POTUS 45

Investment implications of likely Trump Administration priorities

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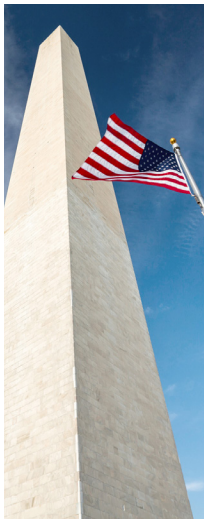

POTUS 45

Donald Trump is the 45th President of the United States (POTUS).

The acronym POTUS came into use by telegraph operators during the late 1800s. The Washington Monument (above) is named for the first POTUS.

Quick guide

The outlook for tax reform

The complexity of the Internal Revenue Code makes it a frequent target for criticism by aspiring politicians eager to hold public office. Nearly every member of Congress supports the concept of tax reform, but enactment requires numerous political compromises among competing interests, which may explain why the last successful attempt occurred more than 30 years ago. President Donald J. Trump has reiterated his intention to reduce taxes for individuals and businesses and thereby stimulate faster economic growth. In this, our second POTUS 45 report, we examine the current policy debate and assess the likelihood that he will be successful in this challenging endeavor.

At campaign rallies, President Trump forcefully argued that his administration would return jobs to America. He focused on the renegotiation of existing trade agreements, the establishment of a more lenient regulatory environment, and the **enactment of tax reform** as the basic pillars of his economic policy. As president, he will retain varying levels of discretion over the first two policy areas. But the third, tax reform, requires active participation by members of Congress in the formulation of legislation. And therein lies the rub.

With the presidency and majorities in both the House of Representatives and the Senate, the Republican Party has the best opportunity to pass major tax legislation in more than two decades. But fractures have already developed between the White House and GOP leadership in the legislature. Speaker of the House Paul Ryan and President Trump both appear intent on lowering corporate and individual income tax rates, but the two have some conflicting views on the details for offsetting revenue.

The absence of agreement on the details of tax reform is likely to prolong the debate and delay passage of legislation. Meanwhile, the repeal

Video Tom McLoughlin discusses this report's highlights. *Click to watch.*

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and replacement of the Affordable Care Act (aka Obamacare) has taken center stage in Washington and may distract members of Congress from efforts to craft a legislative package.

The Speaker's proposal

Paul Ryan has been a tenacious advocate for comprehensive tax reform. He and the chairman of the House Ways and Means Committee, Rep. Kevin Brady, released a legislative framework in June 2016 entitled "A Better Way: a Pro-Growth Tax Plan for All Americans." While President Trump has provided an outline of his plan for lower taxes, the House GOP plan is likely to form the basis of negotiations with the White House over tax reform. Among other provisions, the House plan provides for a reduction in the maximum **personal income** tax rate from 39.6% to 33%. The number of tax brackets would be reduced from seven to three. (See Fig. 1)

Under the GOP plan, the 3.8% Affordable Care Act surtax on investment income would be eliminated and the maximum effective tax rate on dividends, capital gains, and interest income would be reduced to 16.5%. Mortgage interest and charitable contributions should be largely unaffected. The Ryan / Brady plan would curtail or eliminate other tax deductions in favor of a larger standard deduction.

As the American Enterprise Institute pointed out in its assessment of the Ryan / Brady plan, the state and local taxes would no longer be allowable deductions for individuals who choose to itemize.[1] The Congressional Budget Office estimates that the exclusion of state and local taxes would raise approximately USD 669bn from 2018 through 2023, offsetting some of the lost revenue reductions associated with lower personal income tax rates. The House leadership plan also would eliminate the Alternative Minimum Tax and the estate tax.

The ability to reduce personal income tax rates is tied inextricably to the ability to raise revenue in other ways, thereby reducing the impact on the federal deficit. According to the Ryan / Brady plan, the taxation of **business income** would see major changes. Multinational corporations would be taxed only on activity within the borders of the United States (i.e., a territorial system). The maximum corporate tax rate would be reduced from 35% to 20% and would be adjusted at the border. The border tax adjustment (BTA) would benefit exporters by excluding revenue they earn from exporting goods outside the US in computing taxable income.

Conversely, a company reliant on imports would not be allowed to deduct the cost of the imported goods in calculating its taxable income. All else being equal, corporations would be incentivized to identify a domestic source for the goods they sell, rather than importing the item from overseas. The proposal would reward those companies who export their goods and services but penalize others who rely on imports, such as US retailers.

