On December 22, 2017, the much anticipated tax reform that President Trump promised as a candidate and the Republican Congress promoted both prior and post the election, became law. We believe this legislation will prove to be a seminal measure for the U.S. economy based entirely on the reduction in the corporate tax rate. Broadly measured, the act failed to achieve some of the originally proposed objectives, including the simplification of the tax code, a large reduction in individual taxes, the elimination of many deductions and others. However, the reduction in the corporate tax rate moves the U.S. from having the fourth highest rate in the world to one of the lowest rates amongst developed nations.

Corporate taxation has been the subject of extensive debate between economists and politicians for centuries. Many economists consider taxes distortionary and corporate taxes an unproductive addition to the cost of doing business. Others believe taxes should be levied on businesses because they finance the economic and regulatory foundation of the marketplace. This debate will likely never be resolved and corporate taxation will always exist, in part for three totally uneconomic reasons. The first is that governments have expanded and their excessive financial obligations cannot be funded with income or sales taxes alone. Secondly, corporate taxes are relatively easy to collect. And finally, as a corollary to the first reason above, politically, corporations are amorphous entities that are easier to tax than people. Given the foregoing, we think it is remarkable the government succeeded in passing such a meaningful reduction in the corporate tax rate.

The reason the lower tax is important is that it creates an incentive to invest. U.S. companies that might have built a plant abroad or started a new division are incented to make the investment at home. Foreign corporations wanting to do business in the U.S. have an incentive to open plants here and entrepreneurs will be eager to launch new businesses. The stock market's impressive 2017 and early 2018 performance is a testament to the likely economic benefits of the lower tax. In a January 12, 2018 Wall Street Journal editorial, Donald L. Luskin, Chief Investment Officer at Trend Macrolytics, LLC., suggested the market may not be overvalued because, as a consequence of the new tax law, he estimates earnings are likely to be higher than most expect. He adds, "My estimate also doesn't consider business migration. Some American companies with operations in low tax jurisdictions may bring these activities home. Some foreign companies may decide to forward deploy their facilities into the U.S. market. All of this again will create new businesses, factories, jobs and earnings."[1] Investment has a tremendous economic multiplier effect, with new businesses hiring more workers, broadening and diversifying the economy's commercial base, augmenting competition, and ensuring attractive prices.

Ireland is a well-known low tax jurisdiction. The small country with limited natural resources or competitive advantages, realized early it had to compete with intellectual capital by attracting investment. The country has a 12.5% corporate tax rate, lowest among the Euro area countries, which, as an aside, elicited the wrath of some member countries complaining Ireland was "taking" some of their companies. Indeed, after the 2010 sovereign crisis that engulfed the European periphery, Ireland included, the country has enjoyed among the best growth rates in the Euro area. This is not a surprise when considering that gross fixed capital formation (the investment component of GDP) grew from €29.4 billion in 2010 to €87.7 billion in 2016, a 20% annual growth rate. By comparison, investment in Spain, Italy and Greece declined over the same time period. Even regional champion, Germany, had an annual growth rate of 3.9% and, as a whole, the Euro area countries achieved only a 1.75% rate.

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[1] Donald L. Luskin. "Tax Reform Has Released the Bulls." The Wall Street Journal, January 12, 2018.

Year 2017 ended with positive economic momentum, perhaps even euphoria because the world appears to be growing in synchrony. All multilateral entities raised their global growth forecasts, with many citing the likely contribution of the new tax legislation. Optimism led global equity markets to an impressive year of performance, despite substantial apprehension at the end of 2016. A question that vexed many is: what was the trigger for the noticeable shift in sentiment, both domestically and internationally? We may not have the answer, but Mr. Luskin may have put a finger on it when he wrote: "Finally, my estimate doesn't factor in the competitive global response to American tax reform. Nations afraid to be left behind may cut their own taxes in what could turn into a world-wide competition. That would be the delightful opposite of protectionism. Instead of trying to punish each other with reciprocal tariffs, nations could engage in a race to the top to see who can completely liberate their productive sector from the deadweight costs of corporate taxation." [2]

It is evident shareholders benefit meaningfully from reduced corporate taxes. What about bond holders? The new tax law limits deductibility of interest to 30% of earnings before interest, taxes and depreciation, arguably a corporation's added value. This new treatment favors the use of equity over debt in the mix of capital sources. Logical expectations for debtholders include improved creditworthiness and a near-term "technical bid" for outstanding debt. Over time, corporations will likely attempt to optimize their capital structure to maximize return on equity while minimizing their cost of capital. Below is a simple hypothetical depiction of the effect of the new law. For companies with low to modest leverage, the effect of the law is an increased return to shareholders, which helps explain the stock market's performance. For more levered companies, the law alters the capital structure considerations, favoring an increase in the use of equity.

Interest Deductibility Examples

	Low Leverage		**High Leverage**	
	Previous Full Deduction	New 30% Deduction	Previous Full Deduction	New 30% Deduction
Net before Interest and tax	100	100	100	100
Interest Expense	40	40	80	80
Deductible Amount	40	30	80	30
Net Taxable Income	60	70	20	70
Tax (Rates 35%, 21%)	21	14.7	7	14.7
Net Income	39	45.3	13	5.3
Distribution of Value Added				
Equity	39	45.3	13	5.3
Debt	40	40	80	80
Government	21	14.7	7	14.7
Assumed Cap structure				
Equity	500	500	100	100
Debt	500	500	900	900
Return to equity	***7.80%***	***9.06%***	***13.00%***	***5.30%***

Some people wonder whether limiting deductibility will hurt small businesses, and perhaps banks by, in effect, increasing the cost of debt. It is true small businesses may face challenges raising equity, but it is also true that full deductibility can be argued to subsidize the cost of borrowing, thereby incenting its use. Theoretically, in a world with no corporate taxes, the cost of capital and, by extension, optimal capital structure, is determined by the characteristics of the business and the nature of its cash flows. We believe businesses of all sizes will continue to borrow, but going forward more funding will

[2] Ibid.

come from equity. We believe this, by the way, also happens to be a desirable outcome for the long term wellbeing of the economy.

January 15, 2018

Sources: Congress.Gov, Eurostat, Bureau of Economic Analysis, The Wall Street Journal, Bloomberg.

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Gloria Carlson
Director, Sales and Marketing
212 893-7835
gcarlson@giallc.com

Arnold West
Director, Institutional Sales
212 893-7815
awest@giallc.com

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