LPL RESEARCH
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TAX REFORM PIVOT?

Burt White *Chief Investment Officer, LPL Financial*
Jeffrey Buchbinder, CFA *Market Strategist, LPL Financial*

KEY TAKEAWAYS

Republicans' latest unsuccessful attempt to reform healthcare means that we are closer to the pivot toward tax reform.

Despite several challenges, we continue to expect a tax deal to get done in early 2018 that may provide a nice boost to corporate profits and could help to support stock valuations.

The likelihood of the healthcare "status quo" surviving has important implications for the healthcare sector, which should benefit from spending remaining at elevated levels.

Is it time for the tax reform pivot? Earnings season will get a lot of attention this week (July 24–28) with 190 S&P 500 Index companies slated to report, as will the Federal Reserve with its two-day policy meeting concluding on Wednesday, July 26 (though we do not expect any big news). Just as important for markets is the Republicans' latest unsuccessful attempt to reform healthcare, which means that we are closer to the pivot toward tax reform.

This week, given the latest healthcare developments in Washington, D.C., we share our updated thoughts on tax reform's prospects and some implications for the healthcare sector.

HEALTHCARE REFORM ON LIFE SUPPORT

Senate Republicans' latest unsuccessful attempt to reform the Affordable Care Act (ACA, aka "Obamacare") has greatly diminished the odds that either a replacement, or just a straight repeal, will be able to attract the 50 votes necessary for passage. After eight years of Republicans campaigning against the law, and the strengthened Republican majorities in the House and Senate after last November's elections, this is a somewhat surprising development.

This week, perhaps as early as Tuesday (July 25), the Senate is expected to vote either to: 1) debate some version of the proposed legislation; or 2) vote on a full repeal, with a two-year expiration date and no replacement. A successful vote is still possible, but we believe either of these paths carry very long odds at this point, given the states' varying interests on Medicaid and the political obstacles associated with people losing their insurance (as the non-partisan Congressional Budget Office has projected). Too many objections to a straight repeal bill have already been voiced (three to be specific), while we have not seen any evidence that the previous objections to the latest replacement option are having a change of heart. So, although healthcare reform effort isn't dead, it appears to be on life support.

The likelihood of the "status quo" surviving—or at least mostly surviving because the Trump administration can make regulatory changes—has important implications for the U.S. healthcare system, the federal budget (healthcare is more than 15% of the U.S. economy), and individuals receiving insurance subsidies through federal exchanges. These are all important issues. But from a stock market perspective, the most important implication is regarding the timing and nature of corporate tax reform.

CAN TAX REFORM STILL GET DONE?

From a legislative perspective the likely impending finality on healthcare should open the door to tax reform negotiations, though an open door is no guarantee of entry. We understand the view, among many, that if the Republicans can't get a healthcare deal done, why would tax reform—also divisive and complex, be any different? We believe tax reform is different primarily for these reasons:

1. **The pressure is on.** Considering the midterm elections in 2018 are just 15 months away, pressure is on legislators to act on plans to improve economic growth. The experience to date on healthcare only adds to the urgency Republicans must feel to deliver on their campaign promises and achieve a big political win with control of Congress and the White House.
2. **More unity.** We believe Republicans in Congress are more united on tax reform than healthcare, and we have more confidence in the Trump administration's ability, led by Treasury Secretary Mnuchin and Chief Economic Advisor Gary Cohn, to lead on this issue.
3. **Progress has been made.** Our primary contacts in Washington, D.C. have indicated that substantial work on taxes has already been done.
4. **Bipartisan support for repatriation.** One of the challenges with lowering the corporate tax rate is replacing the lost revenue to limit budget impact. A reduction in the tax rate companies must pay to bring overseas cash back to the U.S., which enjoys bipartisan support, could generate $150 billion or more in additional tax revenue over 10 years.
5. **Dynamic scoring.** Dynamic scoring allows policy makers to assume an incremental growth impact, and more tax revenue, from the reduced tax rate that can be used to offset the cost of lowering the rate. Republicans may also be able to change the budget baseline to facilitate revenue-neutral scorekeeping (revenue neutral policy is required under reconciliation which is the legislative maneuver necessary to get tax reform through Congress with only a simple majority rather than the standard 60-vote requirement).

These are the primary reasons we expect a tax deal to make it to President Trump's desk and be signed in early 2018, before the midterm election campaign season heats up. However, some challenges suggest a deal is far from certain. A budget bill must be passed, and that effort is complicated by divisions within the Republican Party around spending cuts. Finding revenue offsets is even tougher with federal healthcare spending remaining at prior elevated levels. And, the legislative calendar is crowded, especially if healthcare remains on policymakers' plates.