Definition

Border Tax Adjustment (BTA): A border tax adjustment refers to the imposition of a tax on the domestic consumption of imported goods, while simultaneously rebating or exempting goods destined for consumption outside of the United States. In effect, sales to US customers are taxed, while sales to foreign customers are exempt or are rebated. Proponents argue that a BTA would improve the US competitive position in international trade and encourage US businesses to relocate manufacturing facilities or otherwise source their inventory from domestic suppliers. Critics suggest that a BTA would raise prices and reduce consumption, while favoring some sectors of the economy over others. The border tax adjustment, as envisioned by the House leadership, would raise the necessary revenue to offset the impact of lower marginal tax rates.

The GOP plan also calls for a tax credit for research and development but does not provide any detail on how the credit would be calculated. In addition, corporations would be permitted to expense their investments in intellectual property and new property and equipment in the year it is purchased, rather than amortizing this expense over a period of time. However, net interest expense would no longer be allowed as a deduction. We believe the ability to accelerate the capital expenditure deduction would boost corporate cash flow by as much as 8%, but about half of this benefit will go away over time due to the non-deductibility of interest expense. On this last point, smaller companies that have less access to equity financing, and those that are more highly leveraged would face bigger challenges.

In addition to a BTA, which raises substantial revenue to finance the tax cuts, the Ryan / Brady plan also relies on "dynamic scoring" to boost projected revenue and minimize the impact on the federal deficit. Dynamic scoring incorporates the positive impact of future economic growth when calculating the "cost" associated with lower taxes. The Ryan / Brady plan pushes on two levers that are some of the most effective at generating faster growth in economic models – lower corporate tax rates and higher investment spending.

Border Tax Adjustability: A bridge too far?

President Trump expressed concern regarding the Ryan / Brady plan in recent weeks, creating some consternation among members of his own political party. Despite his criticism of US companies that move their manufacturing facilities offshore, and his support for new investment in the US, he described Ryan's proposal as "too complicated." Trump's assessment was reinforced by William Dudley, the president of the New York Federal Reserve Bank. Dudley conceded that a border tax adjustment was well-intentioned, but "probably would lead to a lot of changes in the value of the dollar and the price of imported goods."[2]

So, not surprisingly, the inclusion of a BTA as a component of tax reform has become the subject of a spirited debate inside the Washington Beltway. Proponents argue that its inclusion in any tax reform legislation is necessary because it generates more than USD 1tr in revenue to offset the revenue losses from lower tax rates and levels the playing field in the international marketplace. Detractors, who now appear to include the president, argue that its complexity makes it less appealing than a straightforward reduction in corporate tax rates, regardless of the latter's impact on the deficit. American retailers are adamantly opposed to the concept of a border tax on the basis that it would raise prices and reduce consumer spending.

Companies do not report – and many do not measure – their "imports" and "exports," so the impact of this adjustment is difficult to quantify. While there are similar provisions in countries

Fig. 1: Income tax brackets

Current law	Ryan / Brady plan
10%	12%
15%	
25%	25%
28%	
33%	33%
35%	
39.6%	

Source: Internal Revenue Code, American Enterprise Institute

Fig. 2: Dividends, capital gains, and interest income tax brackets

Current law		Ryan / Brady plan
Ordinary income (including interest income)	Dividends and long-term capital gains	Interest, dividends, and long-term capital gains
10%	0%	6%
15%	0%	
25%	15%	12.5%
28%	15%	
33%	15% + 3.8% = 18.8%	16.5%
35%	15% + 3.8% = 18.8%	
39.6%	20% + 3.8% = 23.8%	

Note: 3.8% ACA surtax does not apply to municipal bonds.
Source: Internal Revenue Code, American Enterprise Institute

with a domestic Value Added Tax (VAT), in those cases the BTA is intended to level the playing field for imported goods. The US does not have a VAT, so the World Trade Organization (WTO) could view the BTA as a punitive tariff designed to promote US exports.

Definition

Repatriation tax US-based multinational firms do not pay US corporate taxes on foreign profits until they are "repatriated" to the US. In order to take advantage of this policy, firms have used accounting practices and structured their businesses to report more profits overseas. The proposed "deemed repatriation tax" would apply a one-time tax to US-based multinational firms' foreign profits (even if they don't bring the profits to the US), but at a lower-than-usual corporate tax rate. Deemed repatriation could boost both S&P 500 earnings and tax revenue, positioning it as a potential "win-win" in corporate tax reform negotiations.

