Insights & Strategies

PRIVATE CLIENT SOLUTIONS

February 9, 2018

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US Tax Reform School

Late last year the United States Congress passed the largest tax reform bill in a generation. The impacts from the new tax rules are far-reaching but will affect different parts of the US economy in different ways. In this edition of Insights & Strategies, we will look at what we believe are the key parts of the tax reform law and how they will impact markets on both sides of the border.

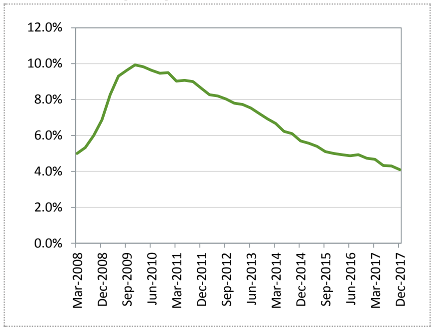
The major tax reform bill signed by President Trump in December is sure to have a major influence on US markets and investor behaviour in 2018. As we move through Q4 reporting season and companies are providing guidance for 2018, investors are already getting a glimpse of the influence the tax changes will have on capital allocation. Although there are a number of adjustments taking place as a result of the bill, we are going to focus on how to position investments in relation to what we think are the three major factors:

1. Lower personal tax rates
2. A new 21% corporate tax rate
3. Foreign cash repatriation

1. Personal Taxes

The lowered personal tax rates were certainly the most controversial from a media perspective, as there is no question that the more wealthy segments of the US population benefit most. That said, the lower rates coupled with higher deduction limits are certain to add a significant amount of cash into all consumers' pockets. This windfall is going to find its way into the US economy through higher consumer spending and into the markets through investment.

US Unemployment Rate



Source: Bloomberg, Raymond James Ltd.

The government is promoting the tax cut as a stimulus measure but ironically it comes at a time when the need for stimulus in the US economy is at the lowest level since the 2008 credit crisis. One need look no further than the Federal Reserve's actions (ending quantitative easing programs and raising interest rates) that come as a direct result of strengthening economic fundamentals including unemployment, which is at a 10 year low.

The infusion of cash at this point in the economic cycle should lead to higher GDP growth but also increase inflation. This reinforces our view that investors should be tilting portfolios more to late-cycle sectors (financials, energy, materials, industrials). Prior to the bill's passage, our interest rate forecast called for at least three quarter-point hikes by the Fed in 2018. The tax bill gives us greater confidence in this view.

Please read domestic and foreign disclosure/risk information beginning on page 9.

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2. Corporate Taxes

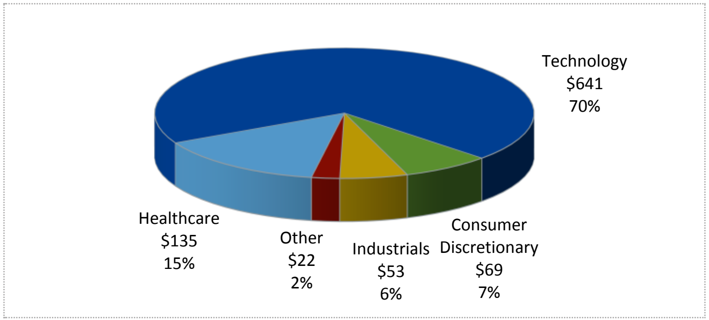
The US corporate federal tax rate drops from 35% to 21%. We have already seen some direct impacts as several companies have taken a proactive approach to their windfalls and announced wage hikes/cash bonuses, higher capital investment, share buybacks and dividend increases. Although we would cynically point out that there is likely some politics at play (attaching cash bonuses to tax cuts is an easy way to get some free advertising from the president), many US companies are already in good economic shape and passing on the newfound cash to employees makes good financial sense in a tightening labour market.

The benefit from lower corporate tax rates, however, is not felt uniformly across corporate America. With the US effectively moving from a high corporate tax rate jurisdiction to one of the lower ones, companies that predominantly generate revenue domestically are likely to see a greater improvement to the bottom line than exporters and multinational corporations. This means that smaller companies (e.g. Russell 2000 Index) will have a disproportionate gain over larger names (e.g. Dow Jones Index). As well, certain domestically-focused sectors of the economy (telecom, utilities, consumer stocks, banks) will see bigger upside than those that are more internationally focused (technology, industrials).

