Focal Point

US: Markets' tax hopes to be tested in Congress

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- Over the next couple of weeks, the Republican majority in the Congress is set to finalize its plan for tax reforms, calling for large cuts to corporate and income tax rates. The final proposal must strike a balance between the need for results ahead of the November 2018 midterm election and selected aversion for higher deficit within the Republicans.
- The Congress may eventually decide on moderate tax cuts, worth around US$ 1.2 tn to deficit over the next ten years, with only a marginal offset in expenditure, with a 60% probability of success by year end, considering the political outlook. It would lift 2018 growth by 0.3 pp, with a small upside risk to the speed of Fed rate hikes and to bond yields.
- Some of the measures, if implemented, would be favorable to equities short term, adding roughly 6% to 2018 earnings growth, and favoring M&A and buybacks. The fading "Trump trade" seen in recent months could regain momentum temporarily. With valuations of the S&P500 stretched, however, we keep our cautious stance on US equities.

The temporary agreement on the debt ceiling increase reached in September and the steps taken by the Administration and the Congress have raised the possibility of a US tax reform being enacted by the end of the year. However, the economic and political constraints remain quite tight. Therefore, we expect a much milder set of measures than those recently announced to be eventually approved. In what follows, we illustrate these constraints, how they could shape the final measures and implementation odds, and the likely impact on financial markets.

The current proposals look expensive

On September 29, the Senate Budget Committee released the draft of the budget resolution, calling for legislation to reduce federal tax revenues by US$ 1.5 tn over ten years. Last week, the House of Representatives unveiled its version. The two proposals will have to be reconciled into a final bill, which has to be then approved by both Houses by simple majority. Their slim lead in the Senate (52 out of 100) has forced the Republicans to resort to the reconciliation process, which allow changes in the tax code to pass with a simple rather than a 60-seat majority, but constrains the measures to be only temporary (ten years).

The proposed reduction in revenue is meant to allow for the implementation of the proposals set by the White House in September, namely:

- A 15 pp reduction, to 20%, of the statutory corporate income tax rate;
- A cut from 39.6% to 25% of the top tax rate on pass through from corporate to personal income for small firms;
- Full expensing of capital expenditure in the year they are made;
- Move to a territorial system, whereby only profits made in the US are taxed;
- A reduction in the level and the number of personal income tax brackets and a trimming of the top rate from 40% to 35%.

The revenue shortfall is to be financed by limiting the deductibility of interest expenses and the deduction of local taxes and by allowing foreign cash holdings to be repatriated at a preferential tax rate.

According to a recent estimation of the Tax Policy Center, and independent think-tank, the move to a 20% rate on corporate income would cost US$ 1.8 tn over ten years and the full corporate tax package around US$ 2.5 tn.

In the end, we think that the final plan will be far smaller, as political and economic constraints limit cuts and widespread reforms.

Political and economic constraints cap ambitions

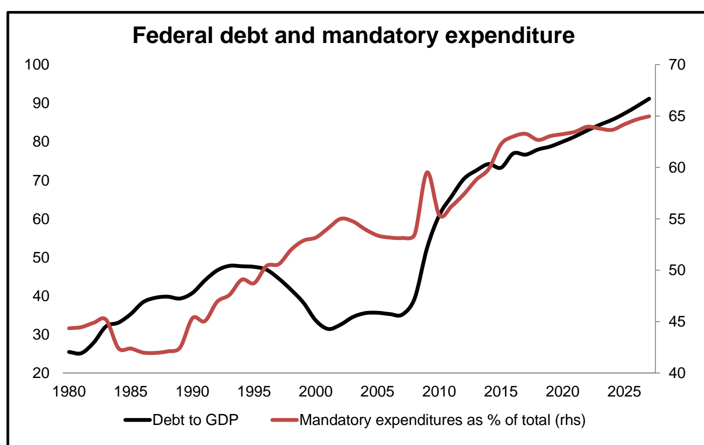
Republican lawmakers have a strong incentive to deliver something tangible ahead of the November 2018 midterm election. That said, the Party is deeply divided on economic matters. Earlier this summer, the opposition within the Republicans sunk the proposal of a border adjusted tax, a way to shift part of the tax burden away from foreign sales to imports. This would have represented an important source of extra revenue.

Political divisions are also likely to rule out another important source of revenue offset, i.e. the limitation or scrapping of the deductibility of local taxes. According to the Congress's Joint Committee on taxation, capping the deduction to 2% (from 100% now) would raise around US$ 1 tn over ten years. However such a move would be highly unpopular as it would increase households' tax bill, affecting Congressmen's chances of reelection.

More broadly, finding sizeable extra resources outside personal taxation would prove hard, as this and social security have by far the highest share of government income (around 80% in 2016).

