# *Financial Sleight-of-Hand: Implications of the 2011 bonus depreciation allowance*

*"Hey Rocky, watch me pull a rabbit out of my hat!"*
*– Bullwinkle J. Moose*

As 2010 drew to a close, the debate over whether or not to extend the Bush-era tax cuts remained front and center. The drama finally reached its dénouement on December 17th when President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRJA). Few were surprised by the Act's more publicized items regarding federal unemployment insurance and a range of tax relief initiatives. One of the less widely known provisions, however, was a measure designed to incentivize equipment purchases, ideally kick-starting our flagging economy by rebuilding the supply chain. This incentive came in the form of an extraordinary tax break **allowing businesses to write off 100% of capital expenditures in 2011** rather than depreciate these investments over a number of years. As Crain's noted in January: "There's a long history of government efforts to spur capital spending through investment tax credits and tinkering with depreciation schedules. In recent years, smaller firms were allowed to expense up to $500,000 in capital expenditures. And the 2009 stimulus package created a 50% first-year write off for certain firms. But never before has depreciation of machinery, equipment and software been totally eliminated for all companies, regardless of size." In 2012, the 100% bonus depreciation is due to drop back down to a 50% allowance, and (ostensibly) will expire altogether in 2013.

Until now, the 100% depreciation allowance has mostly flown under the radar – which probably means it would be prudent to more closely monitor its impact. We view this type of stimulative measure as nothing more than a **macroeconomic shell game** whose true nature will be revealed by early 2012, if it can even produce measurable success in the meantime. Manufacturing seems less and less likely to act as the economic panacea that will get a US recovery on track: Q2 earnings across the sector have been mixed, and if June's slowing durable goods orders are any guide, overall confidence seems to be faltering. Even if the temporary window for 100% bonus depreciation boosts cap-ex by the end of the year, we believe that not only will any positive effects be short-lived but that a number of negative developments could be exacerbated, casting a pall over 2012 markets.

In this paper, we will examine three areas of particular concern:

- a temporal reallocation of growth as **GDP is pulled forward** into 2011 at the expense of the 2012 economy
- the danger that **short-term corporate tax relief** will both **deplete government revenues** <u>and</u> **weigh on future earnings** when temporary allowances expire
- persistent **slack in the supply chain**, which has the potential to undermine any real economic growth

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## GDP: Now you see it, now you don't

When TRJA was first passed, White House economist Jason Furman voiced the administration's expectation that "hiring should rise if business spends an additional $50 billion to $100 billion on capital expenditures [in 2011]…or roughly 5% to 10% higher than had been forecast." Crain's posited at the time that firms such as Caterpillar Inc., Deere & Co., and Navistar International Corp. should benefit from TRJA if spending were to be "spurred by a limited-time-only incentive to buy more equipment and machinery". Along the same lines, a John Deere Financial customer service publication regarding the 2011 bonus depreciation opens by stating that "one of the best reasons to buy equipment now comes straight from Washington, D.C."

However, the January Crain's article further noted that many businesses in 2010 had "waited to see whether the entire $858-billion tax cut package would get through Congress before the end of the year," suggesting that some degree of 2010 year-end cap-ex had been nudged into 2011. Similarly, we believe this same legislation is pulling future cap-ex forward, prioritizing positive data this year at the expense of growth in 2012. Recent reports from Lombard Street Research have highlighted this possibility, stating that "not only does GDP lose the premium from investment brought forward – it also lacks the normal quarterly cap-ex itself, as much of it will have already been done in 2011 to get the tax break." Lombard Street Research views the lackluster June durable goods numbers as an indication that capital spending will spike in the latter half of 2011 on the back of a reasonably strong Q2 earnings season, only to fade again next year. While this could be the case, we can also envision the continued deceleration of cap-ex and stockpiling as businesses remain wary of how consumer demand will hold up during a jobless recovery. In either instance, we think the end result is the same: further stress on the system in 2012.