3. Foreign Cash Repatriation

Looking at the below chart, it would appear that large US technology companies are on the short end of the tax reform stick. This is not entirely the case, however, due to the third major part of tax reform: foreign cash repatriation.

US Foreign Cash Holdings By Sector ($billions)



Source: Congressional Budget Office

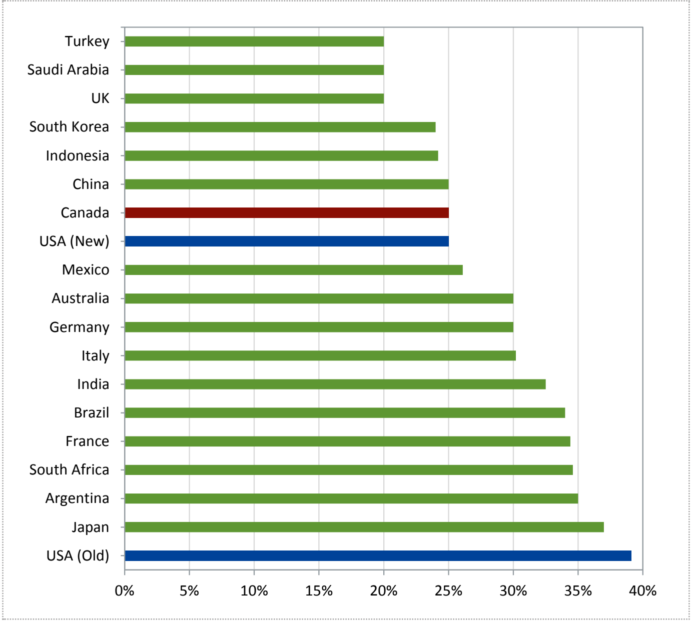
According to Bloomberg, the top-50 US multinationals have close to $1 trillion in offshore cash holdings. With the new tax bill, these companies will be able to bring this money back to the US at a reduced tax rate. Under the terms of the bill, companies choosing to repatriate will take a one-time repatriation charge of 15.5% against their foreign cash and pay it off over the next eight years. The tax payments are amortized but the cash can be invested immediately.

The largest holders of foreign cash are dominated by the technology giants as well as some large health care and industrials companies. The tech companies are mostly in very strong financial shape (i.e. low debt), so we would not be surprised to see the cash going to work fairly quickly through higher dividends, share buybacks and mergers & acquisitions.

Canadian Impact

Finally, let’s look at the impact of US tax reform on Canada. The quick analysis from a macro level is that the tax changes south of the border create a more difficult environment for the Canadian economy. Heretofore, corporate tax rates were a competitive advantage for Canada. Lower Canadian rates gave our companies a leg-up on US competitors and made foreign investment more attractive. This benefit is now effectively removed, with the US now offering a marginal corporate tax rate on par with Canada. The chart below shows the marginal statutory tax rates (federal + state/provincial/local taxes) for the G20. Using this measure, the US drops from the highest to in line with Canada at around 25%. However, the number does not take into account various deductions and credits, and under the new corporate regime, US companies could pay materially less than in Canada in certain low-tax states (e.g. Texas, Ohio, Washington).

G20 Marginal Corporate Tax Rates



Source: Congressional Budget Office

With the Trudeau government apparently not willing to look at corporate tax rates at this time, Canadian companies will have to work harder to compete and attract investment. We expect a weaker Canadian dollar over time to help bridge the gap but, in the meantime, many US business jurisdictions are going to gain a major advantage.

There are, however, some upsides to the situation for the Canadian stock market. A broad theme in our investment strategy for some time has been the benefit of investing in "Non-Canadian Canadian" companies – Canadian-listed companies that receive a majority of their revenue from outside the country. As we show in the following section, Canadian investors have a number of options to invest in TSX-listed companies that have large US-domiciled subsidiaries that will benefit materially from lower US corporate taxes.