We see something in the neighborhood of a 25% corporate tax rate as achievable (down from the current 35%), though above previous proposals from President Trump and House Republicans of 15% and 20%, respectively. A 25% rate still may be enough to potentially push S&P 500 profits 5% higher in 2018 to north of $140 per share, even without reforming individual taxes (though that may come too).

HEALTHCARE SECTOR IMPLICATIONS

The likely failure of the ACA repeal and replace effort has several important implications for the healthcare sector. The biggest implication is regarding the insured base of patients. Should the law remain (largely) in place, people currently insured under the Obamacare exchanges would maintain coverage, which likely keeps the healthcare spending trajectory pointing higher. And more spending on healthcare services has historically correlated with better performance by healthcare stocks.

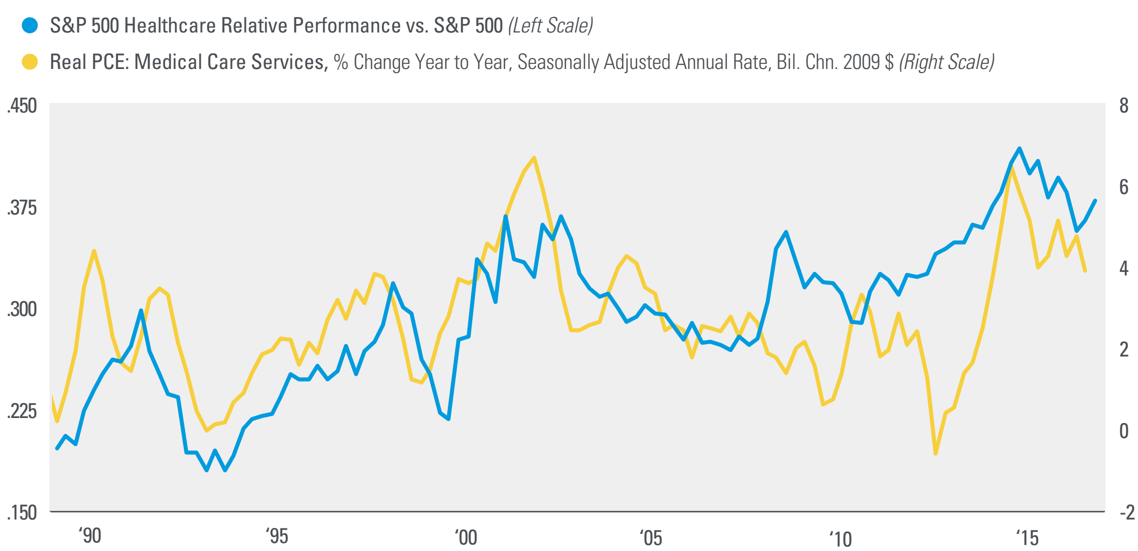
Figure 1 illustrates this tie between healthcare sector relative performance and growth in healthcare spending from the national U.S. gross domestic product data. A big piece of the improved performance of the healthcare sector in recent months, we believe, reflects the market pricing in a higher level of federal healthcare spending.

Regulation to control drug prices remains a risk, but this overall spending and regulatory outlook supports our positive view of the healthcare sector.

Certain industries within the healthcare sector are heavily impacted by Obamacare, most notably hospitals and of course insurers. Obamacare is good for hospitals and other healthcare facilities that benefit from more patients backed by government plans.

Medicaid insurance providers are also big beneficiaries of the status quo. Although the big, diversified health insurers generally like more healthcare spending, and the stocks have performed well in recent months as the spending outlook improved, they have become less sensitive to policy as participation in the exchanges has diminished. Finally, more healthcare spending does mean more spending on pharmaceuticals, although the influence is not as strong as it is for facilities and insurers.

1 NO SURPRISE: HEALTHCARE STOCKS TEND TO DO BETTER WHEN HEALTHCARE SPENDING IS HIGHER



Source: LPL Research, Haver Analytics 07/21/17

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Personal Consumption Expenditures (PCE) is a measure of price changes in consumer goods and services, targeted towards goods and services consumed by individuals.

CONCLUSION

The inability of Senate Republicans to achieve healthcare reform does not mean that the path toward tax reform, a very different animal, has closed. Republicans are more united, the sense of urgency is there, and we believe a lot of progress has been made behind the scenes. Although the eventual outcome may not be as bold as many on the right side of the aisle had desired, we continue to expect a tax deal to potentially get done in early 2018 and, if it gets done, that it may provide a nice boost to corporate profits and help support stock valuations. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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