GENTRUST

US Tax Reform Analysis

October 31, 2017

Introduction

President Donald J. Trump campaigned on tax cuts/reform during the 2016 election. The issue of tax reform is also important for the broader Republican Party currently in control of both the House and Senate. Having failed to reform health care, the Republican Party sees taxes as one of their last chances to deliver a meaningful legislative victory before the mid-term elections in 2018. We care about the passage or non-passage of tax cuts because there is likely to be a large market impact in either case.

What is on the table for tax cuts?

The common framework put forward by Republican leadership and President Trump includes: a) a reduction from the current seven tax brackets to three — 12%, 25% and 35%, with the potential for a fourth higher bracket, b) doubling the standard deduction with an increase in the child tax credit, c) a reduction in many itemized deductions with the exception of the mortgage interest deduction and the deduction for charitable contributions, d) repeal of the *estate tax* and *alternative minimum tax* (AMT), e) a cap on the tax rate paid by owners of pass through entities (LLCs, LPs, etc—typically owned by small and family businesses) at 25%, f) a reduction in the corporate tax rate to 20%, g) the immediate expensing of capital expenses at least for the next five years, and h) a one-time incentive for corporations to bring earnings earned and retained abroad back to the US.

The above proposal is estimated to cost between $4 and $5 trillion in lost government revenue over 10 years when scored statically. The Republican leadership claims that this package is revenue neutral when scored dynamically — i.e., assuming that these tax cuts will produce economic growth, and that this growth produces increased tax revenues. Many economists and some Republicans, however, doubt such claims.

What is the timing of tax cuts?

There are 24 days when both the House and the Senate are expected to be in session during the rest of 2017. Also on the calendar competing for time with tax cuts/ reform is a DACA fix, a bipartisan fix for the stress on the health insurance companies now that President Trump ended subsidies, as well as raising the debt ceiling and funding the government. As a result, the end of 2017 is a challenging deadline.

Conventional wisdom is that major legislation does not pass in an election year. This is not entirely true. The Bipartisan Policy Center lists at least five instances in the last several decades when important legislation has passed in an election year. Some think that such legislation is unlikely to pass in a bipartisan manner, given the current environment of polarization. We have sympathy for this point of view, but we are looking for passage here, not bipartisan passage.

We believe that legislation is more likely to pass in Q1 2018 than late in the year when many in Congress are busy campaigning. However, there were instances of passing important legislation late in an election year such as the Civil Rights Act of 1964 passing in July, the Welfare Reform Act of 1996 passing in August, and the Tax Reform Act of 1986 passing in October. So, there are no hard constraints on a late passage of tax cuts, although early passage (Q1) is more likely than a late passage.

Executive Summary

- We think the market is currently pricing in 50% of the potential impact of tax cuts
- We estimate the odds of tax cuts actually passing to be less than 50% with the timing being more likely Q1 2018 than YE 2017
- We believe equity markets could rally 10-15% on the passage of large tax cuts and 5-10% for more modest tax cuts
- In our opinion, failure to pass tax cuts could result in a 10% decline in US Equities
- We believe that if tax cuts pass, it is not clear they will cause large increases in deficits, although modest increases are possible. Therefore the impact on interest rates, while uncertain, is likely only marginal.

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What are the odds of passage for tax cuts?

One needs to consider passage in the House and passage in the Senate separately. In the House, it is very likely that Democrats will vote on party lines, and Republicans will have to depend on their own votes to carry the bill. On the Republican side, there is resistance from some members against "unfunded" tax cuts — i.e., tax cuts that are not paid for in some other way without considering dynamic scoring. At this time, there are 240 Republican members and 194 Democratic members in the House. Therefore the Republicans can afford to lose up to 23 votes and still be able to pass the tax cut bill in the House.

The Senate passed a budget blueprint recently that allowed for a $1.5 trillion increase in the deficit as a result of the tax cut bill. The House passed the exact same blueprint narrowly a few days ago. This means both parts of the Republican party have agreed to allow $1.5trn of unfunded tax cuts. This also enables the Senate to move forward through a process called budget reconciliation, which avoids a filibuster and enables passage with only Republican votes.

The next challenge is bringing the bill for the tax cuts down from the $4-5 trillion estimated under static scoring to the $1.5 trillion that is written into the Senate budget blueprint. Republicans need to "pay" for the extra $3 trn in cuts by removing various deductions such as the ones for state and local taxes, deductibility of interest expense and special tax breaks for various industries, etc.

Each of the deductions that are currently in the tax code have strong proponents / beneficiaries, and their removal will be fought. Therefore it is very possible that some combination of 23 or more Republican congressmen may find the adjustments needed to fund the broad tax cuts unpalatable. Separately, there is also a core contingent of Republican Senators that dislike any increase to budget deficits and do not believe in dynamic scoring. In the Senate, the Republicans can only lose two votes and still pass the bill. On the flip side, tax cuts enjoys broad corporate support and Republicans are very committed to achieving some legislative victory before election season begins.