Robert Mark, CFA
Portfolio Manager

Equity Winners from US Tax Reform

If the biggest winners from tax reform are sectors that have the highest effective tax rates (ETRs), then US telecommunication services, consumer staples and industrials look promising since over 50% of companies within these sectors have an ETR of greater than 30%; other sectors such as consumer discretionary, utilities and energy also seem to benefit as over 40% have a tax rate greater than 30%. However, we believe there are opportunities in other areas in the market that are more in line with our long term views, including the financials, technology, discretionary and industrials sectors. To no one's surprise, real estate does not stand to benefit since REITs pay no taxes if they pay out over 90% of their earnings in dividends. Although the energy sector shows up near the middle of the list, the past couple of years have led companies to report losses since WTI fell from its highs and has thus reduced the number of companies with a high ETR.

Sector ETRs

US Sectors	Median Effective Tax Rate	% Companies > 30%	# of Companies
Telecom	34.0	100%	3
Staples	31.7	56%	19
Industrials	32.6	51%	36
Discretionary	32.6	49%	41
Utilities	31.5	46%	13
Energy	33.0	44%	14
Health Care	24.0	41%	25
Financials	28.8	36%	24
Information Tech	24.0	34%	23
Materials	22.8	16%	4
Real Estate	23.0	6%	2

Source: Bloomberg, Raymond James Ltd.

Within the sectors we prefer to overweight, we start with financials. We remain constructive on **JPMorgan Chase & Co. (JPM-US)**, which happens to have an ETR of 31.9%, greater than the sector's median. Within info tech, we highlight **Automatic Data Processing (ADP-US)** and **Visa (V-US)**, which have ETRs greater than 30%. Additionally, the potential for repatriation of capital is also promising for the sector especially names such as **Apple (AAPL-US)**, **Microsoft (MSFT-US)**, **Cisco Systems (CSCO-US)** and **Alphabet (GOOGL-US)**. These companies alone have around $500 bln abroad, or close to half of all S&P 500 company cash held overseas. Total S&P 500 company capital abroad is around USD$1.1 tln; the top ten companies in the S&P 500 represent ~70% of that total.

Top 10 S&P 500 Overseas Cash Holders

Rank	Company	Ticker	Mkt Cap ($mlns)	Cash & Marketable Securities ($mln)	Cash held overseas ($mln)	Overseas cash / total cash & marketable securities	Overseas cash / Market Cap
1	Apple Inc.	AAPL	$826,049	$268,895	$252,300	94%	31%
2	Microsoft Corp	MSFT	$696,908	$132,981	$127,900	96%	18%
3	Cisco Systems Inc.	CSCO	$198,239	$70,492	$67,500	96%	34%
4	Oracle Corp	ORCL	$203,047	$66,078	$54,400	82%	27%
5	Alphabet Inc.-Cl A	GOOGL	$749,422	$101,871	$62,800	62%	8%
6	Johnson & Johnson	JNJ	$352,525	$41,907	$41,300	99%	12%
7	General Electric Co	GE	$132,163	$82,000	$38,600	47%	29%
8	Amgen Inc.	AMGN	$127,260	$41,678	$35,900	86%	28%
9	Qualcomm Inc.	QCOM	$95,232	$38,578	$29,400	76%	31%
10	Gilead Sciences Inc.	GILD	$104,946	$32,380	$27,400	85%	26%
	Top 10 TOTAL				**$737,500**		
	S&P 500 TOTAL				**$1,109,834**		
	Top 10 / S&P 500 TOTAL Cash Overseas				***66%***		

Source: Bloomberg, Raymond James Ltd.

Within discretionary we highlight **McDonald's (MCD-US)**, **Home Depot (HD-US)** and **Walt Disney (DIS-US)** which have ETRs of 39.4%, 36.3% and 32.1%, respectively, as a reduction in taxes helps their bottom lines. In addition, a reduction in personal taxes also helps the consumer, in turn helping company top lines. Within industrials we highlight **Lockheed Martin (LMT-US)**, which has an ETR of 63.4%. As Q1/18 earnings season is underway, we believe more analysts will be revising their earnings estimates to incorporate the tax changes. There is further upside to this estimate as not all analysts have made revisions to incorporate the impact of the tax law. According to FactSet, only 40% of analysts have confirmed or revised their 2018 estimates for the Dow Jones Industrial components since December 20, 2017. We assume analyst revisions for the Dow Jones is a good proxy for the S&P 500.

