Opinion **Smart Money**

Forget stocks, it's the bond market that could feel US tax cuts

If tax cuts are seen as stimulative for the economy, the effects on bonds could be significant

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Speaker of the House Paul Ryan (R-WI) (C) is joined by House Republican leaders while talking to reporters

5 HOURS AGO

With the House of Representatives expected to pass a landmark US tax bill later on Wednesday, we can assume that the country's headline corporate tax rate will fall to 21 per cent, along with measures that will have a significant impact on American corporate profits next year. What next?

It appears that this tax cut was mostly but not totally priced in. In the last few days the S&P 500 high-tax rate companies, which benefit least from present loopholes and should therefore gain the most, have at last moved to outperform the S&P 500 as a whole, when measured since election day. But the margin is narrow and there should be a little more to follow.

The US market as a whole had lagged behind the rest of the world until the chances for

The prospect of a tax cut has plainly raised US stocks in absolute and relative terms.

But a lot of news is priced in, and in any case the direct equity market effects should be swift and shortlived. Earnings per share forecasts for 2018 need a one-off upgrading, to reflect the fact that more of those earnings will stay with shareholders. Then the market can continue as before.

The chaotic circumstances of the law’s passage more or less guarantee that a few big individual winners and losers remain hidden in the bill’s small print. Stockpickers will need to nose them out over the next few weeks. This is one time when there is idiosyncratic stock risk, and there is a good chance of a return on an investment in a painstaking read of the final law.

But then the direct effect on the stock market should be done. And the effect on it should not be that big. According to a Barclays estimate, the change in the effective tax rate paid by S&P 500 companies will be relatively modest, from 26 to 20.7 per cent. The net effect, after repatriation is taken into account, will be to raise earnings per share next year by 6.3 per cent.

This will not be uniform, and the more highly taxed sectors at present include relative laggards such as financials, industrials and energy. Recent winners such as healthcare and technology, derive a lot of earnings from outside the US and will not be helped as much. So there is a possibility that the tax change could help usher in a change in sector leadership, which was previewed last month as technology shares dipped and others rallied.

Credit Suisse’s HOLT group points out another possible effect, on deals. Highly unusually, M&A volume has been declining even as the stock market has hit new heights. After the last big repatriation of cash in 2004, most was spent on acquisitions. Companies have been disciplined in the face of high valuations of late — there is at least a risk that the arrival of fresh cash from overseas could prompt them into overpaying for deals. This would at least be good for the potential targets.

But now we need to consider less direct effects on other asset classes. These could be more profound. Start with the dollar. A US fiscal stimulus should, all else equal, increase the chances of rate rises next year. That should mean higher rate differentials, which would mean a stronger dollar. (This would be more bad news for US multinationals if it happened).

the tax advantages of stowing money overseas will not return. This should persuade them to bring their money back quickly.

The currency effect in relative terms will be good news for dollar-denominated investments compared to the rest of the world. But a sharp strengthening for the dollar would also be good news in absolute terms for European stocks, which tend to benefit from a weak euro, and for Japanese stocks which always prosper from a weak yen. Emerging markets could have a different story. Many of their currencies appeared at the point of tipping into crisis at the point when President Trump won election.

Subsequent dollar weakness helped get around that crisis. Now, that risk is back. This is particularly true in Latin America, which must also contend with political risks from big elections in Brazil and Mexico next year and a potential big shock if the Nafta trade negotiations collapse.

Ultimately, most important will be the impact on rates. The more the tax cut does act as a stimulus, or is perceived to be, the more it will push bond yields upwards. It is already a popular prediction that US 10-year treasury yields will hit 3 per cent next year, as central banks outside the US end their own monetary stimulus. Pushing 10-year yields beyond 3 per cent would raise the risk of a financial accident. It would also crimp valuations on stocks and press the US currency upwards.

Bonds globally suffered a sharp sell-off on Tuesday, with little obvious news to justify. As the sell-off was widespread, it is hard to attribute this entirely to events in the US. However, it was noticeable that the rate effect swamped any tax cut effect. Rate-sensitive sectors such as real estate sold off most; financials were more robust. And the stock market overall dipped a bit.

Once the details in this complicated and messy legislation have been sorted out, the question of rates will endure. If the tax cut has as little impact on behaviour as many fear, it will not have much impact on rates either. Once the upward shift in next year's earnings has been priced in, nothing much will change. If it does have an impact, it could push up rates, which could more than counteract any positive fiscal stimulus from the tax cut.

One painful conclusion is hard to avoid. Despite the excitement over the tax cut, the central issue for financial markets remains the same. As we enter the ninth calendar year of the recovery, can rates possibly continue at such low historical levels?