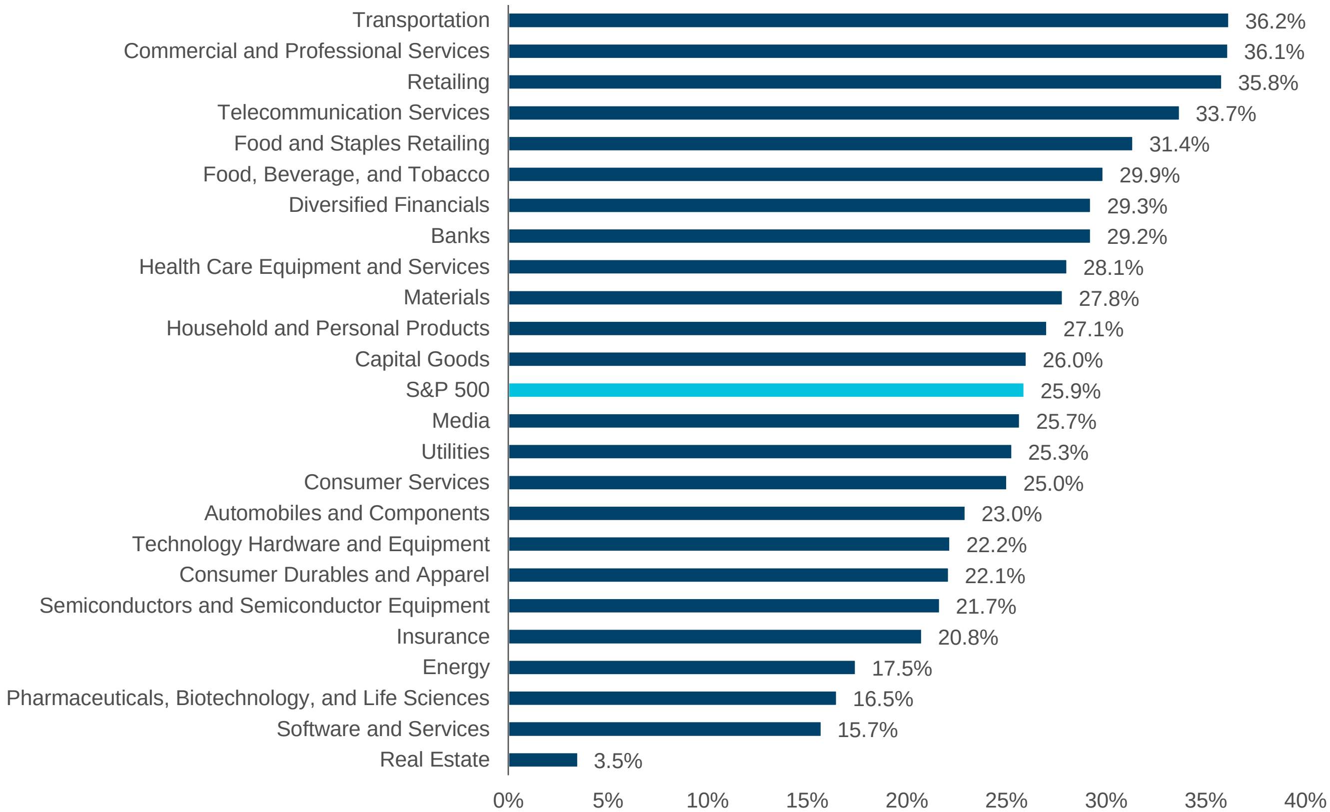
In general, the tax reform measure favors industries and companies that derive all or a large percentage of their earnings from U.S. operations. This includes sectors with many small- and mid-capitalization companies, including telecommunications, consumer discretionary (such as retailing, autos, department stores, and cable), consumer staples, financials, and industrials and business services. Large multinational firms, whose overseas business composes about 40% to 60% of their earnings, have lower effective rates and would receive less of a benefit. These businesses are clustered in the technology, health care, materials, and energy sectors.

Technology companies with large overseas business typically have low effective tax rates, and they could benefit from a repatriation provision giving them easier access to overseas earnings, which some think will spur more merger and acquisition activity in the industry. “Clearly, some will use that money for share repurchases and dividend increases, but many will look to buy other companies,” says Mr. Fath. Mr. Giroux, however, expects technology companies are more likely to use the funds to pay down debt, limiting the economic impact.

Another issue is how companies might deploy tax windfalls. “In industries that are much more competitive—such as retailers threatened by online companies, or airlines—it could be that prices are cut and consumers end up paying less for goods over time,” Mr. Fath says. “If that happens, the tax overhaul could actually be deflationary. When you look at profitability over time, it might not be that much different for many companies.”