As for Canadian companies that could benefit from the tax reform, we continue to favour Non-Canadian Canadian (NCC) companies in the new US tax environment. As we mentioned in our 2018 Outlook, these include “companies that although domiciled in Canada and run by Canadian management teams, generate the majority of their revenue and profits from non-Canadian jurisdictions.” Our preferred NCCs include **Kinaxis (KXS-T)**, **Waste Connections (WCN-T)**, **Intertape Polymer (ITP-T)**, **Alimentation Couche Tard (ATD.B-T)** and **Manulife Financial (MFC-T).**

Larbi Moumni, CFA
Equities Specialist

Non-Canadian Canadian Companies (>50% of revenue from outside of Canada)

Company	Ticker	Industry	USA	Can	Other
Kinaxis	**KXS**	**Tech.**	**93%**	**5%**	**3%**
Waste Connections	**WCN**	**Industrials**	**88%**	**12%**	**0%**
Gildan Activewear	GIL	Con. Discr.	87%	8%	5%
Intertape Polymer	**ITP**	**Industrials**	**83%**	**7%**	**10%**
Cott Corporation	BCB	Con. Discr.	76%	7%	17%
Emera	EMA	Utilities	70%	24%	6%
Brookfield Prop. Partners	BPY.UN	Real Estate	70%	4%	26%
Alimentation Couche Tard	**ATD.B**	**Con. Discr.**	**63%**	**13%**	**24%**
Open Text	OTEX	Tech.	48%	9%	43%
Fortis	FTS	Utilities	46%	49%	4%
CCL Industries	CCL.B	Materials	46%	5%	49%
Sun Life Financial	SLF	Financials	41%	41%	17%
Brookfield Asset Mgmt	BAM.A	Financials	41%	22%	36%
Manulife Financial	**MFC**	**Financials**	**40%**	**25%**	**36%**
WSP International	WSP	Industrials	37%	17%	46%
Maxar Tech	MAXR	Industrials	29%	29%	43%
Brookfield Infrastructure	BIP.UN	Utilities	25%	10%	65%
Shawcor	SCL.B	Energy	22%	28%	50%
Bank of Nova Scotia	BNS	Financials	13%	49%	38%
Dream Global REIT	DRG.UN	Real Estate	0%	0%	100%

Source: Bloomberg, Raymond James Ltd., Screen based on Guided Portfolio holdings (excludes materials and energy companies).

The companies mentioned in this table are the results of an equity screen and are not based on RJL fundamental views.

Capitalizing on Tax Reform in the US

With the United States undergoing some of the largest tax cuts in their history, we wanted to explore the sections of the US market that are well positioned to capitalize on these historic changes. We feel there are three broad sections of the market that stand to benefit the most from these tax code changes:

1. Companies with significant portions of their revenues overseas;
2. Small cap domestic companies; and
3. Quality dividend paying stocks.

Companies With Significant Overseas Revenues

Beginning with tax repatriation, the clear winners are likely to be large multi-national companies with earnings held abroad. This has the clearest impact on major tech firms, for example Apple, Microsoft, Cisco and Oracle, who have over 90% of their cash and marketable securities held abroad. Given the efficiency of the US marketplace, we think one of the best ways to benefit from the positive effects of tax repatriation is pure beta exposure to the NASDAQ, e.g. **Powershares QQQ**. And while we continue to see room for growth in this space, the story remains a cautious one given the immense run up in valuations over the past few years.

Small Cap Domestic Companies

The second area we feel will benefit positively in 2018 from the US tax cuts are small cap domestic companies. Referring back to the market efficiency point from above, we think this is another circumstance where cheap direct beta exposure makes the most sense. Considering the significant number of companies that meet this definition, it makes sense that the market segment as a whole will outperform rather than try to pick individual winners. To get this exposure, the play would be **iShares S&P US Small Cap ETF - XSU (CAD Hedged)** which looks to replicate the Russel 2000 index.