Another, more fundamental issue is related to the expected fast deterioration in US public finances. According to the Congressional Budget Office (CBO) projections, made in June under current legislation, ageing population will be crucial in driving federal debt from 76% of GDP in 2016 to 89% in 2026. It will also increase the share of social security in total expenditure, making cuts in outlays more difficult politically. Moreover, the Congress is very close to finalize the increase in yearly military expenditure from US$620 bn to US$700 and at least US$ 40 bn will be needed for reconstruction expenses after the Texas and Florida hurricanes. This would add to a deficit that the CBO estimates to increase from US$584bn in 2017 to US$ 693bn in 2018 (or 3.6% of GDP).

Therefore a large plan of mostly unfunded tax cuts is at odds with the traditional Republican push toward a balanced budget and debt reduction. The opposition of the more deficit adverse faction might be soothed by expenditure cuts, but the relative stickiness of government outlays and the proximity of the elections make a sizeable trimming in expenditure very difficult.



Compromise on smaller plan is not a done deal…

The most likely solution appears to be a much less ambitious plan. We think its main elements could be:

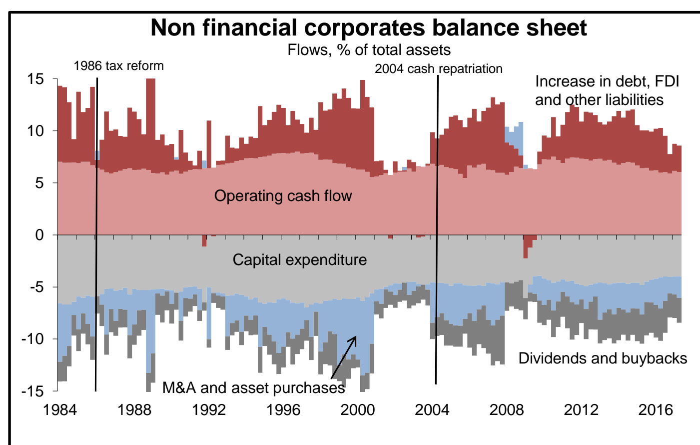
- A 10 pp reduction of the statutory corporate income tax rate, to 25%;
- A 10 pp reduction in the pass through rate, to 29%;
- Reduced taxation on foreign earnings;
- A reshuffling of personal tax rates and benefits, leading to a 0.5% increase in disposable income.

This would be funded only partially by a one-time (temporary) 10% tax rate on repatriated profits (and possibly, minor expenditure cuts) and lead to a cumulative US$ 1.2 tn increase in the federal deficit over ten years. Its full approval is expected no earlier than mid-December.

We evaluate the economic impact with the Fed macroeconometric model. Assuming that these measures take effect in Q1 2018, they would prop up real GDP growth by around 0.3 pp in both 2018 and 2019, being an important driver for growth to accelerate from the 2.1% we project for this year to 2.3% next.

According to the simulations, the impact on unemployment and inflation would be consistent with Federal funds rates only 15bp higher than the baseline and therefore the Fed would not deviate from the three hikes we expect for 2018.

The relatively weak macroeconomic response can be explained by looking at past episodes of significant tax reductions. The extra income (especially in the case of the 2004 repatriation) was mostly spent in M&A, acquisition of financial assets, dividends and share buybacks.



Moreover, even though limited in scope, the implementation of the tax reform plan remains vulnerable to the highly unstable political situation. The discussion could eat up a lot of the limited time (24 working days, at the time of writing) the Congress has until the end of the year. Furthermore, the requirement of a simple majority is not per se a guarantee of success: Reconciliation was also used in the failed attempts to repeal and replace Obamacare.

Therefore, we conservatively keep at 60% our subjective probability of a successful implementation by the end of 2017. A slippage into Q1 2018 remains a distinct possibility.

… but, if approved, would boost equity short term

In this case, the expected pick-up in inflation might be slightly faster, inducing the Fed to proceed more swiftly with normalization, posing upside risk to the three hikes envisaged for next year, and to our forecast on the yield on 10-year Treasuries forecast (2.75% within twelve months). By the same token, the measures would contribute marginally to offsetting USD weakness, expected to reach 1.22 against the EUR in twelve months.

