An early look at the impact of the tax reform law

February 2018

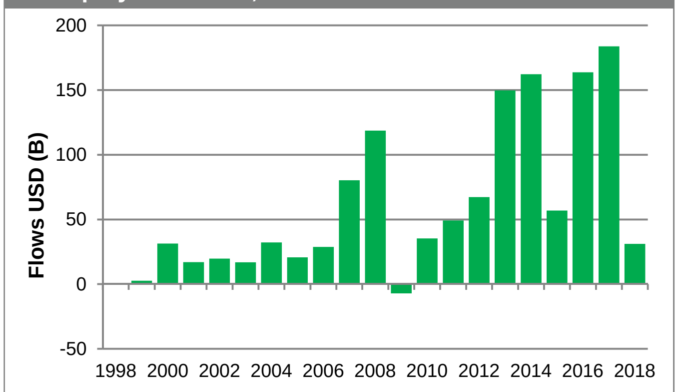
Research Signals

The Tax Cuts and Jobs Act became law on 22 December 2017. The legislation makes sweeping changes to corporate and individual tax rates, the most extensive tax overhaul in more than 30 years. With regard to corporations in particular, the law slashes the corporate rate to 21% from 35%. We study the immediate impact on the overall stock market, industries and at the stock level.

- US equity ETFs enjoyed inflows as the House of Representatives and the Senate were voting on their respective versions of the bill, with another bump when the bill was enacted into law
- While Cyclical Goods & Services is a highly taxed sector and Technology enjoys lower taxes overall, differences are found underneath at the business industry level
- Union Pacific and Progress Software are two examples of firms poised to benefit from corporate tax policy changes with a substantial cut in effective tax rate while at the same time being attractively valued with low shorting activity and improving earnings revisions

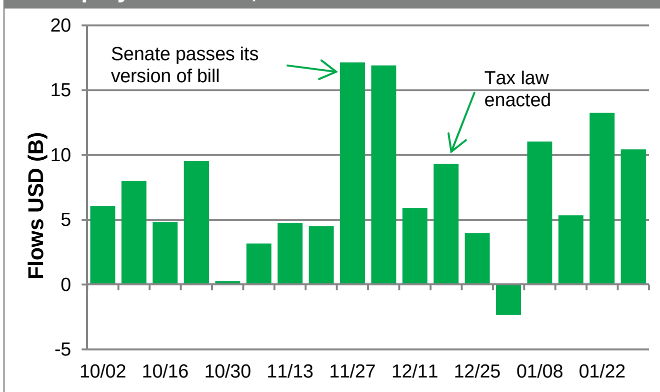
In 2017, US equity ETFs realized record inflows in excess of $180B according to IHS Markit ETF Analytics. The euphoria, or as some call the fear-of-missing-out trade, carried over into 2018 as ETFs globally surpassed the $5T AUM mark, led by the SPDR S&P 500 ETF (SPY) which exceeded $300B. If inflows continued on their current trend in the US (though not likely), the annual inflow would reach approximately $370B.

US equity ETF flows, 1 Jan 1998 - 31 Jan 2018



Source: IHS Markit © 2018 IHS

US equity ETF flows, 2 Oct 2017 - 31 Jan 2018



Source: IHS Markit © 2018 IHS

Contacts

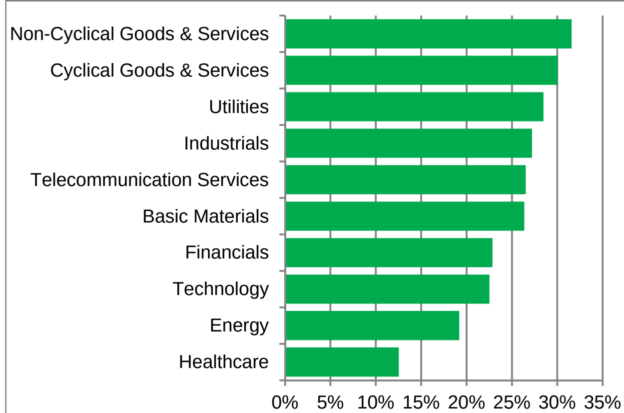
Research Signals · research-signals@markit.com

Taking a closer look at weekly flows around the time of passage of the tax reform law, flows had a boost in late November after the House of Representatives and later the Senate voted on their respective versions of the bill. Another bump in inflows occurred the week the final bill was signed into law.

