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New Tax Plan Offers Promise and Inevitable Battles

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Since last November's election, the S&P 500 is up nearly 20% including dividends. While the economy and various other indicators remain solid, much or most of the market's rise has likely been driven by the "Hope Trade", meaning expectations that new legislative efforts would spur economic growth. In spite of the Trump administration's public relations struggles and failures in achieving health care reform, investors have remained relatively unfazed as the hope trade's primary focus remains on tax reform. On September 27, investors got their first look at the tax proposal, and impressions gleaned from a quick read and multiple sources are fairly good. Essentially, the ambitious plan offers meaningful change, and, as importantly, is conceived in a manner that has a reasonable chance of political and implementation success.

As importantly, Republicans need a victory to run on during next fall's midterm elections. Ideally, Republicans would love to complete tax reform by the end of this year, but more realistically, they are shooting for April of 2018 with a possible fallback position of late summer. Success is highly possible in spite of the challenges because Republican leadership at all levels has been very open about its willingness to apply far more pressure in securing tax reform than health care. Failure for Republicans on this effort would be catastrophic.

The plan's goals are ambitious. It seeks to cut corporate taxes from 35%, the highest in the developed world to 20%, the lowest. Pass-through businesses, the structure used by most smaller businesses, would see their rate plummet to 25% from a current level of 39.6% applicable to most companies. Individual tax brackets would be reduced to three at 12%, 25% and 35% with a possible higher rate for the highest income households. Personal tax deductions would double and refundable tax credits for childcare and dependent care would expand. Businesses would be allowed to accelerate expensing of investments which should spur economic activity, and companies with foreign earnings would be given a one-time exemption allowing them to repatriate offshore dollars.

A couple key deductions remain untouched. Mortgage interest deductions for individuals on loans up to $1,000,000 is the same, and charitable giving also was left as is.

To pay for the changes, the largest single new revenue sources comes from the elimination of state and local tax deductions, a non-issue if you live in Florida or Texas, but a big blow to high income tax states such as California, New York and Illinois. Fixing bad tax policy that forces individuals in low tax states to subside others living in high tax states is good economics, but it's historically been politically difficult because the change impacts so many people in powerful states. This time around, however, the combination of Republicans pushing the plan and mostly "blue" states suffering the negative consequences make the change a likely core component of raising revenue.

If the plan is adopted anywhere close to its current outline, the impact would be enormous. In June, Morgan Stanley's Chief Executive James Gorman stated that a 25% corporate tax rate would raise his bank's earnings by 15%, assuming no changes to the business mix. Given the current proposal of a 20% rate, the benefit would be greater, possible over 20%.

Analyst John McDonald at Sanford Bernstein estimates that a cut to 25% plus the proposed repatriation

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tax holiday on foreign earnings would boost Citigroup's annual net income by $800 million, or about 5% while also improving the bank's return on equity by more than a full percentage point. Smaller banks would likely reap even bigger rewards because their effective tax rates are higher and their businesses are normally all domestic.

In spite of the fairly widespread optimism regarding the strength of the plan and its potential success – at least by Wall Street and Investors – its release barely moved the equity market, likely because expectations have been so high. Successful implementation might justify the currently high stock market valuations and even drive stocks higher, but failure to enact meaningful change would likely result in a significant correction. Without a successful tax overhaul, investors are facing both an expensive U.S. stock market without a catalyst to dramatically raise growth and a Federal Reserve that has already outlined its intentions to raise interest rates and reduce its $4.5 billion balance sheet left over from the financial bailout.

Beyond policy changes, U.S. economic output grew at a higher than expected 3.1% annual rate in the second quarter, marking the fastest pace of growth in two years. Economic output is expected to fall to between 1% and 2% in the third quarter before rebounding in the year's final quarter as regions rebuild after the hurricanes, businesses continue to increase spending, and the global economy strengthens. The economy remains strong with both consumers and business increasing spending.

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Corporate profits are up 7.4% from a year earlier and exports are also increasing as global growth boosts U.S. manufacturing.

In trade talks with Mexico and Canada on the North American Free Trade Agreement (NAFTA), little has changed, suggesting that U.S. President Donald Trump's protectionist threats still have more bark than bite, which bodes well for all three economies.

Europe's economy continues to strengthen, resulting in economists increasing their growth projections. The European Central Bank believes the economy will grow more rapidly in 2017 than it has in a decade. Data firm HIS Market reported in mid-September that its composite Purchasing Managers Index for the eurozone based on survey responses from 5,000 manufacturers and service providers rose to 56.7 in September from 55.7 in August. A reading above 50 signals an increase in activity and the high level surprised economists surveyed by The Wall Street Journal.

The ongoing economic expansion both here and abroad, although historically feeble, is partially making up for its weakness via duration. The U.S. economic recovery which began in mid-2009 will hit 100 months at the end of September and would break the all-time record of 120 months if it continues through June of 2019. Economically, much remains to buoy the stock market, but in the nearer term, it's very possible that perceptions regarding future tax policy could introduce some market volatility – which has been almost non-existent in 2017 – back into the system. The market likely remains attractive to long-term investors but could become much more volatile in the short-term, particularly as the inevitable political rhetoric heats up.

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