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INVESTORS GET READY: CORPORATE TAX REFORM WILL HAPPEN

Washington watchers seemed united in their view that tax reform is on life support because the Trump Administration, the House, and the Senate are in disarray internally, and all three bodies also are squabbling among themselves. They have evidence for this view, but the disarray is temporary for reasons we discuss here. We will present their case first and then explain why investors are being given a golden opportunity.

The Administration is Under Siege:

Special Counsel Robert Mueller is expanding his inquiry beyond Russian election meddling and possible Trump campaign complicity. Former FBI Director James Comey is testifying Thursday before Congress on Russian involvement, and also on whether Trump pressured him to halt the Flynn investigation. Both the House and Senate Intelligence Committees also are investigating Russian election meddling and possible Trump campaign collusion, with potentially market moving revelations possible. As of today, there is no damning evidence and none may appear, but the possibility that something will be uncovered hangs over the Capitol. Given this and other controversies, Trump's approval rating is only 36%, with 43% saying they even support Trump's impeachment. With his popularity low, Trump, it would seem, lacks the ability to rally a united GOP behind a specific policy agenda.

The House: Ryan Cannot Lead

Speaker Paul Ryan often cannot control either the 30-member conservative Freedom Caucus or the 25-member moderate Tuesday Group. He cannot pass major legislation without these ideologically-opposed factions agreeing. Since House Democrats unanimously refuse to reverse Obama's achievements, Ryan needs 217 votes from his 237 vote caucus to do so. The House barely passed "repeal and replace," but many doubt the House Freedom Caucus will swallow a watered-down Senate version, assuming the Senate passes one.

The Senate:

Meanwhile, the Senate GOP has rejected the House version of ObamaCare "repeal and replace," but also is having a difficult time coming up with an alternative that will satisfy at least 50 of 52 Senate Republicans. Mitch McConnell has to contend with these lone rangers, among others: Rand Paul, Ted Cruz, Mike Lee, Susan Collins, Lisa Murkowski, and John McCain. Senator Burr (R-NC) recently put it this way: "It's unlikely that we will get a health care deal".

Alas, Congress won't begin debate over tax reform until an ObamaCare repeal and replace bill is signed into law or set aside. Passing a tax reform bill does not appear to be any easier than passing an overhaul of ObamaCare, if that even proves possible. It is understandable that few Capitol watchers believe that Washington will enact tax reform this Congress.

Tax Reform will Pass Because the Mid-2018 Elections Scare the GOP

"Depend upon it, sir, when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully." --Samuel Johnson

The reason to be bullish about a tax reform bill is precisely because of Republican congressional fears that voters will not vote to retain them in November 2018 if they fail to pass one. No one knows what the political environment will be in 18 months, but it is logical to go with the odds. Historically, the party occupying the White House loses Congressional seats in mid-term elections eighty percent of the time. If the GOP losses 23 or more seats, then Nancy Pelosi (D-CA) becomes Speaker of the House, and she will use a Democratic House majority to block successfully numerous GOP legislative ideas, including tax reform.

The "in" party election mid-term curse occurs for understandable reasons. Halfway through a president's term, members from the "in" party are generally satisfied because their man is in power. Some typically are complacent and see no compelling reason to go out and vote, especially because their leader is not even on the ballot. Members of the "out" party, however, are angry and unhappy. They are eager to "send a message" to the President from the opposing party. Consequently, although overall turnout typically falls from 60% of adults in presidential elections to 40% of adults in mid-terms, turnout from the "in" party falls more than it does for the "out" party, costing the "in" party seats in Congress.

Consider the last three mid-terms. In 2006, Bush's House Republicans could afford to lose 14 seats and still retain control, but they lost 31. In 2010, Obama's House Democrats could have given up 39 seats and still held onto power, but they forfeited 63, and Nancy Pelosi relinquished the gavel to John Boehner. In 2014, Obama witnessed the Democratic Senate majority cave in, elevating Mitch McConnell into the Senate Majority Leader. Democrats lost yet another 13 House seats again, giving the GOP its largest House majority since 1928.

