The new tax law's impact on stocks, bonds, and the economy

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Now that the new tax law has been in effect for a few months, investors may be wondering what impact it will have on the economy, stocks, and bonds.

Economic growth should benefit

According to Roger Aliaga-Díaz, Vanguard chief economist for the Americas, provisions such as changes to individual brackets and rates, the cut in the corporate income tax rate, and the new territorial tax structure are likely to give a modest boost to annual GDP of about 0.2% over the next decade, with most of the benefit coming in the next few years. But he doesn't expect the tax cuts to raise the economy's growth rate over a longer period.

The law increases the current federal budget deficit by about $1 trillion, according to the Congressional Budget Office. As a result, the debt-to-GDP ratio is now projected to be 95% in a decade.

Vanguard expects the Federal Reserve to raise interest rates three times in 2018, and the new tax law raises the possibility of an additional increase this year, Aliaga-Díaz said. But he is less concerned about the economy overheating as a result.

"The markets have done a good job of pricing in the effects of the new tax law, and we don't expect this to change," he said.

The impact on stocks is unclear

On the surface, the reduction in corporate income tax rates results in an immediate increase in business income that can be passed on to shareholders. However, this does not necessarily mean higher returns for stocks. "Under previous tax law, many companies' effective tax rates were much lower than their statutory tax rate of 35%," Aliaga-Díaz said.

Although lower corporate income taxes may provide a short-term boost in equity prices, assessing the long-term impact is much more challenging. Higher after-tax profits should eventually place upward pressure on wages and downward pressure on prices, resulting in earnings returning to normal levels.

The tax law's changes to individual income tax rates—reducing effective tax rates for the majority of Americans—may boost overall economic growth, but the effects on equity markets are more indirect and immeasurable.

"Market prices are constantly updating to reflect future expectations, and the run-up in equity prices following the 2016 presidential election was in part a result of investors' expectations for lower future corporate tax rates," Aliaga-Díaz said. "So a lot of the new tax law's benefit to equity markets was already priced in."

A mostly positive outlook for corporate bonds

According to Vanguard Fixed Income Group's Stuart Hosansky, senior analyst for taxable securities, the corporate income tax rate reduction will provide the biggest boost to bonds of companies whose revenues, earnings, and cash flow are domiciled principally in the United States (such as banks and retail, rail, and communications companies).

This is because many of these companies have experienced effective tax rates close to the previous 35% marginal rate. However, for companies that have significant non-U.S. operations and that have enjoyed effective rates at or below 21%, the benefits of the lower marginal rate will be less or, in some cases, negative.

Hosansky added that companies that issue investment-grade bonds will tend to benefit much more than those that issue high-yield bonds.

"Because investment-grade companies have been paying effective rates that are higher than the new corporate rate of 21%, and many high-yield companies pay little or no tax, we expect the former to fare better under the new law," he said. "In addition, there are far more investment-grade companies that generate a significant amount of revenue and cash overseas; under the new law, this cash, which had been retained overseas because of high tax rates, can now be repatriated to the United States at a lower rate. Further, these companies will have access to future overseas cash at favorable tax rates."

Overall, Hosansky said, he expects the tax law to have a moderately positive effect on the corporate bond market.

"Corporate America has already started responding to the changes—hundreds of companies have announced compensation increases; several have announced incremental investments in the United States, including employee expansion; and scores have announced plans to bring back 'trapped' overseas cash," Hosansky said. "These actions, taken together, help improve the financial position of these companies, and we expect these announcements and actions to accelerate during 2018."

Munis will see a mixed impact

The impact on municipal bonds is more muted.

By limiting taxpayers' ability to deduct state and local taxes (known as SALT) to $10,000, the law could heighten demand for municipal bonds from investors in higher-tax states, such as California, New York, New Jersey, and Connecticut.

But as Adam Ferguson, senior muni portfolio manager in Vanguard Fixed Income Group, pointed out: "State and local governments will have a more difficult time raising revenues since individuals can't deduct more than $10,000 of state and local taxes on their federal tax filing, a longer-term headwind for municipal credit."

The new law should reduce muni supply by banning sales of tax-exempt debt for advance refundings, a financing technique that allows issuers to obtain the benefit of lower interest rates when outstanding bonds are not yet redeemable. However, Ferguson said that the time frame for the municipal bond market to benefit from this change is limited, because the bonds that were refunded typically had call dates within three years.

Demand for municipal bonds is expected to weaken among banks and insurers, in particular, now that the corporate income tax rate has been reduced; this leaves taxable bonds as a more attractive option for them.

Although the new law is likely to have a muted to slightly negative effect on the muni market over the long term, municipal bonds remain an attractive option for many investors, Ferguson said.

"Munis are still attractive, especially for higher-income earners," he said. "Even though the top income tax rate has come down slightly from 39.6% to 37%, the tax advantages of munis still exist for investors."

Notes:

- All investing is subject to risk, including possible loss of principal.
- Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.
- Although the income from municipal bonds held by a fund is fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal Alternative Minimum Tax.
- We recommend that you consult a tax or financial advisor about your individual situation.