Not all businesses within sectors are treated equal

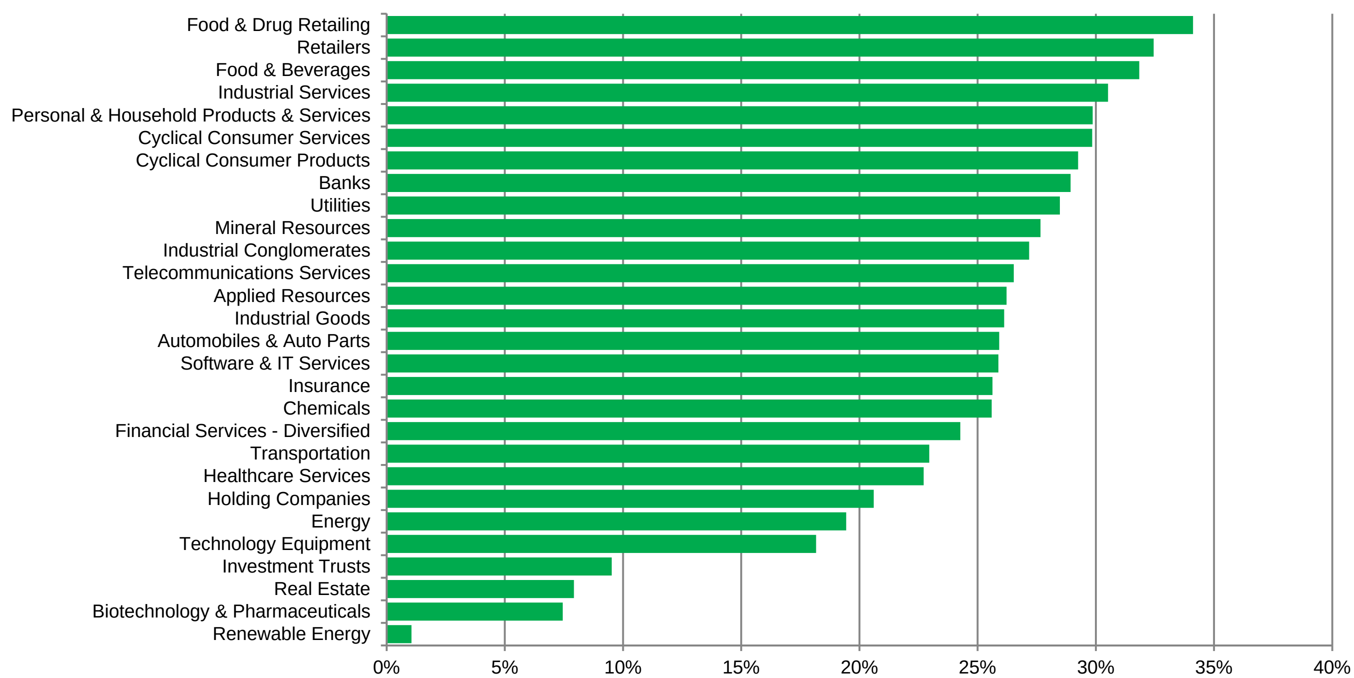
Drilling down to the sector level, we look at the average effective tax rate across sectors and business industries for stocks in our US Total Cap universe (representing 98% of cumulative market cap, or approximate 3,000 names). The two sectors which on average paid the highest effective tax rate as of the end of December 2017 include Cyclical and Non-Cyclical Goods & Services. Energy and Healthcare sit at the opposite end of the spectrum, with the least onerous tax burden. However, not all industries are equal within sectors. For example, in two key sectors, Cyclical Goods & Services and Technology, Retailers are taxed at a higher rate than Services and Software & IT Services over Technology Equipment.

Effective tax rate - Sector, 29 Dec 2017



Source: IHS Markit

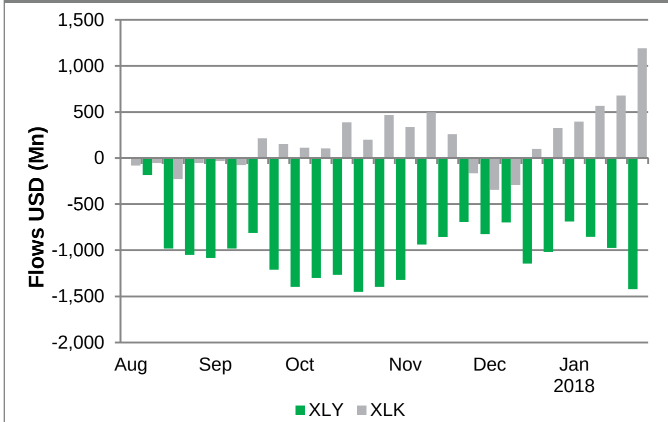
Effective tax rate - Business industry, 29 Dec 2017



Source: IHS Markit

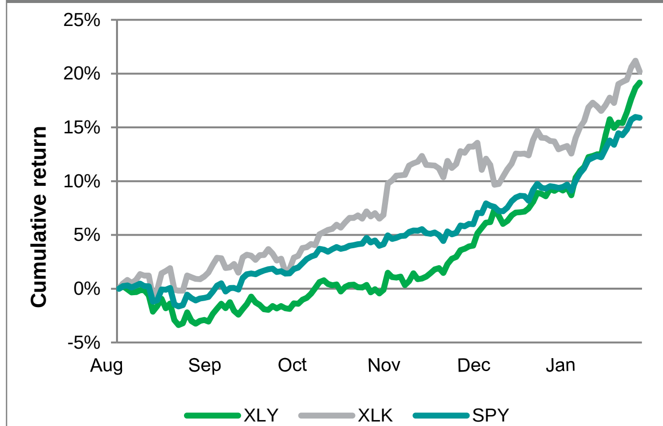
Focusing further on consumer cyclicals and technology, two key sectors in the current market environment which reside at the opposite ends of the effective tax rate spectrum, we evaluate investor reactions based on the Consumer Discretionary (XLY) and Technology (XLK) Select Sector SPDR ETFs, respectively.

ETF cumulative flows



Source: IHS Markit © 2018 IHS

ETF cumulative price return



Source: IHS Markit © 2018 IHS

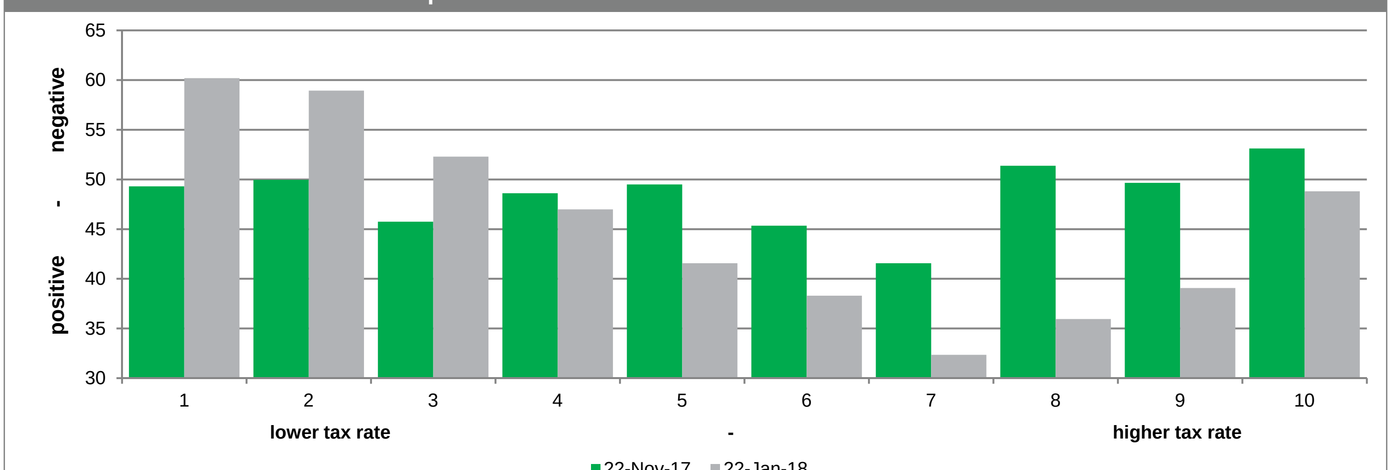
Leading up to the tax plan debate, XLY tended to see outflows in the ETF market. Yet, as the policy started to unfold and votes were taking place on the House and Senate versions of the bill, investors showed less of a negative stance toward this sector which was poised to benefit to a greater extent from tax policy changes. At the same time, sentiment toward XLK seemed to wane somewhat. However, fortunes soon reversed for both sectors as ETF flows returned to previous trends subsequent to enactment of the tax law, though XLY price returns did bounce handsomely in January.

Factor exposures across tax 'brackets'

Lastly, we investigate factor positioning of stocks based on their effective tax rate. For this analysis, we divide stocks from the US Total Cap universe into deciles, with the lowest decile (D1) representing stocks with the lowest tax rate. First, we test for a possible reaction from analysts to the changes in the tax code based on percentile ranks of Net # of Revsions for Fiscal Year 2, a measure of earnings estimates outlook.

Around the time that the House and Senate were voting on their respective versions of the bill, firms with the lowest tax rates (D1) had an average percentile rank of 49, compared with a slightly more negative positioning (53) for D10 names. However, recent rankings have shifted substantially, with the average D10 (D1) percentile rank standing at 49 (60), indicating that analyst outlook has turned more positive (negative) on the firms with higher (lower) effective tax rates.

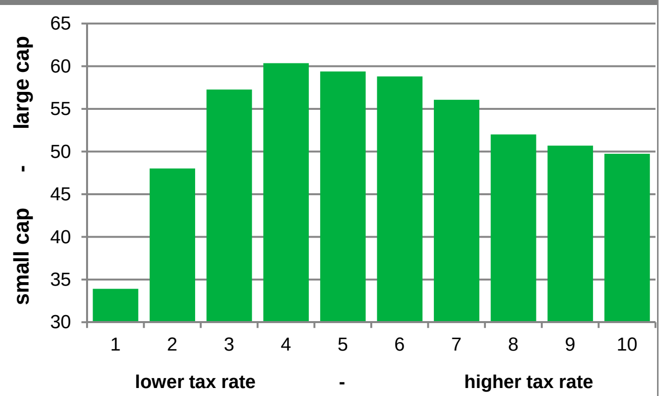
Net # of Revisions for Fiscal Year 2 percentile ranks across effective tax rate deciles



Source: IHS Markit © 2018 IHS Markit

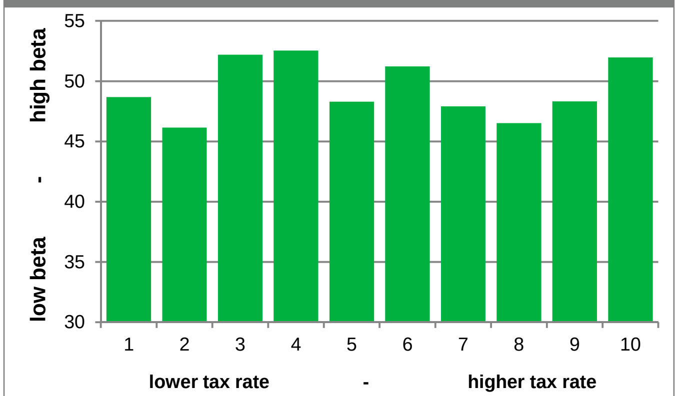
Next we analyze size and beta exposures for stocks paying various levels of effective tax rates using our Natural Logarithm of Market Capitalization and 60-Month Beta factors, respectively. Here we find that the lowest effective tax rate payers (D1 and D2) tend to be small caps, while midcap stocks (D3 through D7) on average pay the highest effective tax rate. From a beta perspective, less information is discerned, though the most highly taxed firms tend to have higher beta compared with the least taxed firms.

Natural Logarithm of Market Capitalization percentile ranks across effective tax rate deciles - 22 Jan 2018



Source: IHS Markit © 2018 IHS

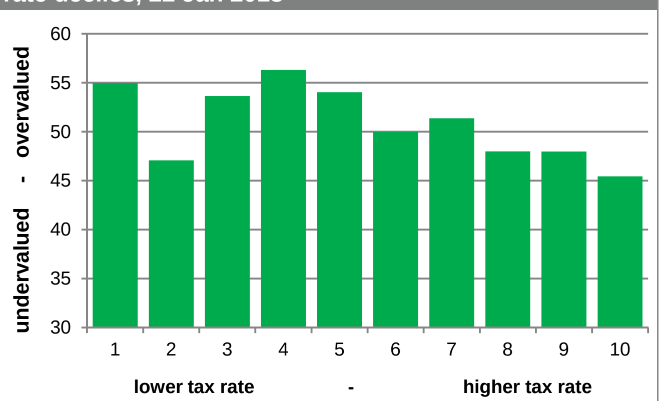
60-Month Beta percentile ranks across effective tax rate deciles - 22 Jan 2018



Source: IHS Markit © 2018 IHS

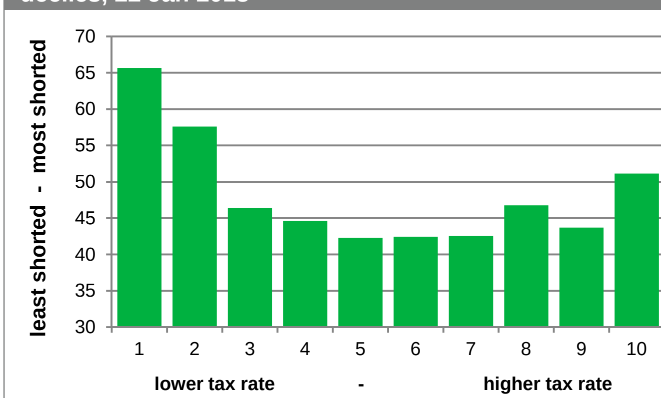
Finally, we take a snapshot of current valuation (Book-to-Market) and sentiment from the securities lending market (Utilization) across the effective tax rate spectrum. We find that firms with the lowest tax rates are more overalued in general than their higher tax rate counterparts, with average Book-to-Market percentile ranks of 55 and 45, respectively. They are also more highly shorted on average based on a Utilization percentile rank of 66 compared with 51 for D10 names.

Book-to-Market percentile ranks across effective tax rate deciles, 22 Jan 2018



Source: IHS Markit © 2018 IHS

Utilization percentile ranks across effective tax rate deciles, 22 Jan 2018



Source: IHS Markit © 2018 IHS

Thus, we round out our review by filtering for stocks which are poised to benefit the most from the new tax policy (D10 effective tax rate) which are also undervalued (D1 Deep Value model) with low utilization (lowest 20% Utilization) and improving earnings revisions. Note that in this case we use our Deep Value model rather than Book-to-Market given its more robust multi-factor approach to identifying securities trading at a steep discount to their intrinsic value.

Highly taxed firms which are undervalued with low shorting activity, 22 Jan 2018

Name	Ticker	Sector
UNION PAC CORP	UNP	Industrials
PHILLIPS 66	PSX	Energy
CENTERPOINT ENERGY INC	CNP	Utilities
PROGRESS SOFTWARE CORP	PRGS	Technology
OMNOVA SOLUTIONS INC	OMN	Basic Materials
CRA INTL INC	CRAI	Industrials

Source: IHS Markit

Union Pacific (UNP) moved into the top decile of the Deep Value model in late October 2017 and has seen its Net # Revisions for Fiscal Year 2 percentile rank drop from 23 to 11 over the past two months. Progress Software (PRGS) is also attractively ranked by the Deep Value model with an improving Net # Revisions for Fiscal Year 2 percentile rank residing in the top percentile since mid-January.

IHS Markit Customer Support:

Support@markit.com
Americas: +1 877 762 7548
Europe, Middle East, and Africa: 00800 6275 4800
Asia and the Pacific Rim: +65 6922 4210