



# Is US Tax Reform Good for Stocks?

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Equity investors appear to have voted in favor of US tax reform. But the optimism may need to be tempered. We believe that the impact of the tax overhaul on individual stocks will be mixed and will depend on several factors.

Rapid progress has been made in recent weeks on US tax overhaul, with the final bill unveiled late Friday afternoon. If the bill passes both the House and Senate, it's on track to be signed into law by Christmas. It would be the Trump administration's biggest political achievement in its first year.

US companies are eagerly awaiting the legislation. It would slash the corporate tax rate to 21%, from the current rate of 35%. This would deliver tangible benefits to thousands of companies in a wide range of industries. But at the same time, we believe that closer scrutiny of individual companies is necessary to understand which firms are likely to receive the biggest boost from a sweeping tax bill—and how the benefits will filter down.

## Competition Could Erode Earnings Boost

Not all companies will be affected in the same way. Many US companies, including some of the market's mega-cap leaders, have been shielding earnings overseas for years. So although the proposed tax cuts will reduce the impetus to keep cash offshore, companies' bottom lines will be affected differently depending on their global earnings footprint. In contrast, companies that are more domestically oriented, which currently pay taxes near the statutory rate, should benefit most directly.

However, tax cuts could also spur fierce competition. If tax relief is distributed evenly across companies in cutthroat industries, we believe they're likely to compete it away by lowering costs to customers, with profits settling at a reasonable return on capital.

## Advantaged Companies to Enjoy Bigger Windfall

Some companies may reap longer-term gains. In particular, companies that already enjoy competitive benefits could be the big winners from tax reform. For example, many of the current tech giants enjoy significant advantages in their lines of business, and are in a good position to keep more of the spare cash generated by lower taxes, in our view. In general, companies that pay higher tax rates in more concentrated industries will be more likely to enjoy a bigger windfall.

Similarly, industries where matching competition is harder may also maintain at least a temporary benefit. Consider a company with a multibillion-dollar chemical plant in the US. While the tax reform may encourage overseas companies to relocate more assets to the US, it's not so easy to move an existing plant, and it will take years (and money) to build a new one.

## Cash Repatriation

The tax bill also aims to spur the repatriation of corporate cash from overseas. Under the reform, companies will be incentivized to bring cash back to the US from abroad with an attractive one-time tax rate.

For a company like Apple, with \$250 billion in cash overseas, the potential impact is huge. Investors already recognized this, and have been factoring in Apple's cash hoard as part of their valuation analysis. But the potential tax relief will give companies like this more flexibility to manage their use of cash and balance sheets, which will take time to fully assess.

## Big Benefits for Small-Caps

On the other end of the spectrum, US small-cap companies should enjoy a bigger earnings boost from tax cuts than do large-caps because they tend to pay a higher tax rate. But the impact of tax cuts will be complex and could affect different companies in different ways, as we explained in a recent blog.

It's easy to get seduced into thinking that a major policy decision will be a broad catalyst for equities, especially if equity markets rise in response to approval of the tax reform.

But short-term sentiment is never a good guide for long-term investing strategy. We believe that the full impact of tax reform on industries and companies will be understood only over time. Investors need to look closely at individual companies' cash positions and competitive environment to understand which ones will reap the biggest benefits from tax reform in the coming years.

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