2 October 2017

United States: $5.8 trillion tax reform could prove disappointing

Tax reform has finally been announced. Economic growth is strengthening. Fed balance sheet normalisation begins. Rise in rates and the US dollar. High risk for equities.

Key points

- In the end, corporate tax will be set at 20% instead of 35%
- Income tax reduced; maximum rate decrease from 39.6% to 35%
- Donald Trump's tax reform could cost the state US $5.8 trillion
- GDP growth shows that the trend picked up the pace in the 2nd quarter
- Leading indicators confirm that consumption is doing well
- A little more patience is needed to see inflation head above the Fed's target
- Boost to the upward trend on long rates
- Favourable environment for the US dollar
- The Fed is taking a softly-softly approach to normalising its balance sheet, and will raise rates in December
- Could the S&P 500 benefit from the announced tax reform? "Buy the Rumor, Sell the News"?

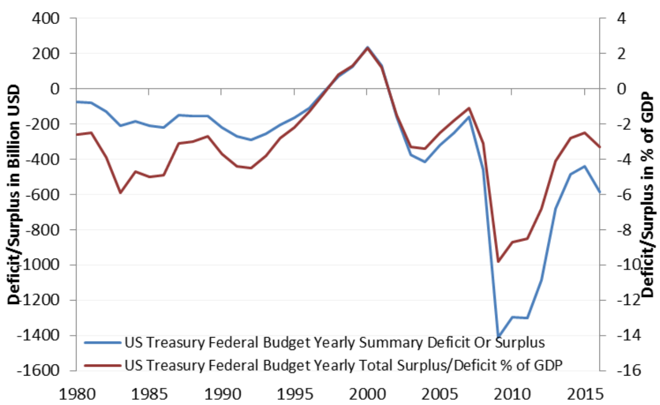
Donald Trump's tax reform could cost the state US $5.8 trillion

In the end it will be 20% instead of 35%. Donald Trump needed nine months in the White House before being able to announce a plan setting out a historic tax cut. The recovery policy that had been announced aimed to stimulate demand, reduce tax and increase public spending, however, it now seems to be limited to a plan touted as very ambitious, but which has left the country very much divided for a few days now.

The aim behind the tax reform was to rekindle purchase power and create jobs. The plan, concocted by a working group exclusively made up of six White House and Congress representatives, has two pillars. The first is corporation tax, with the rate dropping from 35% to 20% in the end, bringing it close to that of many other industrialised countries. The second pillar is income tax, rates of which have been reduced, mainly by increasing tax allowances and reducing tax brackets. The top bracket is dropping from 39.6% to 35%. A flat rate of 25% has also been introduced for entrepreneurs.

With this, Donald Trump has announced measures that will cost the state around US $5.8 trillion dollars, without including countervailing measures. The US deficit would increase government debt by that same amount without such measures.

US Treasury Budget Deficit



Sources: Bloomberg, BBGI Group SA

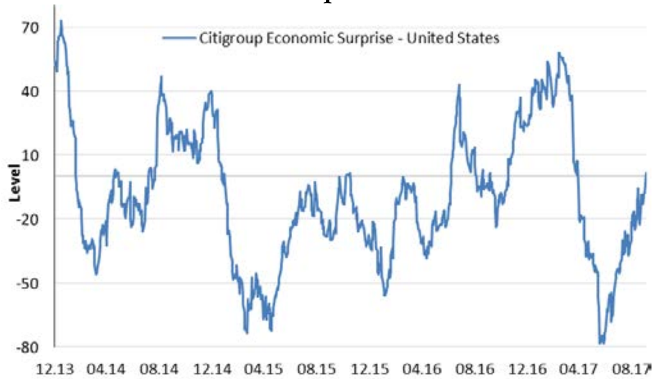
The US Senate Committee on the Budget had agreed on a US $1.5 trillion increase over ten years, which is a very far cry from the Committee's estimate of the US $5.8 trillion cost over twenty years for this project. For the time being, the official version given by the White House's economic adviser explains that these tax breaks would be paid for with the extra growth achieved by GDP growth above +3% over the coming years. Gary Cohn stated that an extra percentage point of growth could generate US $3 trillion over ten years. This argument will undoubtedly be considered extremely optimistic and will soon meet with criticism from the US Congress, despite Republicans holding a majority. Notwithstanding a Republican majority in both Congress and the Senate, Donald Trump has not managed to repeal Obamacare or pass any major draft bill since being elected.

The hotly anticipated tax reform bill is already very divisive in terms of the potential social and economic consequences of the reform, which is the first since the last amendment to the tax code in 1986.

GDP growth showed the trend picked up in the 2nd quarter

After disappointing growth in the 1st quarter and a drop in the economic surprises indicator in the months that followed, we set out the arguments pointing to an economic recovery in the 2nd quarter, which would contradict the rather more unsteady global sentiment that prevailed at the time. The revision of growth forecasts went hand in hand with fresh uncertainty and the risk of the US economy potentially heading back into recession. At the time, we highlighted the fact that the fall on the economic surprises indicator did not point to any significant erosion of economic conditions in the United States, instead underscoring the perhaps excessive optimism in the short-term on the part of forecasters.