## Corporate Taxes: The illusion of escape

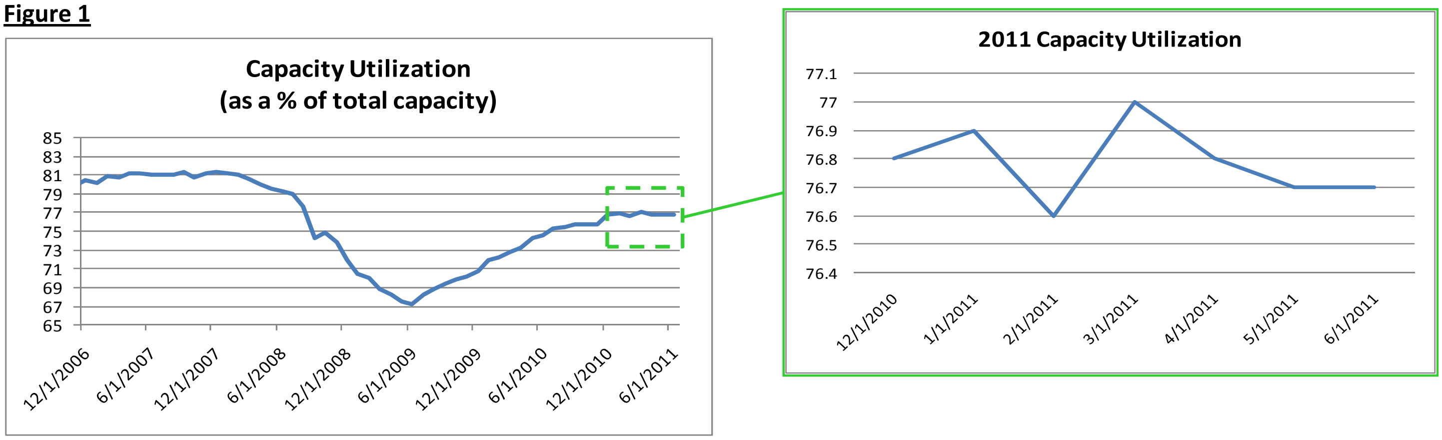
As a legislative device, the unprecedented bonus depreciation window should be a powerful way to incent business investment. Union Pacific's Q1 earnings call reported that "cash dividends paid in the first quarter of 2011 were up 38% from 2010 levels. Bonus depreciation contributed positively to cash flows in both years." Credit Suisse's research on the topic agrees to some extent, conceding that "the initial boost to cash flow from bonus depreciation can be significant." However, Credit Suisse also warns of the so-called *bonus depreciation boomerang*. "When bonus depreciation expires, the depreciated assets cannot provide their 'normal' tax shield. That means in subsequent years lower depreciation expense, higher taxable income, and higher cash taxes, causing a drain on cash flows."

Even the above-quoted John Deere Financial customer service publication points out that "with or without" the expansion of depreciation allowances, "your tax savings over the course of six years will be the same. However, the purpose of the acts is to create movement in the economy right now. The money you save in the short term can be reinvested in capital improvements, expansion projects, and more…" It doesn't seem to be much of a secret that these tax savings are short-term and that revenues will be paid at some point in the future. With this in mind, we do not put too much stock in the healthy cash flows supported by 2011 bonus depreciation, and we expect to see an inversely proportional reaction in future earnings as the corporate tax burden reasserts itself. Meanwhile, if enough businesses decide to take advantage of the bonus 2011 write-offs, we think the negative effect on federal tax receipts will simply weigh further on the already beleaguered government coffers.

## Capacity Utilization: A relentless vanishing act

In theory, the TRJA should improve the velocity of money as heretofore stagnant cash is diverted into training, equipment upgrades, hiring, etc. Though corporations may have previously held off on such investments due to economic uncertainty, the additional write-offs are designed to offset those concerns significantly enough to get cash moving. In practice, however, it is important to consider the following: once businesses have spent some of their reserves in the pursuit of 2011 tax breaks, how long can they hunker down again before spending? According to Lombard Street Research, more than 50% of equipment and software cap-ex assets have a five-year depreciation lifespan. If the bonus write-offs expire and the surge in spending subsides before the US recovery can gain momentum, then we may have just set ourselves up for a systemic echo of the "cash for clunkers" boom/bust mini-cycle. Excess capacity would become even more pronounced, yanking the rug out from under the supply chain. In fact, capacity utilization is slightly down (-0.06%) YTD and still has not recovered back to pre-2008 levels (Figure 1), leaving little hope that the system will take up a significant amount of slack before year-end.

**Figure 1**




*Source: Bloomberg*

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We do not believe the 2011 bonus depreciation represents a new breed of alchemy capable of producing positive economic data out of thin air. Rather, we surmise that growth has been pulled forward at the expense of GDP over the next year (or more). Much of the support given to the equity markets by TRJA (as well as the boost from healthy Q2 earnings and constructive steps toward resolution of the Euro debt crisis) could well evaporate within six to nine months, to be replaced by an exaggerated down-move. There are already plenty of macro inputs on the wrong side of the ledger, so the last thing equities need is a simultaneous deceleration of cap-ex, federal tax receipts, and capacity utilization rates – especially considering that manufacturing has been a strong driver of any YTD recovery worth mentioning.

In fact, the downside potential could be even more extreme: if markets are expecting a meaningful jump in cap-ex for Q3 and Q4 but does not see this reflected in either employment or durable goods data, then a sell-off could materialize even more swiftly and dramatically. Though capital spending may have grown by the "5-10%" estimated by the White House, nonfarm payrolls in the goods producing industry are not impressive enough (+1.17% YTD) to engender much optimism, conveying a lack of commitment on the part of manufacturers to a permanent restoration of the supply chain. The economy is still vulnerable to a pullback, with little to show for the fact that we have nearly exhausted our bag of tricks in attempting to engineer a structural recovery.

As stated by Newton's third law of motion, "to every action there is always an equal and opposite reaction." When the 100% bonus depreciation allowance expires, we expect to see a flurry of negative market forces that should mirror the nature and magnitude of any positives that might have been prompted by these temporary incentives. That is, if the measures succeed in lowering corporate taxes while boosting sales during 2011, we would not be surprised to see a subsequent spike in the corporate tax burden at the same time that sales numbers decline. To put it bluntly: we think 2012 could be a disaster for financial markets, particularly US equities. We will closely monitor how these potential scenarios unfold, remaining nimble in the expression of our directional views while tactically protecting the portfolio during periods of heightened volatility.

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