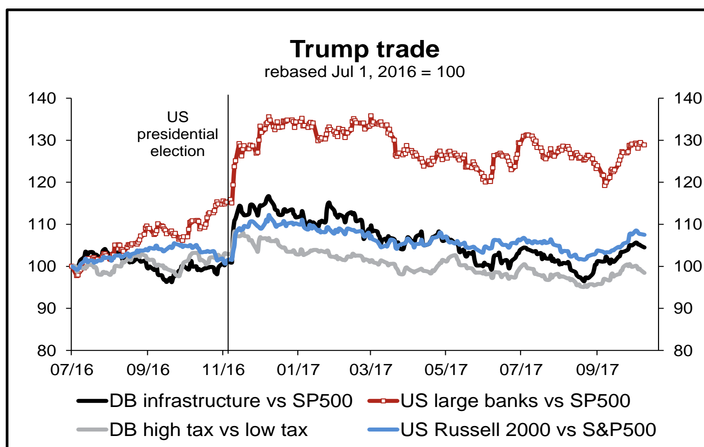
The impact on equity would be more sizeable. Increased confidence in tax reforms being delivered has been indeed one of the factors which have supported US equity since the summer, despite already high valuation, on top of good macro and profit momentum, a weaker trade-weighted USD and higher oil prices.

The two most important reforms on the corporate side (tax cuts and repatriation) could result in an additional net posi-

tive earnings growth of nearly 6% in 2018: +8% due tax cuts minus a 2% tax increase on cash repatriation. Indeed, a nominal 10 pp cut in the statutory tax rate for domestic profits may translates into a reduction in the effective tax rate of around 6 pp (from 28% to 22%), as only 60% of the S&P 500 profits are realized in the US. Such 6 pp tax cut then corresponds to a higher increase in net earnings of nearly 8% (proportionally higher due to the lower magnitude of net profits vs. the pre-tax ones).

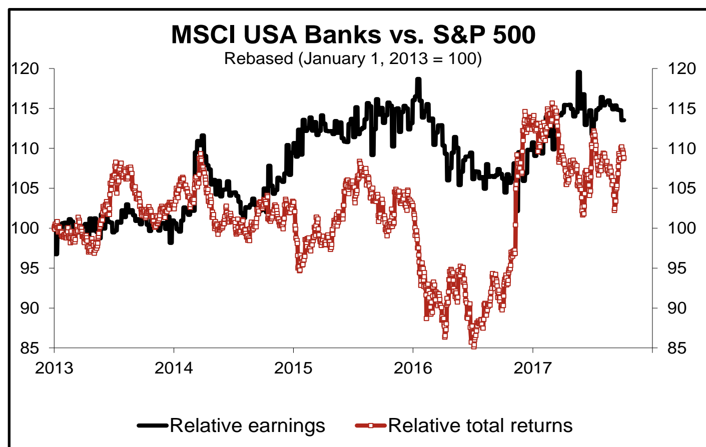
Telecom, utilities and energy to benefit the most

Sectors with a higher tax rate and larger domestic exposure should benefit the most. The impact on earnings would range from around +15% for telecom, utilities and energy to +5% for pharma, IT and materials. For real estate, utilities and oils, estimation is more difficult due to the distortions originating from other specific tax treatments and the fact that their sales are partly subject to price regulation.



Banks (+10% earnings impact from the reform) appear to be fairly priced against the broad index, in terms of both price and earnings performance, and their market multiples show a premium to history of around 15% which is slightly lower if compared to the US index's one: 18.5%.

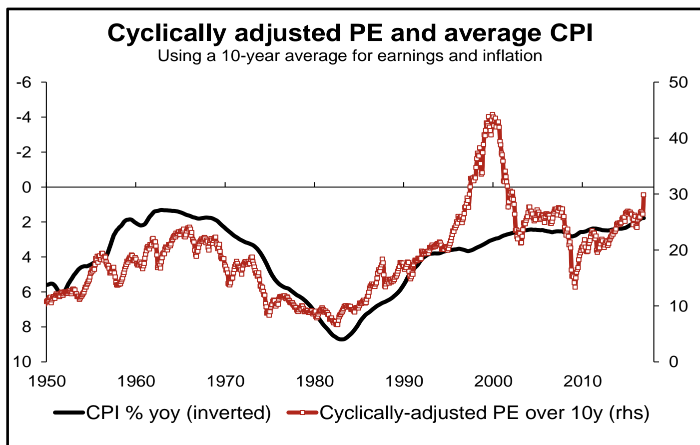
In sum, should the tax reform be approved, banks could continue to perform relatively well vs. the broader US index, especially in a context of higher yields and decent GDP growth. Outperformance would be enhanced by the possible loosening of regulation.



US equities remain an underweight

However, the less ambitious set of tax reform, if implemented, would have only a small macroeconomic impact The reform would spur earnings and market performance, thanks also to the possible impact of M&As and buybacks, but only in the short term. Moreover, even with a 6% earnings boost from lower taxes in 2018, the S&P500 would remain rather expensive and unattractive, especially versus euro area and Japan.

The 12-month PE is as high as 18X and the CAPE or Shiller PE is 30X, close to the highs seen in the last century. Even taking into account that inflation and 10-year real rates are low compared to history, the S&P 500 still shows a potential downside of nearly 5%. This would at best be zeroed by the tax reform.



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