Quality Dividend Paying Stocks

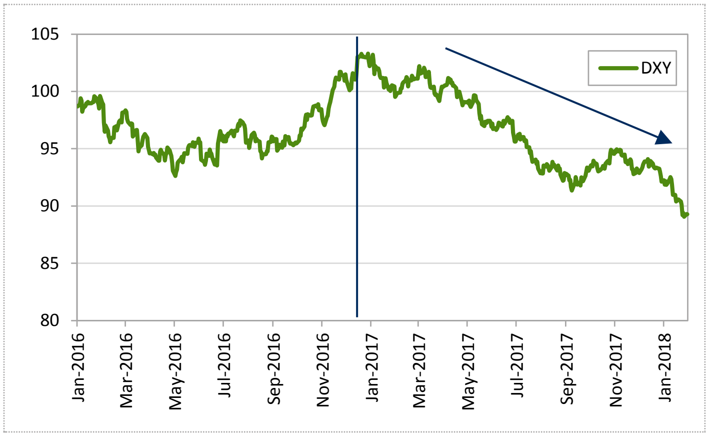
Our last approach to capitalizing on US tax reform from a managed money perspective is looking for companies that can take advantage of the extra cash on their balance sheets. Although we feel this will predominately impact smaller cap names as described above, there is another market segment we think is well positioned for the next 12 months, and that is quality dividend paying companies. We think the additional cash generated from a lower marginal tax rate can strengthen dividend yields, provide room for growth and offer flexibility should market conditions become unfavourable. Although we have focused on pure beta plays so far, we think that this is one area that can benefit from some strategic quantitative screening and quality overlays. WisdomTree has a suite of Quality Dividend Growth ETFs that we think does this well. In the US market, this would be **DGR (CAD)** or their variably hedged version, **DQD (CAD)**. Many companies offer factor-tilted ETFs that among many things can give you exposure to dividend paying companies, but we think WisdomTree's three step screening approach is worth considering. Most important for us, particularly in challenging markets, is the quality screen. Their process begins by looking at two quality measures starting with ROE, a good measure of dividend strength, and ROA, which helps to eliminate highly levered companies that may be unable to sustain their dividend in the future. These strong balance sheet metrics should also help companies do better than their peers during down markets. Next, these quality metrics are paired with 3-5 year earnings growth estimates. Finally, the companies that pass the screen are weighted by their dollar dividend amount, on the condition that earnings must cover this dividend.

Spencer Barnes, MSc.
Mutual Fund & ETF Specialist

FX Impact from Tax Reform and NAFTA

The US dollar started off the year on the back burner, with the DXY trading below the 90.00 level for the first time since December 2014. As you can see from the following chart, the DXY has been trading in a downward trajectory since November 2016, when Donald Trump was elected President of the United States. While the US continues to grow and the Federal Reserve is on a clear path of hiking rates, the Greenback has unfortunately failed to materially reverse course. We believe that Trump's protectionist policies, especially towards trade, and his "America first" position may ultimately be a headwind for the US dollar and a major source of volatility.

DXY



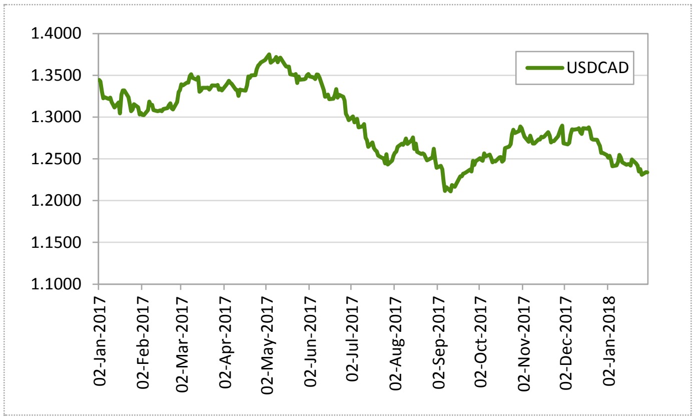
Source: Bloomberg, Raymond James Ltd.

