Multi-Asset Solutions Team

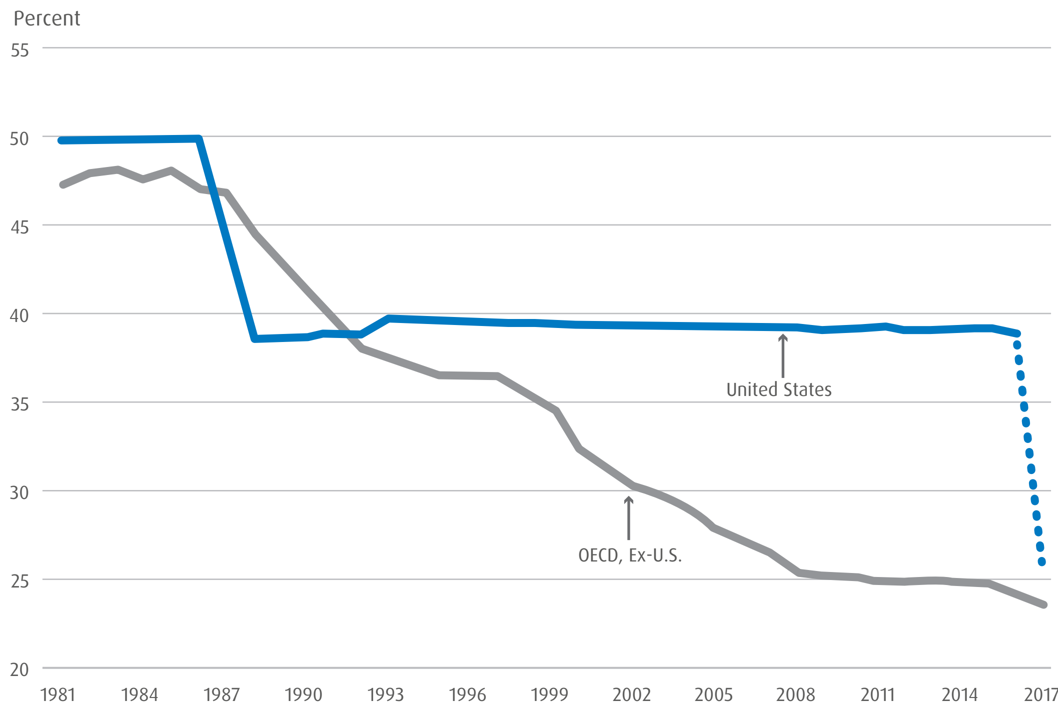
Strategy Spotlight

U.S. tax reform: An early Christmas gift to corporations and a stocking stuffer for individuals

As we approach the end of the year, congressional Republicans are frantically putting the finishing touches on their promised tax-reform bill. Since mid-2017, we have believed the odds of passage to be higher than consensus; this is one of the reasons we remained overweight equities in our multi-asset portfolios. With passage of the bill imminent, we thought it would be a good time to examine the implications of the second largest tax cut in modern U.S. history.

At its core, this bill is a corporate tax cut. The federal corporate tax rate is expected to decrease from 35% to 21% — and drop about 26% overall with state and local taxes included — putting it in line with averages compiled by the Organization for Economic Co-operation and Development (OECD).

Statutory corporate tax rates (combined Federal and subnational tax rates)



Sources: Strategas, OECD, BMO Global Asset Management

Contributors

Jon Adams, CFA
Chicago

Michael Dowdall, CFA
Chicago

Steven Bell
London

Paul Taylor, CFA
Toronto

While very few corporations pay the statutory tax rate, it should be noted that the average effective corporate tax rate should still fall about 5%. This decrease in corporate taxes provides a near-term boost for stocks, likely increasing 2018 earnings 5% to 10% for the S&P 500 and more for higher-taxed small-cap companies. Those higher earnings should then persist into the future, meaning stocks have greater value due to higher expected after-tax cash flows.

In the short-term, we may see additional corporate investment due to a provision allowing companies to immediately expense (rather than depreciate) their capital expenditures. Under current law, a company builds a plant and then depreciates it over a long period of time, reducing their tax burden a small amount each year. Under the new law, a company can expense the plant cost when it's built, reducing its tax burden in the current year. Since this provision has a five-year sunset, we expect additional capital expenditures in the near term, which would be another boost for the economy. Higher investment may also increase worker productivity (people can be more productive when working with newer technology), the key laggard over the last two decades. The effects on productivity — if they materialize — may take years to observe but they are the key to the success of this tax bill.

The bill's implications for individual taxpayers are more nuanced, with lower headline tax rates and a higher standard deduction balanced by fewer itemized deductions. Individuals (such as ourselves!) residing in high-tax states will have deductions on state and local taxes capped. However, overall tax rates should decline moderately due mainly to lower rates. We think these tax declines may lead to small increases in consumer spending as individuals start seeing larger net paychecks in 2018, though the effects will not be drastic.

There is a near-term risk and a long-term risk to this tax bill. In the near-term, lower taxes and higher capital expenditures could lead to a sugar high in the economy, especially in the context of the relatively strong growth we are currently experiencing. A boost in growth could then feed into inflation, causing the Federal Reserve to raise rates faster than markets expect and in turn imperiling the economy. The longer-term concern is that this $1.5 trillion net tax cut fails to deliver sufficient growth and saddles the government with additional debt. The Tax Policy Center expects this bill to increase the ratio of federal debt to GDP by 5.4% by 2027, even after projecting increased economic growth. While not crippling, this higher debt load could preclude additional fiscal stimulus in the event of another economic downturn.

Concluding thoughts: We remain overweight both U.S. and international stocks as the market re-prices for the benefits from this tax cut. Analysts are still working to incorporate tax cuts into 2018 earnings expectations, and we expect upward revisions as a result. Some of the pro-growth implications — such as increased capital expenditures — are not fully priced into the market, providing further upside for both domestic and international developed-market equities.

Unless otherwise noted, all data is as of the date of publication.

You should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. For a prospectus, which contains this and other information about the BMO Funds, call 1-800-236-3863. Please read it carefully before investing.

BMO Asset Management Corp. is the investment adviser to the BMO Funds. BMO Investment Distributors, LLC is the distributor for the BMO Funds. Member FINRA/SIPC. BMO Funds are not marketed or sold outside of the United States.

This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This presentation may contain forward-looking statements. "Forward-looking statements," can be identified by the use of forward-looking terminology such as "may", "should", "expect", "anticipate", "outlook", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof, or variations thereon, or other comparable terminology. Investors are cautioned not to place undue reliance on such statements, as actual results could differ materially due to various risks and uncertainties. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investment involves risk. Market conditions and trends will fluctuate. The value of an investment as well as income associated with investments may rise or fall. Accordingly, investors may receive back less than originally invested.

Past performance is not necessarily a guide to future performance.

BMO Global Asset Management is the brand name for various affiliated entities of BMO Financial Group that provide investment management and trust and custody services. Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions and may not be available to all investors. Products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. BMO Financial Group is a service mark of Bank of Montreal (BMO).

BMO Asset Management Corp., BMO Investment Distributors, LLC, BMO Private Bank, BMO Harris Bank N.A. and BMO Harris Financial Advisors, Inc. are affiliated companies. BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. BMO Harris Financial Advisors, Inc. is a member FINRA/SIPC, an SEC registered investment adviser and offers advisory services and insurance products. Not all products and services are available in every state and/or location.

All investments involve risk, including the possible loss of principal.

Securities, investment advisory and insurance products are: **Not FDIC Insured – No Bank Guarantee – May Lose Value.**

© 2017 BMO Financial Corp. (6469866, 12/17)