Macro

U.S. tax cuts: Pressure to succeed, fears of failure

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Trump has promised the biggest tax reform ever. We expect considerably less. The bargaining is only starting.

The expectations for the tax reform remain enormous, and so is the risk of failure. After all, U.S. President Donald Trump has promised no less than the "largest tax cut in [American] history" and a "tax reform that will make America great again."[1] He and his Republican allies in Congress are under considerable pressure in this regard. After all, Republicans have been promising tax cuts for eight years now. Despite Mr. Trump's rallying cry "Obamacare: repeal it, replace it, get something great"[2] , they have not achieved anything in terms of healthcare reform, their second large project. Trump's lack of success concerning these two milestone projects probably stings, seeing that he claims that "never has there been a president – with few exceptions [...] – who's passed more legislation, who's done more things than what we've done."[3] And the election calendar is further increasing the pressure, given that Republicans need a legislative success by the mid-term elections in autumn 2018. Then, all members of the House of Representatives and one-third of the Senators will be up for (re-)election.

This last point – Republicans urgently needing something they can present as a success – currently appears to be the main reason why the reform has a chance of being implemented. Just think for a moment about the implications of that fact. Skepticism is obviously widespread. This is even more astonishing as Republicans have a majority in both chambers of Congress and Mr. Trump is someone who claims to be a problem solver[4] who can rely on his Ivy League education, his high intelligence and "one of the great memories of all times."[5] These capabilities would certainly be helpful in dealing with the considerable challenge of a tax reform that is really worth that name. Major tax reforms have always and everywhere been a truly Herculean task, and even well-attuned governments have failed to deliver. In this particular case, there are several additional hurdles:

- According to the budget draft, the tax package is allowed to have a maximum net cost of 1.5 trillion dollars over the coming decade. And several Republicans think that this amount is considerably too high.
- Relations between Trump and several Congress members are tense.
- The Republican majorities in both chambers are small.
- Citizens are considerably less interested in a tax reform than in the healthcare issue. They might still be outraged if the

In a nutshell

- Republicans have long struggled to come up with a detailed tax-reform draft.
- Even as they are edging closer towards a common set of priorities, numerous difficulties still lie ahead.
- Our expectations are modest. If a reform ultimately passes, listed companies should benefit.

[1] https://www.whitehouse.gov/the-press-office/2017/09/27/remarks-president-trump-tax-reform-event
[2] American Airlines Center in Dallas last year, Mr. Trump said, "Obamacare. We're going to repeal it, we're going to replace it, get something great. Repeal it, replace it, get something great!" http://dfw.cbslocal.com/2015/09/14/trump-america-a-dumping-ground-for-the-rest-of-the-world/
[3] http://www.politifact.com/truth-o-meter/statements/2017/jun/13/donald-trump/donald-trumps-boasts-about-accomplishments-office-/
[4] https://www.theatlantic.com/politics/archive/2017/08/full-transcript-donald-trump-announces-his-afghanistan-policy/537552/
[5] Trump said: "I have one of the great memories of all times". See, for example, http://www.telegraph.co.uk/news/2017/10/26/donald-trump-have-one-great-memories-time/

tax reform turned out to be nothing more than a tax cut for corporations and top income earners. However, corporations and top income earners are the most important donors to the Republican Party, and they expect something in return from the government.

Against this background, the term "tax cut" appears more appropriate than "tax reform."

Today (Thursday, November 2nd) the Ways and Means Committee of the House of Representatives is expected to provide a first, more detailed draft of the reform plans. The fact that this had originally been scheduled for Wednesday fits this reform's fate so far and is another sign of the controversies this package stirs within the Republican Party. We therefore believe that this draft will undergo plenty of further changes. Investors at this point thus have to ask three crucial questions:

- Will Congress actually adopt a tax package in the coming months?
- What will be the net impact of this package on economic activity, on interest rates, on the exchange rate and on unemployment in the United States?
- How will the package affect the earnings situation of the S&P 500 companies?