With US equity markets posting record numbers, US Treasury yields at their highest level in almost four years, and a landmark US tax reform bill, the USD should catch some relief from broad-based selling pressure. We believe that in H1/2018, the USD should in fact catch a bid versus its G10 peers on the back of lower corporate taxes, especially as US companies begin to repatriate billions in overseas foreign currency to the United States. Perhaps a lower USD will prove to be quite beneficial to these companies when converting their foreign currency back into USD-denominated funds!

If tax cuts and rate hikes do little to boost the Greenback, the currency will be exposed to more downside risk. Strong global economic growth will surely attract money to emerging economies from developed markets. Another USD-negative factor is the US's deteriorating twin deficit problem (i.e., a budget deficit coupled with a trade deficit). An added catalyst which is exacerbating the budget deficit is the recently passed US tax cut bill, which the GOP admits will add about $1.5 trillion to the deficit. All in all, we are anticipating a weaker USD relative to the G10 basket to close out H2/2018 as these various factors begin to bubble up to the surface.

What does all this mean for the USDCAD currency pair? We believe that NAFTA risks will continue to linger over the Loonie as we look towards the next round of negotiations in February to shed some light on how talks are progressing. We should also have our first Fed rate hike in Q1 (March or May rate hike probabilities are currently at 91% and 92%, respectively). With strong US employment data, month-end USD selling pressures pretty much subsided, ongoing NAFTA risks and US yields continuing to push higher, there is clearly more topside risk to the USDCAD pair. This is primarily why we believe that the pair will trade in the 1.25-1.28 range in H1/2018. Looking at the back-end of the year, we feel a more formal NAFTA proposal should begin to take form and alleviate some of the pressure on the Loonie. We are also calling for the next BoC rate hike to materialize in Q3 (July or September probabilities are currently at 89% and 90%, respectively). It is also important to reiterate that, as the global economy continues to grow, there is risk of added long-term pressure on the greenback as investors begin allocating more capital to other emerging market economies and sectors. For these reasons, we believe that the pair will trade in the 1.21-1.24 range in H2/2018.

USDCAD

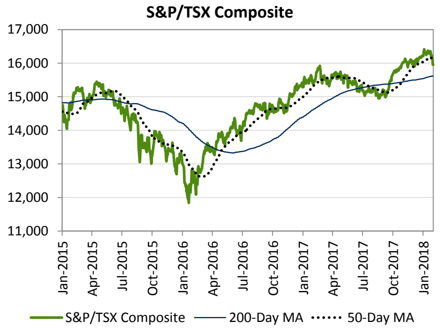


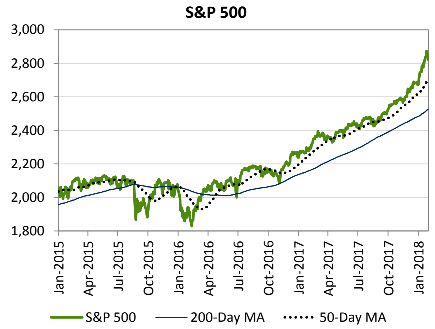
Source: Bloomberg, Raymond James Ltd.

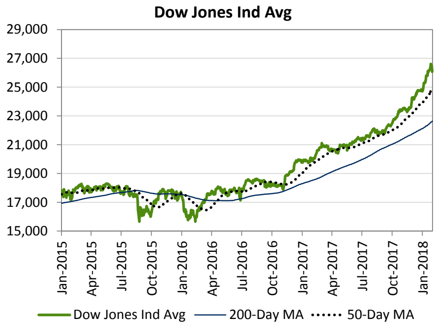
Ajay Virk
Fixed Income & Foreign Exchange

