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State of the Markets: Macro Commentary

Trump Tax Reform

The First Step…Finally
Yesterday the Trump administration released its framework for tax reform, which means they added 7 pages to the original 1 page they released a few month ago. However, the release provides much greater clarity about the details of tax reform and the probability of its being passed that goes far beyond the details released in additional 7 pages. The key is to understand that the Trump tax reform plan has now morphed into Ryan's house Republican "Blueprint" for tax reform he release last year. The two plans have the same name, the same 20% corporate tax rate (not the 15% of Trump original plan), the same 25% maximum rate for pass-through corporations, the same increase in standard deductions, child care, estate tax and most other details. The exception, which should not come as surprise, is the absence of a boarder tax.

I draw a couple of conclusions from his morphing. Clearly, there is a lot more details already to the plan than are revealed in the additional 7 pages. More importantly, the probability of the plan being passed is significantly higher than the markets are pricing because the "Trump" tax reform is now the "House Republican" tax reform. The house has already thought about, discussed, written language for votable legislation, and that has been ***agreed*** to back in 2016. Yes, agreed to in 2016 does not mean agreed to in 2017/18. But it clearly increases the odds. The probability of it being passed is also higher because it will likely score on a static basis of below -$1.5 trillion cost of lost tax revenue. The Tax Foundation (TF) analyzed the house plan back in 2016. After taking out the border adjustment and change in capital gains and giving only half credit to the 100% expensing of capital investment, would put the static cost at roughly -$1.8 trillion over the next 10 years. The change from 33% for the top bracket in the house/Trump plan to 35% and potentially an addition higher bracket in the "Trump" plan could bring the number down below the agreed to cap of -$1.5 trillion for ten years.

Over the coming weeks, the key debate, however, will not be on the static cost of the "Trump" plan, but rather about the potential impact on future GDP. Basically the debate will be: what will the -$1.5 trillion get us in terms of growth and additional tax revenue to offset the cost? After making the adjustment above, based on the TF analysis the potential upside is 6% of additional real GDP over the 10-year period, about $7trillion of additional GDP over ten years. The Tax Policy Center (TPC) would probably come up with no upside given their framework. The difference is TPC argues that increased deficits will offset any gain because it will increase interest rates and Federal government funding costs, which would reduce government spending on other programs. TF does not have this offset in their model. I am on the side of the TF. In my analysis of research, it has been very difficult to prove a strong link between deficits of the order of magnitude that would likely result from tax reform and higher rates. Having said that it would appear that Republicans have already agreed to taking that bet with $1.5 trillion of upfront cost with potential of higher GDP growth.

I looked at both plans in my piece from November which I am including with this note. I am also adding the piece from the house Republicans on their "Blueprint" for tax reform.   My recommendations for trading Trumpanomics remain pretty much the same with the exception of the long dollar trade.