In the Senate, passage is further complicated by personal animosities between President Trump and some key Senators. Senators Bob Corker and Jeff Flake, both of whom recently announced plans for retirement after 2018 and Senator John McCain who is ailing from cancer have all expressed deep concerns about the President. It remains to be seen if these Senators put aside their dislike for President Trump to vote for a bill that President Trump wants. Remember, on the last healthcare vote, it was Senator McCain who ultimately doomed Republican efforts.

What has the market priced in for tax cuts?

Following President Trump's victory last fall, the market began to price in tax cuts, infrastructure spending and a regulatory overhaul. While stock prices have been rising for much of 2017, the first quick rise between early November and end of December represents this change in expectations. We believe the subsequent rise in stock prices are largely due to improved corporate earnings. We draw this inference from the fact that price-earnings (PE) multiples rose sharply in November/December, while PEs have stayed in a narrow range through much of 2017.

Source: Bloomberg

The bump in S&P PEs through November/December 2016 was about 8%. It is hard for market participants to guess at the probability of a large scale political event such as the passage of a tax cut bill. In such a case, it is rational for the market to move from a 0/100 chance to a 50/50 chance after the election awaiting further information. Thus, arguably a roughly 50% chance of changes to taxes, infrastructure and regulation was worth about 8% for the S&P. We have already started seeing a lot of activity on regulation, but no mention about infrastructure from the Administration.

Please refer to ***important disclosures*** *at the end of this communication.*

What happens to equities if tax cuts "do/do not" go through?

Let's assume we are correct in our analysis that equities rose about 8% on a 50% chance of some combination of tax cuts, infrastructure spending and deregulation. If tax cuts do not go through, the market should give back some of those gains. Since deregulation continues to progress, and since infrastructure has not even come up for discussion, a benign scenario could be a give back of perhaps 5% of the original 8% of gains. Current high equity market valuations and the potential for momentum reversal could cause losses to be larger, say 10-15%.

Even if some form of tax cuts do pass, it's impossible at this stage to know the size of those cuts. There are numerous combinations of tax changes that could be put forward from the earlier list and we know Republicans are actively negotiating with themselves to find something that can pass. It is perhaps simplest to characterize the size of the tax cuts in terms of the additional budget deficit they will create when scored in a static manner. Therefore, a $1.5 trillion budget deficit (resulting from tax cuts) would be a large tax cut. Something below $1 trillion could be small. We suspect a large tax cut would include a reduction in the corporate tax rate to 20% in addition to other cuts to personal taxes, while a smaller tax cut would mean something like a 25% corporate tax rate.

While tax cuts are generally stimulative to the economy, large tax cut could speed a reduction in monetary stimulus by the Federal Reserve. After the election, senior leadership at the Fed indicated that they did not think tax cuts were necessary at this stage of the recovery. It is possible that the Fed may respond by being more hawkish — either raising interest rates faster, or letting its balance sheet run off faster. This could be limit gains in asset prices that one would assume would naturally follow from substantial tax cuts.

On the other hand, we do not yet know who President Trump will choose to be Fed Chair starting in 2018 and realized inflation needs to rise for the Fed's hawkish reaction to be appropriate. Recent Consumer Price Inflation (CPI) data has come in below expectations making it hard for the Fed to justify hiking rates aggressively.

Thus even taking the potential for higher interest rates into account, we think a large tax cut could result in about a 10-15% gain for equities, and a smaller cut could result in a 5-10% gain in equities. We believe the tax cut will benefit equities across several dimensions:

1. They are likely stimulative to consumption and therefore growth especially if key reforms to corporate tax rates are enacted
2. They will directly increase the profits of corporations by reducing the corporate tax rate
3. They will put money in the hands of investors who buy assets (like equities)

This is before we factor in any infrastructure spending (which the market will view as more likely after Republicans show that they can pass some legislation) and other potential knock on effects.

We estimate the odds of any tax cut passing at less than 50% given the divisions within the Republican Party, the likelihood of no support from the Democrats, and the record of failure to repeal the Healthcare Bill. The broad tax reform President Trump and Republicans hoped for appears off the table and even tax cuts are likely to face substantial challenges in the weeks ahead.

What is the effect of tax cuts on interest rates?

Tax cuts likely reduce revenue for the government and force the government to borrow more but whether that has a meaningful crowding-out effect and therefore increases the real interest rate is highly uncertain. Will the yield curve steepen materially on the back of tax cuts as some fear? Actual data shows less connection for these ideas than one might think.