Corporate earnings and the equity market

Most of our readers will probably be interested in the effects on the stock market, which is why we turn directly to the third question. We assume that a tax package adopted at some time in 2018 might reduce the tax burden for the S&P 500 companies by up to $10 for the index as a whole. In our calculations, we have used a relief of $4 and arrive at index earnings of $144 by September 2018. Assuming a target price-to-earnings (P/E) ratio of 18 (the index currently trades at 21x, based on trailing 12-month earnings) suggests that the S&P 500 may stand at 2600 in September 2018.

We expect that the corporate tax rate will be reduced from 35% to 25% (the Republicans are currently aiming at 20%). However, this tax relief will not be directly reflected in the S&P 500 earnings (if it was, earnings would jump by more than $20), as the following factors need to be taken into account: 1. Domestic pre-tax profits amount to approx. 60% of total pre-tax profits. 2. Even today, the effective tax rate for the S&P 500 companies is only at 29%. We expect it to end up in a 21-22% range after the tax reform. 3. Even if taxes are indeed cut, several loopholes may be closed at the same time. 4. We expect that companies will have to pass on part of their tax savings to their customers.

The effect on earnings after tax might be reinforced by new provisions on the repatriation of U.S. corporate earnings held abroad. This might lead to higher equity buybacks. However, much will depend on the details. We believe that earnings per share might rise by up to 1.5% as the number of outstanding shares is reduced.

Effects on economic activity, interest rates and the exchange rate

While forecasts about the impact of the tax cut on corporate earnings are already fiendishly difficult, it is almost impossible to calculate the potential effect on the economy as a whole on the basis of the available data. Only one thing is certain: the maximum new debt cannot exceed $1.5trn over the coming ten years. Even under conservative assumptions, this amount is equivalent to just 0.6% of U.S. GDP.

It is not yet clear how the tax relief will be shared between the corporate sector and households. The government hopes that higher corporate investment and higher household consumption will stimulate the economy. This would require companies not to use the additional cash for higher distributions or takeovers, as they have done in the past few years, and households' savings ratio not to increase after having declined recently. At 3.1% of disposable income, the U.S. savings ratio was very low in the last quarter; only 11 other quarters since 1946 saw a similarly low ratio. This suggests that most of the stimulus will have to come from the corporate side. However, even in our most optimistic scenario, this stimulus would only boost the real U.S. GDP growth rate by one-quarter of a percentage point (at best half a percentage point) over the coming two years.

This means that the tax cut alone (i.e. unaccompanied by additional fiscal stimulus or deregulation) is unlikely to have a significant impact on the interest-rate decisions of the Federal Reserve (Fed). We continue to expect up to three rate increases in 2018. In our view, 10-year Treasury yields will rise to only 2.6% by the end of September 2018. The yield curve is therefore likely to flatten further, reflecting concerns about long-term potential growth among investors. This is one of the reasons why we have become less optimistic about the dollar earlier this year. At the same time, this rate scenario points to another widening of the spread between two-year Bund and Treasury yields, which is why we do not expect the euro to strengthen versus the dollar, either.

If, contrary to our expectations, the tax cut stimulates not the supply, but the demand side of the economy (i.e. private consumption, thus affecting unemployment and inflation), we might even see several unfavorable side effects. The Fed might be forced to hike rates more quickly and long-term yields might rise sooner than expected – a development which should support the dollar in the short term. However, such an outcome might weigh on valuations of other assets, such as equities, and on credit demand as financing conditions become tighter. Again, given the current lack of detail, we hesitate to include the tax cuts in our dollar forecasts. We currently forecast a GDP growth rate of 2.3% for both 2017 and 2018.[6]

[6] In Q4 of each year and in year-on-year terms

Washington procedures – the long way towards the first saved dollar

We could write a lot more about the numerous hurdles which the draft to be presented today by the Republican representatives will have to clear before it might one day arrive on the president's desk. However, we will focus on the salient points.

