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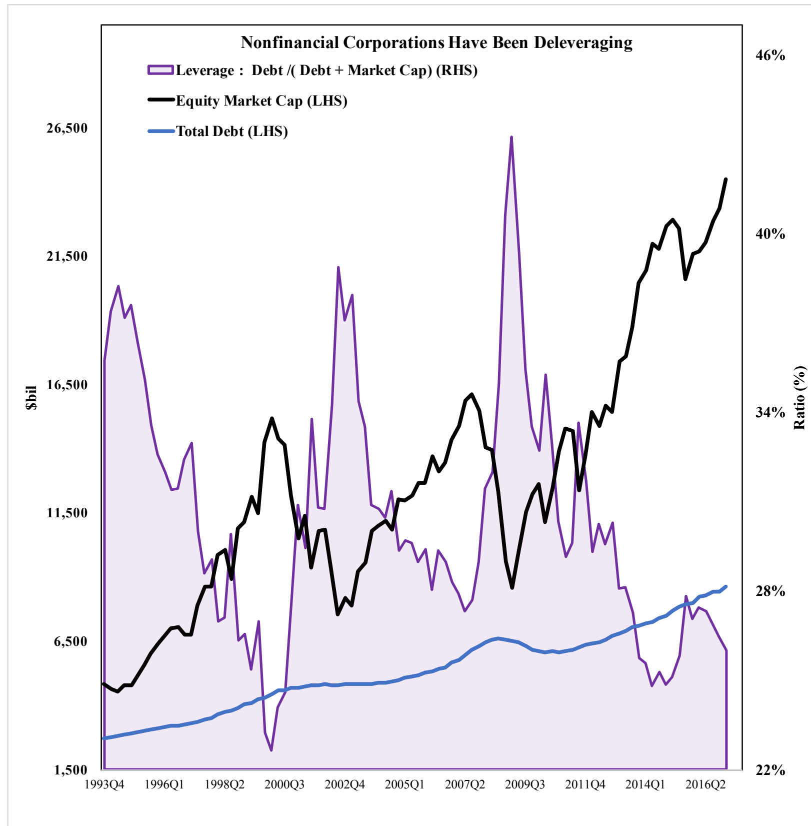
State of the Markets: Macro Commentary

Macro Thoughts For The Fall

The coming surprise in personal consumption
The Q2 GDP report was consistent with my underlying view that first quarter was a fluke driven by a one-time inventory correction and a slowdown in autos. Both reversed in the second quarter. The real question will be where from here, and more importantly what will be the surprises? In my view one source could be personal consumption. Look at the recent employment report. Weekly earnings grew at over a 4% annual rate vs a mid 2% the previous few months. Over the last 12 months, weekly earnings in the private sector grew at 2.8% rate, which understates the impact on consumption. Over this same period, total earnings grew by 4.6%. The difference is the growth in private employment of over 2 million, a growth rate of 1.7%. Employment growth added almost $100 billion to personal income. So, the surprise could be that employment adds another 2 million to jobs and weekly earnings accelerate given the tightness in the job market. Add to that the fall in savings rates, potential cuts in personal income and you have a surge in consumption. And then if middle income tax cut……

Is debt a bubble? My view is no, and that spreads could tighten, potentially substantially, under Trump Corporate Tax Reform
I am out with a piece that argues for investors to buy US corporate debt. Debt is not a bubble, and spreads could tighten substantially under Trump corporate tax reform. This view seems out of consensus of many investor who believe that corporate spreads are too tight given the growth of non-financial debt. Accordingly, corporate debt could be the next subprime bubble and will likely implode, spreads will widen, equity markets will fall, defaults will accelerate, and the US economy will fall into a recession. In my piece, I make the opposite case. Corporate debt is not a bubble, and, if anything, spreads are potentially too wide given declining credit risk. Yes, the growth in debt has been substantial, however, the equity market rally has been even greater. As result, leverage---the prime driver of credit risk—has been falling.



More importantly, Trump corporate tax reform could tighten credit spreads substantial form current levels. Both empirically and theoretically, leverage is driven by the tax shield for interest expense. Trump tax reform would reduce this incentive and push firms to reduce leverage substantially. Spreads would tighten, particularly for highly leveraged credits such as high yield, as firms reduce their debt load. Even without reducing interest deductibility, lowering the marginal tax rate will have the same effect by also reducing the value of the tax shield. The risk is that current debt is not grandfathered in the event of a reduction of interest deductibility, which could be pretty nasty even for highly leveraged companies.
My trades:

1. Buy IG debt

2. Buy HY debt if tax reform does not touch interest expense deductibility or existing debt grandfathered

Trump Tax Reform is Coming

It's been over 7 months and the administration is only now getting to the key piece of their agenda, Tax Reform. Surprising how much time was wasted on Obama care. So, the defeat of that effort means that tax reform is DOA? Easy to think that. The process was not a pretty sight clearly. However, that view misses the fundaments of voter motivation: voters hate losing stuff they were given—Medicaid, Obama health care--- **but** they love getting stuff, think tax reform. Think how tax reform will play in back hills of western Pennsylvania vs taking out Obama Care? Further, why else would Mnuchin and Cohen still be in the administration and even defending it? So, I think it coming soon. So, how does it get passed?

My own take would be that they will make the personal tax reform a tax cut for the middle class and use that to support major corporate tax reform. They will give on personal tax reform to get more substantial corporate tax reform because that it will give them more upside from economic growth. Other than the absolute level of the marginal rate, one of the issue will be the extent of the reduction in interest expense deductibility. Probably there will be sectors that will still retain current deductibility, e.g. finance, REITs. In addition, they could allow current debt to be grandfathered. They will use the extra cash, which could be substantial, to provide incentives for capital investment through 100% current expensing. Finally, the tax debate to come will focus on the static cost of the cuts and its high projected deficits vs the dynamic benefit that could outweigh the static cost through increasing tax revenue from accelerating economic growth. The key to this debate turns out to be the linkage between deficits and interest rates. The analysis of the Tax Policy Center (TPC) argues that there is no payback from economic growth. They argue that increasing deficits push up interest rates substantially, which in turn crowds out government spending and actually pushes the economy into a recession. In contrast, the Tax Foundation (TF) argues that tax reform will work to create economic growth and offsetting tax revenue. They see no substantive impact of deficits on rates. Well, the link between rising deficits and interest rates is very, very (did I say very) difficult to prove empirically, and debated continuously for the last almost 50 years, remember the issues with Reganonomics? So, in the end nothing will be decided or proved but tax reform will be passed. Of course, accelerating economic growth would drive up interest rates, which would seem to be a good thing (particularly if you have on trade 3 below)

My trades:

1. Buy 30 delta calls on equities for 3-months
2. Buy regional bank stocks (financial reform is also coming…)
3. Buy payer swaptions

a.

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