The size of the losses is correlated with the President's approval rating on election day. In the last three mid-terms, the sitting President has been in a slump. On Nov 4, 2006, W. only had a 38% approval according to Gallup. Obama's early November approval ratings in 2010 and 2014 were better, 45% and 42%, but that didn't save Democratic congressional majorities. Right now, Trump is at 36%. Unless Trump's approval rating spikes, history suggests that the GOP's House 23-seat majority seats will be in jeopardy next year. If the GOP wants to pass tax reform for positive reasons, because they truly believe in it, they are taking a big risk if they don't get the job done this Congress. Election handicappers see the GOP and the Democrats as having equal chances of controlling the House when the next Congress convenes in January 2019.

The GOP has another reason to pass tax reform before November 2018. Imagine this dire scenario for the GOP: Trump's campaign is implicated in the Russian election meddling by Special Counsel Robert Mueller, who brings indictments a few months before the November 2018 elections. Calls for impeachment swell as Trump's approval rating hovers near 30%. Meanwhile, the Congressional GOP has spent the last two years squabbling, unable to settle their differences in time to pass at least one major bill that the public supports. If this happens, then the House majority is certain to fall, as disgusted Republican voters stay home, while enraged

Democrats pour into the polls. The GOP cannot control Special Counsel Robert Mueller, nor know what his investigation will bring. What they do control is whether they have something positive to campaign on to give their own voters a reason to show up in November 2018. Is there anything more popular to potential mid-term election Republican voters than simplifying the tax code and reducing their taxes?

Can the Consensus Really Be Wrong?

It has happened before. For example, in January 2010, an obscure Massachusetts politician, Scott Brown, based his underdog Senate campaign on a promise to oppose passage of ObamaCare as it was winding its way toward final passage. His shocking defeat of Massachusetts Attorney General Martha Coakley on January 19, 2010, to capture the Senate seat previously held by Ted Kennedy, astonished the political world. The pundit class overwhelmingly pronounced ObamaCare dead. If supporting ObamaCare was politically lethal in a very deep blue state, they reasoned, there was no chance it could clear Congress if only 40 of 257 fearful House Democrats voted for personal political survival instead.

Two months later ObamaCare became law. CAN's president was one of the very few who stood against the consensus, and on national television in late January said it would pass. Off camera, I was told I was alone in making this forecast and probably committing professional suicide. I made this call for two reasons. First, the pundits misunderstood the parliamentary status of the bill. More importantly, they didn't appreciate that killing ObamaCare would destroy Obama's presidency barely a year after he took office, and guarantee that Democratic voters would stay home in droves later that year and cost them their House majority. There was no way that House Democrats would let this happen. The less risky strategy was to pass an unpopular bill, and then hope to rally support for it later.

After being in and around national policy debates for forty years, I don't mind making contrarian calls when the political logic is compelling, as it is now: There is an 80% chance of a corporate tax rate reduction this Congress, and investors should bet on it.

Investors Will Make Money if They Bet on Highly-Taxed Companies

In their public presentations, the congressional GOP will emphasize how they are helping middle class taxpayers. That is where the votes are. More importantly for investors, however, will be the changes to the corporate income tax code. CAN believes numerous companies will benefit when tax reform becomes law, most likely in 2018. A precise forecast on the timing of passage of an omnibus tax reform package is impossible, and unnecessary to benefit. That said, the GOP has yet to make two huge decisions:

- Will the tax bill be revenue neutral or will taxes be cut by trillions of dollars over ten years? The size of the benefit to investors will be determined by this decision as well as how many companies end up winning -- or even losing.

- If the GOP cuts taxes, will they pay for them by cutting spending by an offsetting amount?

The answer to these questions will determine if the tax cuts are permanent or last for only ten years. Investors should get answers when the House Budget Committee approves the fiscal year 2018 First Concurrent Budget Resolution later this year and the full House approves it. This Resolution will include "reconciliation instructions," launching the parliamentary process that blocks Senate filibusters. This will make tax reform an all-GOP affair. Democrats will be powerless to block it. Only a subset of factional self-destructive Republicans would have that power and in the end they will relent out of self-preservation. The Resolution also will specify dates for the House Ways and Means and Senate Finance Committee to approve their versions of tax reform. Investors will know how large the tax cut will be, if any, and when to expect detailed specifics from the House and Senate.