The history of the tax package already suggests that we are unlikely to see a thorough reform of the tax system as a whole. In order to prevent the Democrats from exercising their influence, the Republicans decided to use the reconciliation procedure to pass the budget for 2018. This means, however, that they may not adopt any measures which would increase the debt burden over a ten-year horizon. While they could circumvent this restriction by limiting the tax relief to ten years, as George H.W. Bush did in his time, this option is not very popular.

In order to advance, each of the two chambers needs to agree on a detailed draft. Then, representatives of the two chambers will meet and negotiate to arrive at a common text. This draft will subsequently have to be assessed by the Congressional Budget Office and approved by the Senate parliamentarian[7]. And this approval is not a foregone conclusion, as the procedure includes an assessment of the (growth) assumptions and of the constitutionality of the budget.

Before all that, however, Congress has to take a vote. And this raises another problem: Republicans have only wafer-thin majorities in either of the two chambers. They need 50 votes in the Senate, but there are only 52 Republican Senators. And at first sight, at least five of them may not be relied upon to vote along party lines: John McCain likes to thumb his nose at party discipline; Rand Paul is skeptical about taking on new debt; Susan Collins belongs to the more moderate wing of the party; and Bob Corker and Jeff Flake do not seek re-election and therefore act more independently. Lately, Flake, Corker and McCain have had plenty of heated exchanges with Trump. The Republicans have 239 seats in the House of Representatives and need a majority of 218 (provided that all 435 Representatives are present at the vote). On 26 October, the tax bill was passed with 216 to 212 votes. It was quite telling that eleven of the 20 Republicans who voted against the bill represent districts in New York or New Jersey. Understandably, these lawmakers oppose abolishing or limiting the deductibility of state and local taxes. Such a change would mostly hit well-off taxpayers in states with high local taxes. New York and New Jersey have relatively high local taxes and Republicans in Congress fear rejection from their voters. The federal government, however, would save $1.3trn over ten years if local taxes were no longer deductible. The provision is therefore key to financing the tax cut.

The dispute gives a foretaste of the upcoming clashes in Congress and of the imminent attacks by a number of lobby groups. For example, the National Association of Home Builders (NAHB), which represents 130,000 residential construction companies, has already

[7] The CBO is an institution which reports to Congress and estimates and reviews the expenses for each fiscal year. The Senate parliamentarian advises the Senate on how to interpret the rules of procedure.

announced that it will fight the draft. According to the NAHB, the draft does not go far enough in keeping mortgages affordable for low-income households.

Competing pressures

The haggling will only intensify, as further details become available. So might conflicts among Republicans within the Senate and the House of Representatives, and between both chambers. Interventions from the White House add another source of uncertainty. And of course, various lobby groups will vehemently try to influence the final package. In the midst of all this, hammering out the many remaining details will not be easy.

Both Trump and his party will need to gauge how voters, as well as donors respond to the tax plans. After all, the mid-term elections are coming up in autumn 2018. And history suggests that, from the turn of the year, representatives will start to become less willing to pass laws which the public does not like. Which, in this case, could happen if voters believe corporates or top income earners are being favored. All in all, we would not be surprised if the reform turned out to be much smaller than current plans suggest. While it might bring some relief to numerous corporates and households, we do not expect major effects on growth, interest rates or exchange rates. And in view of the fact that the U.S. government has not had much success with its projects so far, we cannot exclude the possibility that the efforts might fail completely.

Glossary

Bunds

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years

Democratic Party (Democrats)

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

House of Representatives

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

ObamaCare

ObamaCare is the colloquial term for the Patient Protection and Affordable Care Act, the reform of the health-care industry introduced by U.S. president Barack Obama in 2010.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Republicans

The **Republican Party (Republicans)**, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "the **Fed**", is the central bank of the United States.

United States Congress

The **United States Congress** is the legislature of the federal government. It is comprised of the Senate and the House

of Representatives, consisting of 435 Representatives and 100 Senators.

United States Senate

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

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