Figure 1: **S&P 500 Effective Tax Rate by Industry Group, 2016**

As of December 31, 2016



Source: Stratregas Research Partners.

Mr. Giroux's advice: "You need to be very, very selective because stock valuations, even with tax reform, are still elevated. You wouldn't buy a company just because it has a high tax rate because it might not get much benefit from a lower rate."

Importantly, tax changes alone are not likely to alter secular trends. Small-Cap Stock Portfolio Manager Frank Alonso notes that "retailers are domestically oriented and so they have high tax rates. But they also have Amazon, which is coming at them aggressively and disrupting their businesses. Tax reform will certainly give them a lift, but it doesn't make me think that some companies will necessarily be well positioned longer term."

IMPLICATIONS FOR BONDS

The changes in taxes also pose opportunities and challenges for the bond markets. The cut in the corporate tax rate, the repatriation of foreign earnings, new limits on interest deductibility, and increased expensing of capital equipment could generate additional corporate cash flow and result in less debt issued in the U.S.—reducing supply and boosting bond prices.

While the high yield bond market is considered a relative loser in tax reform because of the interest deductibility provision and its impact on highly levered companies, there may be a silver lining. The provision could encourage companies to pay down debt and thus reduce the credit risk to bondholders. And the high yield market, like the investment-grade market, could benefit from an overall reduction in bond issuance.

"I expect to see less high yield issuance as companies improve their balance sheets or shift borrowing overseas or even get upgraded into the investment-grade market," says Mark Vaselkiv, High Yield Portfolio Manager and chief investment officer of fixed income. "Meanwhile, there is robust ongoing demand for higher-income strategies from insurance companies and pension funds. If the high yield market shrinks, that will create a scarcity value for those higher-yielding assets."

Another apparent anomaly is that the energy sector—the largest in the high yield market—could benefit, despite relatively low effective tax rates among producers. "Energy is one of the most capital-intensive industries in the economy, so it benefits from the 100% expensing of capital expenditures," says Andy Jamison, High Yield Associate Portfolio Manager. Also, the energy sector is recovering from a downturn, and it may be able to shield more profits as a result of the tax overhaul. It tends to be one of the industries in the high yield market that is less leveraged on a debt-to-cash flow basis relative to other high yield sectors."

"Tax reform aims to reward healthy companies that are investing for growth, and it penalizes companies that are zombies—those that are over-levered, have not been investing because they don't have the cash flow, and really do need to liquidate or restructure and start over with a clean balance sheet," Jamison says. "Those are the kinds of companies we're avoiding."

Mr. Jamison adds, "Regulatory and tax reform are important, but if there is a strong fundamental outlook for a sector that is disadvantaged by tax reform, we may still be investing in it. Tax reform is just another component of our analysis."

Mr. Vaselkiv says other high yield segments that may benefit from tax changes include autos, cable television, food and beverage, restaurants, telecommunications, and financials.

He notes that tax reform is likely to reduce the number of risky, leveraged buyout transactions in which some of the most highly levered businesses are taken private. "That's positive for high yield because that's where the defaults originate."

"Of the top five things we worry about," Mr. Vaselkiv says, "tax reform would be near the bottom of that list. We're a lot more concerned about how long this economic expansion lasts."

MIXED IMPACT TO MUNICIPAL BOND MARKET

The municipal bond market could face challenges from reform. Banks, property and casualty insurance companies, and life insurance firms held about U.S.$1.1 trillion of muni bonds as of mid-2017, accounting for 29% of the U.S.$3.8 trillion muni market. Lower corporate tax rates could present them with less incentive to hold muni debt. However, Hugh McGuirk, head of the municipal bond group, says he does not expect a big impact, as these companies' involvement in the market has been steady over time.

Also, the tax reform measure eliminates advance refunding bonds, which are issued to retire old debt. These bonds account for 10% to 20% of the market's annual supply, helping to offset any loss of demand. Indeed, demand is expected to remain strong, especially in high-tax states with new limits on income and property tax deductions.

"With the expected reduction in supply next year, and muni yields attractive relative to Treasuries, we would expect that the munis you hold today will appreciate relative to other assets," Mr. McGuirk says.

In any event, the muni market, like other fixed income markets, may be driven more by the trend in interest rates and the economy than the tax overhaul.

"The interest rate outlook will drive the market," Mr. McGuirk says. "I'm not optimistic on rates, but people have been predicting higher interest rates for years and it hasn't happened yet. And I think the dynamics of the muni market, especially as impacted by tax reform, will help munis do very well on a relative basis. There is a core of investors who like the conservatism of the muni market, the low volatility of return, and the steady tax-free income potential."

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price International Ltd. (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. T. Rowe Price International Ltd. is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides in Australia. T. Rowe Price International Ltd. is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.