



Philequity Corner (December 4, 2017)

By Wilson Sy

A tale of two tax reforms

In our past articles, we discussed the many similarities between Trump, Duterte and their respective agendas. Both presidents not only share many personality traits but they also have a common program for their governments. Both leaders have explicitly stated that their administrations will focus on infrastructure spending and tax reform (*Year of the Underdogs*, November 14, 2016). As though these similarities were not enough, the tax reform initiatives in both countries simultaneously hurdled important milestones last week.

Dow Jones surges as US Senate passes tax reform

The Dow Jones Index gained by 256 points last Tuesday, 104 points on Wednesday and 332 points on Thursday as Republican senators gathered more supporters for the tax bill. Last Friday, the Dow closed only 41 points down after dropping by more than 300 points from its intraday high. The sharp intraday drop was caused by news about the guilty plea of former national security advisor Michael Flynn. Yet, the index recouped most of its losses as news filtered out that the Senate will muster the necessary votes to pass the tax bill. With last Friday's move, the Dow advanced 673 points last week and posted one of its biggest weekly points gain in recent memory. This translates to a return of 2.9% which is the Dow's best weekly performance for the year.

US tax reform triggers sectoral and geographic rotation

The passage of the tax bill in the Senate has triggered a rotation into the US and in sectors that are deemed beneficiaries of tax reform. Below, we identify some of the sectoral rotation / shifting themes that we have so far witnessed.

- From emerging market (EM) stocks to US stocks
- From momentum stocks to cyclical stocks
- From growth stocks to value stocks
- From tech stocks to financials
- From companies driven by international businesses to those supported by domestic revenues

PSEi pulls back despite passage of tax bill in Phil Senate

Instead of moving in tandem with the Dow, the PSEi dropped last week despite the passage of our own version of tax reform in the Senate. Below, we enumerate the reasons why the PSEi corrected.

- 1) MSCI rebalancing.** In the latest rebalancing, Meralco was added to the MSCI Phils Index with an estimated weight of 2%. Net foreign buying for Meralco amounted to P4.06b from the date of announcement (November 14) until November 29. However, Meralco's addition into MSCI Phils meant that other index components would have reduced weightings. Excluding Meralco, net foreign selling for the stock market amounted to P5.32b from November 14 up to November 29. This resulted in the selldown of other index stocks and the 2.6% drop of the PSEi last week.

- 2) **Senate version of tax bill is complicated.** When tax reform was passed by Congress, the PSEi went up 1.15% (*Stock market cheers tax reform passage by House, June 5, 2017*). The House bill was better accepted by the market as it was more aligned with the DoF version. On the other hand, the recently passed Senate bill is not as clear and straightforward as the House version. The former contains provisions which have been reserved for tax packages that the DoF intends to roll out in the future. Moreover, the Senate bill reconfigured many of the proposed taxes and exemptions, thus leading to confusion regarding its actual revenue contribution.
- 3) **Heightened regulatory risk in certain sectors.** The Senate tax bill proposed higher taxes on coal and mining activities. This has led to heightened regulatory risk for certain companies in the coal, mining and power sectors. This has caused a sharp correction in the stock prices of affected companies.
- 4) **Shift of fund flows from EM to the US.** With the approval of tax reform in the US Senate, fund flows have shifted away from EM countries such as the Philippines and back to the US.

Bicameral deliberations are crucial

After the passage of tax reform in the Senate, a bicameral committee composed of senators and congressmen will convene to reconcile, unify and finalize the tax reform bill. It will be crucial for the bicameral committee to achieve the following milestones:

- Yield net revenues of at least P100b-P130b, as proposed by the DoF
- Simplify prospective changes to improve collectability
- Align proposed changes in the first package with the four remaining tax reform packages of the DoF
- Finalize the tax reform package in a timely manner

Tax reform – a major catalyst for the economy and stock market

At last Friday's close of 8,144, the PSEi is now trading near support levels. Thus, all eyes will be on the bicameral committee as members from both Houses seek to finalize the tax reform package and pass it into law. It will therefore be crucial for the committee to come up with a version that is closer in substance and form to the DoF version. As we have said in our past articles and presentations, the timely passage of a tax package which meets proposed revenue thresholds will be a major catalyst for the economy and the stock market (*Tax reform – the next big catalyst, February 20, 2017*). However, roadblocks to the timely passage of tax reform or the passage of a diluted version may cause disappointment among investors and exacerbate the PSEi's ongoing correction.

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