Bottom line

The net result is an uncertain environment in which political opposition to key elements of tax reform will prolong debate and potentially delay passage. Republicans in the House will support legislation to lower taxes but also are expected to demand constraints on deficit spending. House leaders are adamant that a BTA will remain part of the tax reform plan but, to the extent that border adjustability is abandoned, lawmakers will be obliged either to identify other ways to offset the cost associated with lower tax rates or tacitly accept a higher deficit.

The senate, meanwhile, has been relatively silent on the prospects for tax reform, instead watching the results of negotiations between the new administration and the House leadership and monitoring the public's response. While we still foresee substantive changes to the tax code as the most likely outcome, this may well entail a less ambitious package than originally proposed and a longer timeline for implementation.

The 'levers' of corporate tax reform

The table below highlights the policy tools that the Trump Administration and Congress are considering, and how those tools are likely to affect markets.

	Current	Trump proposal	Ryan / Brady plan	Likely compromise	Market impact
Corporate tax rate	35%	15%	20%	20–25%	Without offsetting adjustments, lowering the statutory corporate tax rate to 25% would **boost profits by 8–9%**,[3] but the impact's magnitude will depend on offsetting adjustments and the size of deficit expansion. **Biggest winners include the telecom, consumer discretionary, and financials sectors**, which boast a combination of above-average effective cash tax rates and higher levels of domestic exposure.
Repatriation	N/A	Yes; 10% tax rate	Yes; 8.75% rate on cash, 3.5% rate on other earnings (paid over eight years)	Yes	With around USD 2.6tr of non-repatriated overseas profits for US corporations, a "repatriation tax holiday" would likely provide **a 3–4% boost to S&P 500 earnings. Primary beneficiaries are technology, healthcare, and industrials stocks**, which collectively represent about 70% of the overseas cash hoard.
Other provisions	N/A	Some	All	Some	
	While the other two "levers" of corporate tax reform are fairly broad-based and skewed to upside risks, these adjustments pose a more balanced impact for the market, with more distinct winners and losers.				
	– Immediate expensing of capital expenditures				Capital-intensive businesses such as **energy, telecom, materials, and industrials** stand to gain the most. Regulation would limit any earnings gain for the utilities sector.
	– Reduced interest deductibility				This change would increase the overall cost of capital, providing a headwind for equity valuations and **particularly hampering sectors with higher debt costs (such as commercial real estate, telecom, industrials, materials, and consumer discretionary)**. Financials would likely be exempt from this change due to the nature of their business. Regulation would tend to limit the utilities sector earnings impact.
	– Border tax adjustment				The current global structure of the US corporate income tax system has encouraged firms to move production and intellectual property overseas to be taxed at lower tax rates. This proposed tax would attempt to remove this incentive in an attempt to encourage US-based production. Firms do not currently measure or report "imports" and "exports," so the proposal's impact is somewhat difficult to measure, but the US is a net importer so this has broad-reaching implications. Domestically oriented firms that rely on overseas production, such as **manufacturing, retail, and technology, could be particularly vulnerable**.

Source: UBS, as of 25 January 2017

Implications for US equities

Bipartisan support for the concept of tax reform has been an important impetus for the 6% rally in the S&P 500 index since the election. We believe that enactment of a corporate tax reform package could boost S&P 500 earnings per share (EPS) by an additional 5–15% over the next couple of years. Consider that every 1% reduction in the corporate tax rate boosts S&P 500 profits by approximately 0.85%. While we readily concede that this estimate disregards the possibility of offsets (such as the exclusion of interest as a deductible item or the BTA), the prospect of lower taxes has been an important stimulus and enactment will likely validate investor expectations.

The GOP could prompt the repatriation of $700 billion, adding 3.7% to S&P EPS.

Unlike border tax adjustability, the repatriation of profits held outside of the US enjoys broad support among members of Congress. Under current law, American companies can defer the payment of taxes on profits that remain outside US borders, which totals about USD 2.6 trillion. This is comprised of USD 1tr of cash and USD 1.6tr that has been reinvested back into overseas operations in the form of illiquid property plant and equipment.

Both Speaker Ryan and President Trump have expressed their support for "deemed" repatriation, so the overseas profits would be taxed at a lower rate even if the cash is not returned to the US (which only adds to the incentive to bring the cash home). Based on our calculations, the GOP could prompt the repatriation of USD 700bn, adding 3.7% to S&P 500 EPS (if the cash was used for share buybacks). Trump's proposal, for which we have fewer details, could stimulate return of approximately USD 600bn. This would add 3.2% to S&P 500 EPS, using similar assumptions.

Corporate treasurers can deploy repatriated cash in one of four ways: investment in new plant and equipment; stock repurchases; acquisitions; or debt retirement. Regardless of which alternative is chosen, we believe that US companies will likely earn a higher return than they are currently earning on low-yielding liquid assets, hence the source of the upside to our S&P 500 EPS estimates and share prices.

Recommendations

- We retain an overweight on US equities and believe that tax reform will be a positive driver of higher earnings.
- Avoid increased exposure to US retailers until the details of the tax reform legislation are known with certainty.
- Exercise a preference for technology companies that stand to benefit from the repatriation of overseas profits and may be a target for future acquisitions.
- Share prices of pharmaceutical companies have been beaten down by critical comments from President Trump but are also poised to benefit from repatriation and lower tax rates.

Implications for US fixed income

Under the existing US tax regime, corporations are incentivized to raise capital through the sale of bonds and other types of debt instruments. First and foremost, the use of debt does not dilute the position of existing owners of corporate equity. Second, a corporation's net interest expense may be deducted from its tax liability. Tax reform has the potential to meaningfully influence the corporate credit market by reducing a corporation's motivation to borrow.

We expect to see lower supply for non-financial companies in the wake of tax reform.

Reducing corporate tax rates, or eliminating interest expense as a deductible line item, lessen the incentive to incur debt by raising the cost of capital on an after-tax basis. The same holds true for repatriation as corporations with cash parked overseas may borrow less if they can repatriate it back to the US with a minimum tax liability. We expect to see lower supply for non-financial companies in the wake of tax reform, as issuing debt to fund share buybacks becomes more expensive and net interest potentially no longer deductible.

In terms of the supply reduction from repatriation, issuers with the largest overseas cash raised roughly USD 200bn in debt last year, slightly less than 20% of total institutional grade (IG) issuance. So while supply may incrementally decline, it shouldn't negatively alter market liquidity. We also expect healthy investor demand, so prices should be supported. Under this scenario, the IG debt market would grow larger over time but a reduction in the pace of growth would be a welcome development.

The fundamental credit implications are mixed. Consider the following:

- On the positive side, a reduced corporate tax rate would boost companies' profits and after-tax cash flows. With less incentive to borrow, tax reform is also likely to result in a gradual reduction of outstanding debt in the market.
- On the other hand, the possible loss of interest deductibility could lower the after-tax income of some corporations. This would create strain for more highly leveraged / lower-rated companies that bear the burden of higher interest costs.
- We do not expect US companies to reduce debt at an accelerated rate, however. The 2004 tax holiday showed that companies did not slow the pace of capital returns. Rather, they used their repatriated funds primarily for share buybacks given the fungible nature of cash.[4]
- While the Ryan / Brady proposal would eliminate state and local taxation as a deduction, municipal bond tax exemption appears less susceptible to limitation. While the situation remains fluid, we have a higher degree of confidence in the retention of tax exemption than we did just three months ago.

Recommendations

- We recommend that investors favor corporate debt from fundamentally strong issuers. Corporations with weaker fundamentals will be at a relative disadvantage if the tax reform package disallows interest as a deductible item.
- We recommend that holders of investment grade bonds retain their positions as the technical outlook for the market appears positive.