Corporate Tax Rate Cut Beneficiaries

Company (Ticker)	4-yr Ave Tax Rate	Company (Ticker)	4-yr Ave Tax Rate
Reynolds American (RAI)	69.1%	Alliance Data Systems (ADS)	36.6%
Automatic Data Processing (ADP)	56.9%	Macy's (M)	36.5%
CDW Corporation (CDW)	49.9%	Landstar Systems (LSTR)	36.1%
Humana Inc. (NYSE:HUM)	48.3%	Charles Schwab (SCHW)	35.5%
Cardinal Health, Inc. (CAH)	47.8%	Quest Diagnostics (DGX)	35.3%
Amerisource Bergen (ABC)	45.0%	Paychex (PAYX)	35.0%
Centene Corporation (CNC)	44.6%	The Home Depot, Inc. (HD)	35.0%
Whole Foods Market (WFM)	44.2%	Ross Stores (ROST)	34.9%
Synchrony Financial (SYF)	43.6%	Fidelity National Info Services (FIS)	34.6%
Express Scripts (ESRX)	41.5%	Kellogg (K)	34.4%
CBOE Holdings, Inc. (CBOE)	40.3%	AMN Healthcare Services, Inc. (AMN)	33.3%
Aetna Inc. (AET)	39.5%	Ulta Beauty (ULTA)	33.0%
UnitedHealth Group (UNH)	38.9%	O'Reilly Automotive, Inc. (ORLY)	32.8%
CVS (CVS)	38.6%	Cigna Corporation (CI)	32.1%
Dr. Pepper Snapple (DPS)	38.0%	Fiserve (FISV)	31.6%
United Therapeutics (UTHR)	37.6%	Nordstrom (JWN)	31.5%
Dollar General (DG)	37.4%	Old Dominion Freight Line (ODFL)	31.1%
Gap (GPS)	37.0%	LifeHealthcare Group (LHGC)	30.9%
Anthem, Inc. (ANTM)	36.8%	Signature Bank (SBNY)	30.2%

It is highly-taxed companies that stand to benefit most when the federal corporate tax rate falls from 35% to 25%, and perhaps lower. The math is straightforward. Consider a corporation paying the full 35% federal corporate income tax and also another 5% to state governments. Their shareholders capture $60 out of every $100 earned pre-tax. If the federal corporate tax rate drops to 25%, they will keep $70, a 17% boost in after-tax returns. Such stocks could, and should, rise by about 17%. We have developed a list of tax reform alpha generators, using a screening methodology described below. But the list of potential winners is long, and investors are encouraged to consider others, including First Trust's Corporate Tax Reform Portfolio and Goldman Sachs 50 Highly-Taxed companies. For our list of tax rate cut winners:

- CAN first identified companies that generate more than 90% of their revenues domestically. U.S. tax cuts will affect most those with the greatest share of their earnings produced in the United States.

- We then excluded selected companies that incurred losses during 2013-2016 because companies with net loss carryforwards will not benefit from tax reform until these are exhausted, perhaps years from now.

- We then compared the cash taxes paid from their cash flow statements to pre-tax income to establish average 4-year cash tax rates. Only companies with 4-year cash tax rates in excess of 30% appear above. We use cash taxes paid from cash flow statements rather than the effective tax rate from income statements, because the they represent ***actual payments to the IRS***. Effective tax rates often mislead; they include taxes that may be deferred for many years, perhaps decades.

Is Tax Reform Already in the Stocks?

If you accept the work of Goldman Sachs, then the answer is "no." Their analysts find that the "Trump trade" has given up its gains. "Trump stocks" spiked on his surprise victory, outpacing even the rapidly rising market, but they have given back all of their relative gains and now have gone up by the same amount as the S&P 500. This is true for highly taxed companies as well as for bank stocks, and infrastructure plays. The market, it would seem, is trading on fundamentals, expected earnings and interest rates. Apparently, it believes the press narrative that Trump and the Republicans cannot get their act together. On tax reform, at least, the press is wrong. We recommend investors stay long highly-taxed stocks and pick up the free money that Washington is handing out courtesy of the media's misreading of GOP congressional politics.

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