Economic Surprises Indicator



Sources: Bloomberg, BBGI Group SA

As such, we were expecting a recovery in the 2nd quarter, which did indeed materialise in the form of considerable GDP growth of +3.1% year on year. Naturally, this performance came in above consensus forecasts. Thanks to this growth, US economic activity has received a very significant +2.2% boost year on year, which is the best result since 3rd quarter 2015. The Federal Reserve's growth target for 2017 was +2.4%; this target should be hit providing that the economy proves sufficiently robust for GDP to grow +2.6% in the second half of the year. Over the period, growth has been mainly driven by consumption, which made the largest contribution (+2.24%), followed by investments (+0.53%) and net exports (+0.21%).

US consumers should take comfort in the influx of positive economic news in the second half of the year. In this context, we believe that +2.6% GDP growth is likely.

Leading indicators confirm that consumption is doing well

The Chicago Purchasing Manager Index is heading towards its highest level for ten years. The ISM Manufacturing Indicator hit a new record of 60.8 in September – its highest level for ten years – and was mirrored by the indicator for new orders (64.6). American consumers are optimistic; Conference Board data still showed high levels of consumer confidence in September, despite the fact that prospects were considered slightly less favourable. The same story was reflected in the University of Michigan sentiment indicator.

GDP and PMI

Sources: Bloomberg, BBGI Group SA

Leading indicators are taking off, very much pointing towards a stepping up of economic activity in the second half of the year.

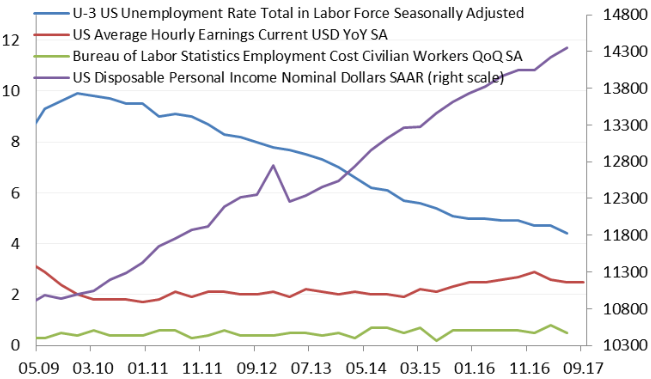
Consumer Confidence

Sources: Bloomberg, BBGI Group SA

The +2.8% rise in personal income certainly helped to boost household spending, which was up +3.3%. The labour market remains in good shape and continues to improve, with unemployment rates close to full employment at 4.4%. Disposable household income should rise again over the coming quarters, along with labour costs.

In the short-term, employment figures have been rather skewed by the consequences of hurricanes, but the situation on the labour market is fundamentally positive. The unemployment rate has stabilised (4.4%), and now sits at below pre-2008 crisis levels. In time, this should provide stronger support for increases in wages and household spending.

Unemployment, Disposable Income, Labour Costs, Salaries

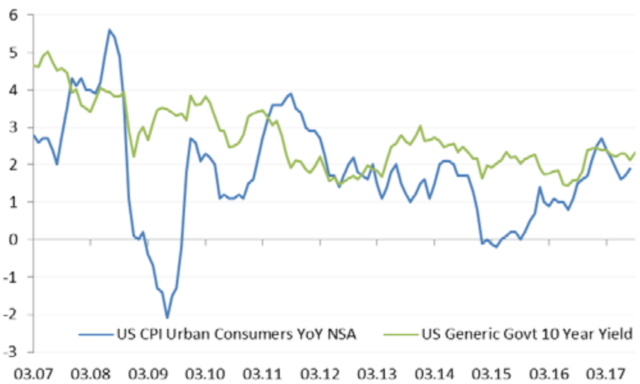


Sources: Bloomberg, BBGI Group SA

Inflation will soon surpass the Fed's target

Pressure on salaries is struggling to make itself felt despite a constantly improving labour market. Contrary to theory, inflationary pressures are still weak, although the unemployment rate is falling regularly, and heading towards 4% and therefore full employment. These observations are of concern for investors and the central bank. However, the Fed remains relatively calm and convinced that there is still a link between employment and inflation, even though the Phillips curve seems much flatter for the time being than before.

Inflation 10-Year US Treasury Bonds



Sources: Bloomberg, BBGI Group SA

In August, inflation came in slightly under the +2% target (+1.9%), while import prices gained +2.1% year on year, which is significantly less than in February, when the yardstick had been considerably affected by crude oil prices. It is likely that the fall of the US dollar in the first half of the year has had some positive consequences for imported inflation. Equally, future inflation at between 1 and 10 years remains close to 2.7%. Inflation should soon head back above +2%.