Priorities and impact

	Tax reform	Regulatory relief	Spending initiatives	Global engagement
Overview	**Expect a reduction in the corporate tax rate from 35%.** Proposals for the new rate: 15% (Trump) and 20% (Ryan), but 20–25% is more likely. Other reforms could include accelerated depreciation of capital expenses, reduced interest deductibility, and a border adjustment that taxes sales based on final destination (an advantage for exports over imports). **A tax break on the repatriation of foreign earnings is most likely** – it has bipartisan support and generates revenue. House Republicans will push hard, but legislation might not happen until August 2017 or later, due to complex negotiations. **Lowering and simplifying personal income tax rates is also a goal**, but may be difficult to achieve this year.	Relief is likely to come in three forms: rescinding of executive orders; passage of new legislation; and a selective defunding of agencies. Presidential action is likely to occur quickly as it is an easy win. **Congress can also overturn recently issued regulations** under the Congressional Review Act. Repeal and replacement of Obamacare is a priority, with a focus also on energy and environmental-related regulations (possible withdrawal from the Paris Climate Agreement), and an overhaul of Dodd-Frank. Congress will look to reform the federal regulatory process, requiring congressional votes on certain regulations from the executive branch.	President-elect Trump has mentioned a USD 1 trillion infrastructure spending package over ten years, as well as a boost in defense spending. **Actual spending is likely to be more modest, around USD 400 billion** over ten years. The Administration appears to be focused on public-private partnerships and tax credits tied to repatriation of foreign earnings to pay for the package. Consequently, the plan may only get Republican support. A new infrastructure program could be dealt with through the budget reconciliation process in 2017, but that could require other spending cuts. A more likely timeline is early 2018.	Donald Trump is committed to putting the interests of US citizens above those of non-citizens. The Administration is also looking to "reset" US foreign policy to favor US priorities over global interests. On trade, the Administration is likely to take a much harder line with trading partners. The White House has already indicated a desire to negotiate NAFTA. This could also include bringing complaints before the WTO, **labeling China a currency manipulator**, and antidumping and countervailing duties on particular imports. The President has limited ability to impose new tariffs. For immigration, Trump is apt to more aggressively enforce immigration laws and actively seek the deportation of illegal immigrants.
Prioritization	High	High	Low / medium	Medium / high
Expected timing	Summer / fall	Immediate and ongoing	Late 2017 – 2018	Immediate and ongoing
Probability	High	High	Low / medium	High
Economic implications	**Modest boost to GDP growth** from corporate tax reform (<0.5ppt and not until late '17/early '18). Small but positive impact on inflation. Fed stays on pace for two rate hikes in 2017, with upside risk. Full border tax adjustment is unlikely, but could be inflationary and cause dollar appreciation.	Specific areas of the economy may get a significant boost, but the **aggregate impact on growth is likely to be modest in the near term.** Over the longer term, reforms could lead to faster productivity growth, which can be disinflationary.	Positive for growth, but **the GDP impact should only be 0.2–0.3ppt** if annual investment is USD 40 billion. Reinforces the rising inflation trend, with a faster-than-expected pace if the spending is closer to USD 100 billion annually.	Increased trade barriers are a negative for growth and could overwhelm the potential benefits of increased domestic production. **They should also be inflationary**, especially for consumers and businesses more reliant on imports.
Investment implications	Positive for US equities. **Foreign earnings repatriation could boost S&P 500 EPS by 3–4%.** Reduction of corporate rate to 25% could boost profits by 8–9%. Domestically-focused companies benefit the most.	**Initial benefits are likely to be concentrated in specific sectors**, with energy, healthcare, and financial services most directly impacted.	Benefits of additional spending are likely to be concentrated in certain companies. US **infrastructure-related stocks appear to be already pricing in USD 300–400 billion of spending** over ten years. This supports our expectation that rates are likely to rise gradually.	The Administration may support a lower dollar to reduce the trade deficit, against a long-standing "strong dollar" policy. However, **the dollar would likely appreciate if global trade tensions escalate.** Trade restrictions are bad for equities, especially globally-focused companies.

Recent developments

President Trump hit the ground running after his inauguration with a spate of executive directives beginning within hours of taking the oath of office. Many of these changes signal a u-turn on aspects of President Obama's legacy:

- Withdrawing the US from Trans-Pacific Partnership (TPP) negotiations
- Reopening the North American Free Trade Agreement (NAFTA) to renegotiations
- Advancing the Keystone XL and Dakota Access oil pipelines
- Directing federal agencies to loosen enforcement of the Affordable Care Act
- Instituting a government hiring freeze for civilian agencies
- Reinstating the "Mexico City policy" restricting funding for federal aid to non-governmental organizations (NGOs) that perform or promote abortions or sterilization procedures
- Outlining new restrictions on refugee admissions
- Paving the way for bolstering border security and immigration enforcement, including construction of a border wall

Endnotes

[1] Alex Brill, Tax Reform: Ryan-Brady is a Better Way, American Enterprise Institute, October 2016.

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[3] "US equities: 2017 outlook: Profits to pick up, pressure on policy to pounce", UBS, 16 December, 2016

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