

Tax Uncertainty and the Credit Markets

“In this world nothing can be said to be certain, except death and taxes.”

—Benjamin Franklin

With all due respect to Mr. Franklin, tax policy in the current political environment is anything but certain. Uncertainty surrounding everything from future tax rates and changes in deductions, to the timing of any bill ultimately winding its way through the legislature, seems to grow with each passing day. We believe there will ultimately be tax relief, but that it will not be as grandiose as initially proposed. The aggregate effect of tax relief will likely be a net positive for credit markets, but it will vary by leading industry and company, and actions by company management teams and the Federal Reserve could offset these positives.

Exhibit 1 shows the current tax plan and the recent proposal that has emerged. The most recent version is shown under the column titled “Big Six” Proposal.

Exhibit 1: Business tax summary

	Current	Recent “Big Six” Proposal
Corporate Rate	35%	20%
Maximum Pass Through Rate	39.60%	25%
Interest Deductibility	Unlimited	Partially Limited
Corporate Expensing	Sliding scale with accelerated bonus dropping from 50% to 30% by 2019	100% expensing for next 5 years
Foreign Profits	35% when earnings repatriated	Territorial system
Repatriation	N/A	Reduced rate on repatriated earnings
Border Adjustment Tax	N/A	N/A

Source: IRS, Aegon AM

Tax relief may not occur until first quarter 2018 through the reconciliation process, but it has a reasonably high likelihood of passage. Exhibit 2 charts the relative performance of a basket of high tax companies to the S&P 500 Index. As you can see, following the election there was an initial spike upward, with higher taxed companies rallying sharply given expectations for fast action on the Republican agenda. Things gradually reversed course as progress on key items slowed and the market questioned passage of any major component of the agenda. Recently, higher prices reflect a renewed optimism among market participants that Congress can enact tax reform. While earlier equity rallies were based on less tangible and more controversial proposals, the current version offers a more realistic starting point for negotiations.

Exhibit 2: Stocks with high effective tax rates versus the S&P 500 Index



Source: Goldman Sachs Global Investment Research
 As of September 30, 2017

Effects on the credit markets

Any tax reform that is enacted will undergo many iterations, but the following are likely outcomes that could affect the credit markets:

1. lower statutory federal tax rates;
2. full capex expensing allowed for a period of at least five years;
3. increased repatriation of foreign held cash; and
4. reduced interest deductibility.

Overall, the credit markets will likely benefit from the proposed tax changes. Fundamentally, lower tax rates will lead to increased free cash flow for those companies currently paying more than the post-reform effective rates. More free cash flow is unambiguously good for credit markets.

Additionally, by lowering the amount of interest firms can deduct, the after-tax cost of debt will be higher. All else equal, this will lead to less leverage in the corporate sector and, consequently, lower net new issuance over time. Lower supply could tighten spreads, to the benefit of fixed income investors.

Also, allowing firms to repatriate offshore profits could lead to lower supply. Companies—primarily from the healthcare/pharma and tech sectors—would gain direct access to previously constrained cash pools, and would likely have lower borrowing needs as a result.

The combination of these factors could reduce debt issuance in the credit markets while improving some income statements and credit profiles. Reduced supply should provide a boost to market technicals and, alongside improved fundamentals, support tighter spreads.

Yet, not all of tax reform may be unambiguously good for credit markets. Major policy changes often have second order effects with unintended consequences.

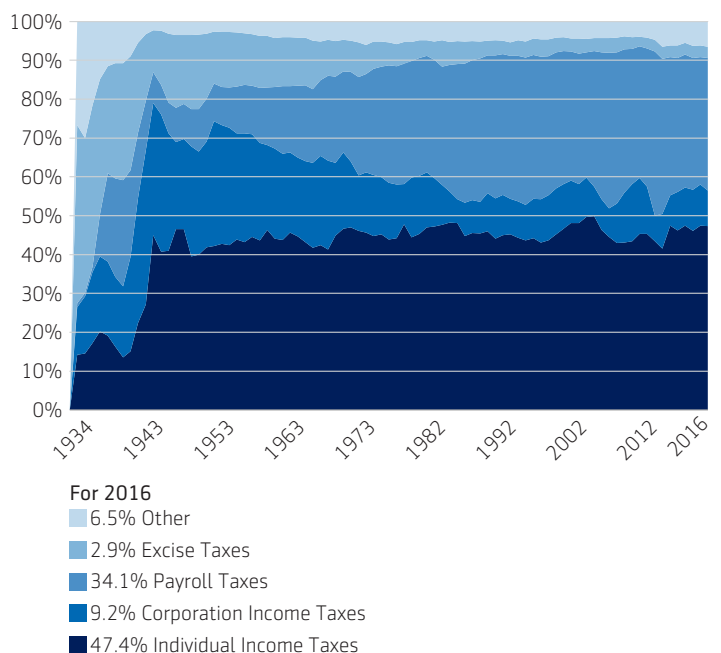
For example, increased free cash flow and the repatriation of previously stranded profits could lead to a pick-up in M&A activity, some of which could be dilutive. In addition, a sudden surge in available cash could facilitate shareholder-friendly activities instead of retiring outstanding debt, which may be good in the near-term for investors. However, it could also lead to increasing net debt levels in the corporate sector, which would weigh on the market over the longer term. Still, this

effect could be relatively modest given that the cash available for repatriation is heavily concentrated among a small group of firms, with estimates of roughly 25 companies accounting for 50% of the total.