Long rates recover to upward trend, favouring the US dollar

After an expected short-term consolidation of long rates in the relatively soft context of the 1st quarter, our forecasts for the 2nd quarter indicated a recovery of the upward trend, propped up by an influx of more robust economic data. Specifically, we underscored the fact that the 10-year Treasury rates' correction from 2.6% to 2.1% did not seem at all compatible with our forecasts of a +3.1% bounce back in economic activity and normalisation of monetary policy. We believed it very likely we would see a further boost to long rates in the second half of the year. This is now in part the case, with long rates increasing to 2.6% at the end of the quarter.

We are not altering our forecasts, and expect the trend to continue, potentially bringing interest rates up above 2.8% by the end of the year.

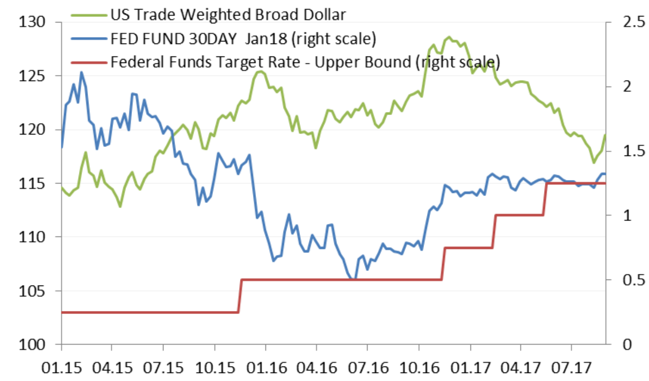
The macroeconomic context certainly provides grounds for new tension on long rates, which should be magnified by the announcement of the start of normalisation of the Federal Reserve's balance sheet. In this context, we can find no grounds to justify the weakness of the US dollar over the past nine months. The roughly -8% depreciation of the trade weighted USD index against a basket of currencies should correct relatively quickly, unless prospects of a deterioration of public finances linked to tax reform pull the US dollar down.

The US dollar should find favour with investors again and bounce back above parity with the Swiss franc.

The Fed is taking a softly-softly approach to normalising its balance sheet, and will increase rates in December

The latest Federal Reserve meeting provided an opportunity to unveil the balance sheet normalisation policy which should begin in October. Unsurprisingly, the Fed announced a programme to reduce its balance sheet that is so extremely restrained as to be almost imperceptible. Indeed, the monthly caps initially set at US $6 billion for Treasury Bonds and US $4 billion for MBS are symbolic sums given the current size of the balance sheet (4.5 trillion). However, these caps will be gradually increased within a year, up to definitive limits of US $30 billion (Treasury Bonds) and US $20 billion (MBS). In parallel, the key rate target (Fed Funds) remains unmodified at 1-1.25%; this situation will undoubtedly change in December. The bank is thus declaring the start of the second phase of its monetary policy normalisation.

Fed Funds, Key Rates and Trade Weighted Dollar



Sources: Bloomberg, BBGI Group SA

Could the S&P 500 benefit from the announced tax reform?

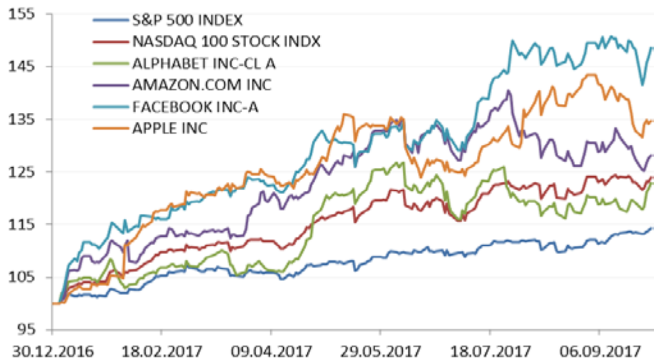
After nine months waiting and a +20% rise in US equities, the hotly anticipated announcement of tax reform came at long last. Since the election of Donald Trump, US stocks have benefited from positive macro- and micro-economic fundamentals, as well as forecasts of increasing profits, which were hoped for as a direct result of and promised as part of the change in tax rates.

For now, published profits are rather positive and could very much stand to benefit from this tax change in 2018. At this juncture, mention is often made of the considerable profits reaped by American multinationals abroad, which could be repatriated and divided up amongst shareholders as dividends if this tax measure is adopted.

The OECD estimates them at US $2.6 trillion. In theory, this should be enough to sustain interest in US equities, but is it really such good news for the stock market trend?

After nearly a year of speculation as to the outlines of this reform, it is finally public and open to analysis. Still hot off the press, it is already dividing observers and politicians before it has even been presented to Congress or the Senate. A few weeks ago, we were concerned about the weight of the GAFA web giants in overall S&P 500 performance in 2017. We pointed out that this craze had pushed up valuations exponentially, to levels probably unsustainable in the short-term. This suggested there would soon be a change in investor psychology towards them and made sectoral rotations likely. Any future rise on the S&P 500 was therefore dependent on prospects of a profit growth cycle recovery.

S&P 500, Nasdaq and GAFA



Sources: Bloomberg, BBGI Group SA

The rise on equity markets most probably already incorporates the positive impact of tax reform on profits. We have chosen a cautious approach at a time at which profit taking could cast a shadow over the announcement of reform, recalling the adage "buy the rumour, sell the news".

BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae