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News Release

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Contact Information:

Media:
Madelyn McHugh
(212) 805-6039
mmchugh@leggmason.com

Promised Trump Administration Corporate Tax Cuts Could Unleash Long Overdue Cash Expenditures

"Cash to CAPEX" May be a Major Driver of U.S. Corporate Investment

(New York, NY, December 20, 2016) – The prospect of lowering U.S. corporate taxes under President Donald J. Trump has raised expectations that companies will use the money saved to expand capital investment (CAPEX), viewed as long-expected and equally long overdue.

Legg Mason brought together four senior investment leaders from its affiliates to discuss where the new administration may lead the economy, and what role corporate tax cuts and the money saved would have. They believe a surge in CAPEX is a likely – and mostly welcome – result.

The full video, "Where to Seek Opportunity in 2017," can be accessed via this link: https://youtu.be/UpI9adpN_tk.

"If we see more capital expenditures, that will increase productivity, that will lead to better corporate earnings," said James H. Norman, President of QS Investors. "That will lead to better opportunities to use those earnings however companies want to do it. If they're finding investments that they want to invest in, and continue to invest, that would be great. But in addition, it allows them to continue to pay out, either buy shares back or increase dividends."

"Our expectation going forward is that economic growth is not going to be fantastically strong and returns aren't going to be fantastically strong in equity or fixed income. If you can build up that income stream that you're getting out of those better cash flows, CAPEX being effective and increasing corporate profits, that's certainly a great thing. One of the key metrics we focus on is earnings expectations over the next two years. A lot of that will be determined by CAPEX and how that will actually translate into corporate profit growth."

Asked what one policy might tip the scale quickly to more CAPEX, Mr. Norman was ready.

"Absolutely, tax cuts and repatriation are two things that would be key drivers," Mr. Norman declared. "I don't think it's a question of if that's going to occur. More the question is what's the scale? How large will the tax cuts be? There's been discussion of 15 percent. It's not 100 percent likely to occur, because they have to get agreement. How do you finance that? The repatriation is much more likely. So I think it's more about [details], not if it's going to occur.

How these changes could impact wages and inflation drew the attention of Brandywine Global portfolio manager Jack P. McIntyre.

“How is it going to impact growth of particular economies, both in the U.S. and outside?” Mr. McIntyre mused. “That sustainability, and the inflationary implications as well, because we’ve seen this move higher in wages in the U.S., to me it’s a double-edged sword.”

“But isn’t it going to expedite these potentially job-destroying investments: it’s the technology, the automation ... That genie’s out of the bottle. I’m not sure how politicians can outlaw that. So wages increase, more investment and productivity enhancing. That should put downward pressure or keep the lid on how high wages, and therefore inflation can increase.”

Western Asset Management portfolio manager Carl L. Eichstaedt focused on the credit cycle.

“When we look at investing in corporate bonds in the U.S., we think the key is where are you on the credit cycle?” Mr. Eichstaedt said. “Are you in the seventh inning or the eighth inning? Are you getting near a potential recession? We try to take it a little more granular than that and look at where is each industry. For example, banking is still in the repair phase; everything they’re doing is bondholder friendly. They’re not re-leveraging the balance sheet. Energy just had their recession, and everything an energy company is doing is for the benefit of the bondholder.”

“Then you look at the other side, at an industry like transportation or maybe pharma, healthcare. They’re at the end of their credit cycle. They’re now doing bondholder unfriendly things. As a bondholder, the CAPEX side isn’t quite as important maybe as for the equity holder.”

Scott Glasser, Co-Chief Investment Officer of ClearBridge Investments, took the equity view.

“I am excited about repatriation,” Mr. Glasser reported. “I’m less excited though about a restoration of growth through CAPEX. Companies will spend money if they think they’re going to get a return on it. To get a return, there’s got to be demand. I’m not sure the uptick in growth is enough to really make a big step function change in the level of CAPEX that’s being spent by companies. It’s easier for me to say that money is going into share repurchase and dividends and restoring the balance sheet, and CAPEX itself is staying at a more moderate level.”

“I’m not sure companies are going to admit to a lot of capital investment in the face of questionable demands late in the cycle,” Mr. Glasser said. “I see a lot of those tax benefits going to shareholders in different forms.”

Using Uber and Airbnb as examples, Mr. Eichstaedt suggested other issues may be at work.

“I think that there’s a secular change,” he said. “We might be missing something and focusing too much on CAPEX.

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