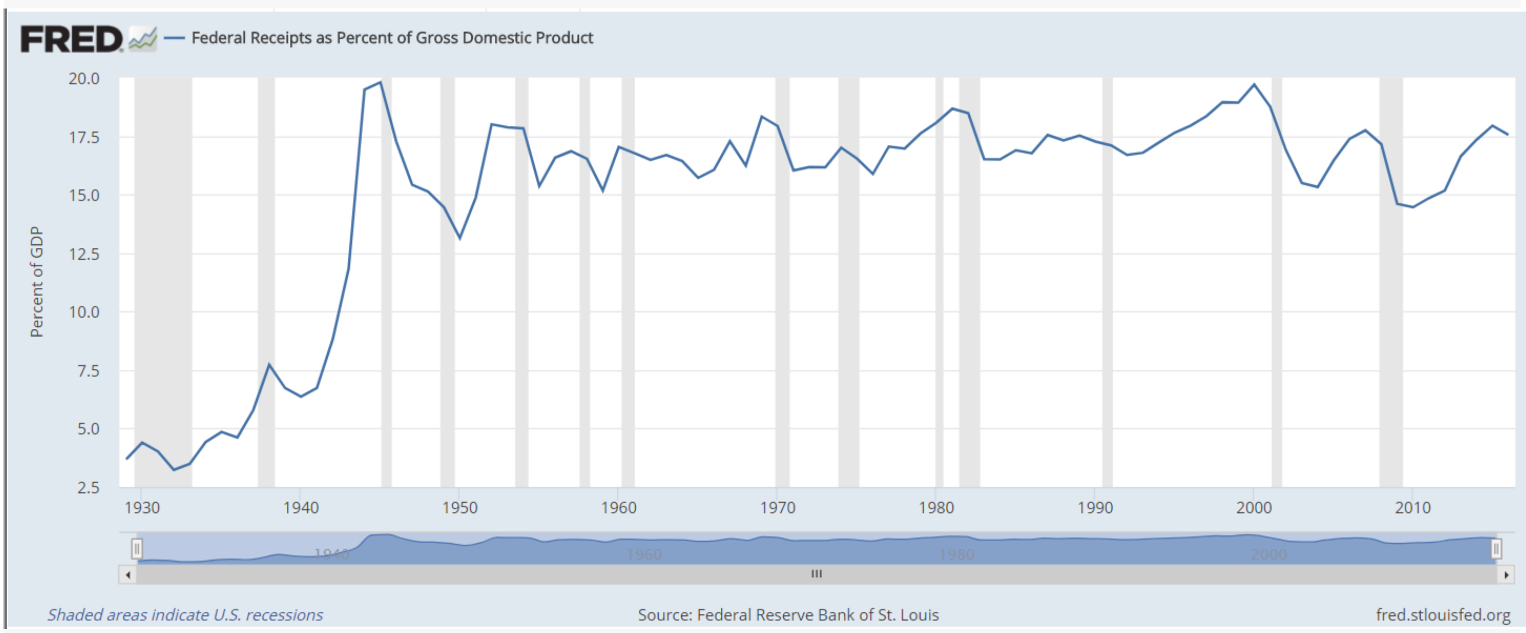
Most of the material changes in government revenues come from recessions. Big tax cuts do not stand out on the below chart for Federal receipts. President John F. Kennedy cut taxes from 90% to 70% in 1961. President Ronald Reagan proposed tax cuts in 1980s but Federal receipts did not fall in the 1980s except for the early recession in 1981-1982. President George W. Bush cut taxes in 2001 and 2003. The tax increase of the senior Bush in the early 1990s also does not show up conspicuously in Federal receipts.

Further, we are not sure if the proposed tax cuts are at a large enough scale to impact federal revenue and the budget deficit materially. Further complicating our analysis, supply-siders often cite the Laffer curve, which predicts that cutting taxes increases economic activity and tax compliance and thus can actually improve federal revenue collection. Often dismissed by economists as Voodoo economics, even in the best case scenario for Laffer the positive revenue impact is almost certainly higher when cutting tax rates from 90% to 70% than when cutting taxes from already low levels. Some argue that when you cut taxes from already low levels, it is a straight revenue loss.

It is possible that the truth is somewhere in between — i.e., there will be some revenue loss, but perhaps not as large as what opponents of the tax cuts suggest.

It is also unclear whether revenue losses and deficit increases result in interest rate increases. The data does not support this conclusion. Deficits and the federal debt have risen since the early 1980s, and interest rate have been in a downward drift since then. In fact, the point in time when the federal debt is at its lowest between 1945 and the present time is the early 1980s, and the early 1980s are also the time when interest rates have been the highest in recorded history. One can also look at Japan which has consistently run a substantial budget deficit to stimulate growth and yet has the lowest interest rates in the world. The United States fiscal deficit is currently at close to a record high and yet interest rates remain near record lows due to low inflation, low growth in developed markets, an increase in demand for yield and a host of other factors . So the link between an additional $1.5 trillion in deficits and higher interest rates is weak.

We think nominal interest rates will remain contained. For example, we would look to fade a move in 10y Treasury yields if they rise above 3%; although, we would be open minded about which instruments we would use to express that view.



Source: St Louis Federal Reserve Database FRED

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