A larger concern for the broader markets is that the pro-growth tax policies could lead to a more aggressive Fed tightening. The increased economic activity may result in the Fed taking action to keep inflationary pressures at bay, and raising rates or reducing its balance sheet faster than anticipated. This would place increased pressure on rates, increase concerns about the end of the credit cycle, and materially affect market sentiment (much like the taper tantrum from a few years ago).

Exhibit 3 shows the US government funding sources, and how that has evolved over time. This is a useful chart to keep in mind when considering the effect of the various aspects of tax reform on the overall economic environment. Payroll and individual taxes make up over 80% of the total while corporate income taxes are just under 10%.

Exhibit 3: How the US government is funded
Percent of total revenue



Source: Office of Management and Budget data, Aegon AM

Effects on companies

The biggest positive for companies will likely be the increased free cash flow created through a reduction in tax rates. That reduction will be positively magnified for companies that spend heavily on capex as it will further reduce taxable earnings during the first five years as these investments are fully expensed. Conversely, companies that currently benefit from reduced taxable income due to large interest expense deductions will likely be negatively impacted. Most notably, companies with higher relative leverage and with higher cost debt will see their taxable income rise (and after-tax cash flows decline) as a result of the reduced deductibility of interest. From a balance sheet perspective, the proposal should incentivize a shift in optimal capital structures to carry lower leverage, and when combined with higher free cash flow, would be positive for credit quality. Finally, those companies with cash trapped in overseas affiliates will have an opportunity to return it to the US in a more economically efficient manner.

Broadly speaking, the largest beneficiaries will be companies:

- that have a high level of taxable income, and high effective tax rate (financials, communications, consumer, particularly investment grade companies);
- that operate in capex intensive industries (industrials, metals and mining, telecom);
- that carry low levels of debt (investment grade companies would be less affected by the loss of interest deductibility, thereby increasing the value of being a higher quality credit relative to a lower quality issuer); and
- with a high degree of cash trapped overseas (technology, pharma) although this could be offset by the efforts to increase taxes on tax haven profits.

In conclusion

Overall, we believe that the effects of the tax policy changes will be a net positive to the credit markets—increased free cash flow, incentives to reduce leverage, and improved market technicals through reduced supply—particularly over the near term. This justifies maintaining an overweight exposure to credit risk, particularly higher quality credit. However, investors must keep a close eye on company activities, such as increased M&A or shareholder-friendly uses of released cash, as well as that of the Fed, such as more aggressive balance sheet reduction or rate increases. Shifts in either could lead to unanticipated deterioration in market technicals or other disruptions to the credit market that result in wider spreads. We don't anticipate either to change until the tax policy is finalized or details become clearer. In the interim, all else being equal, we expect the effect of the anticipated tax changes to be a continued grind tighter for credit spreads, particularly investment grade credit.

Disclosures

The archived content contains information that is historical in nature and may be outdated. This material is provided for informational purposes only and should not be relied upon for investment decisions.

Aegon USA Investment Management, LLC (AUIM) is a U.S.-based SEC registered investment adviser and is also registered as a Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). AUIM is a member company of Aegon Asset Management, the global investment management brand of the Aegon Group.

This material is to be used for institutional investors and not for any other purpose. The enclosed information has been developed internally and/or obtained from sources believed to be reliable. This material contains current opinions of the manager and such opinions are subject to change without notice. AUIM is under no obligation, expressed or implied, to update the material contained herein. This material contains general information only on investment matters; it should not be considered a comprehensive statement on any matter and should not be relied upon as such. If there is any conflict between the enclosed information and AUIM's Form ADV, the Form ADV controls. The information contained does not take into account any investor's investment objectives, particular needs, or financial situation. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to you. The value of any investment may fluctuate. Past performance is not indicative of future results.

Results for certain charts and graphs are included for illustrative purposes only and should not be relied upon to assist or inform the making of any investment decisions.

This document contains "forward-looking statements" which are based on AUIM's beliefs, as well as on a number of assumptions concerning future events based on information currently available to AUIM. These statements involve certain risks, uncertainties and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance and actual outcomes and returns may differ materially from statements set forth herein.

This material contains the current opinions of the authors and not necessarily those of AUIM and such opinions are subject to change without notice. This material is intended for illustrative and discussion purposes only. None of the information contained herein is intended to be an endorsement, or imply approval or disapproval of any political candidate or position, or to be a prediction of results by AUIM.

Recipient shall not distribute, publish, sell, license or otherwise create derivative works using any of the content of this report without the prior written consent of Aegon USA Investment Management, LLC, 6300 C Street SW, Cedar Rapids, IA 52499.

Copyright © 2017 Aegon USA Investment Management, LLC