Charts of Interest

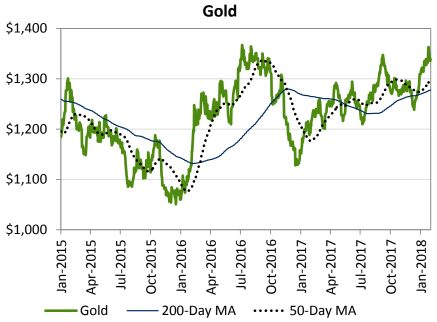
Markets

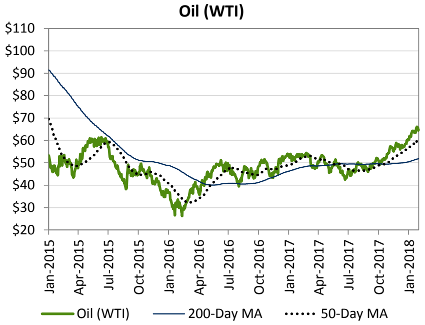


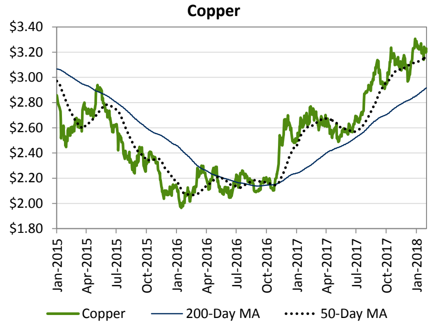




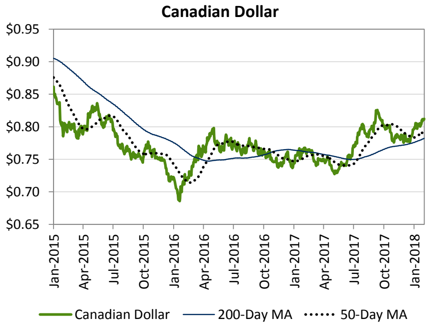
Commodities

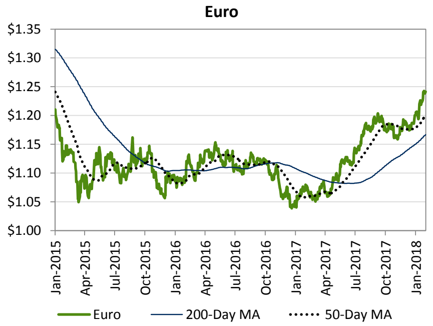


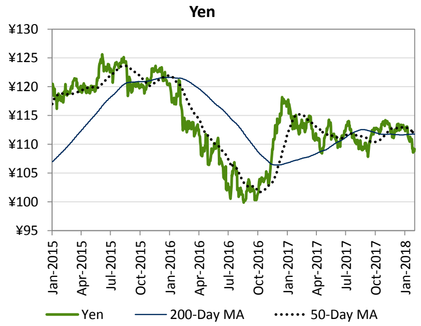




Currencies

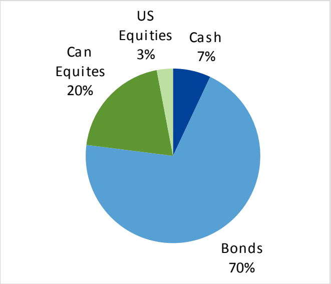
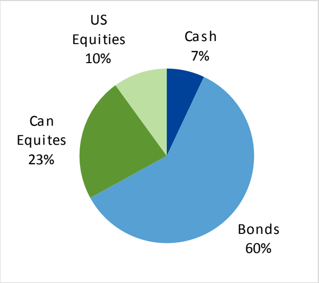
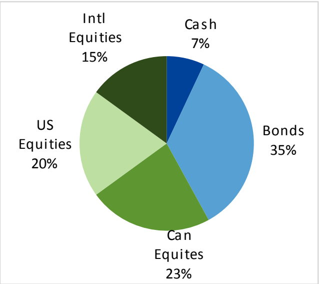
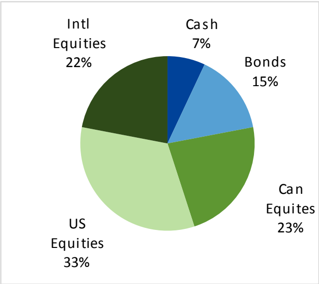
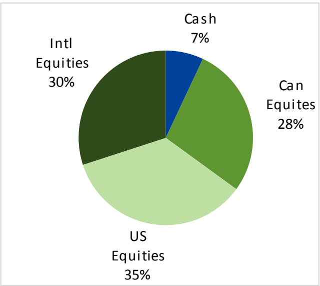






Source: Bloomberg, Raymond James Ltd. Performance as at January 31, 2018.

Investor Profiles and Asset Class Weightings

Recommended Asset Allocation					
	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
					
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100
Description					
	May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

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