August 2018 Market Commentary:

Tax Reform 2.0, Stocks Find Their Footing

By Paul Hoffmeister, Chief Economist

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- House Ways and Means Committee released outlines of another round of tax cuts.
- Key features of Tax Reform 2.0 could be to make permanent the recent individual income tax cuts and index capital gains for inflation.
- We believe, at the present macro trajectory, tax cuts can buy more growth, but monetary policy will ultimately determine the duration of the recent economic resurgence.

Tax Reform 2.0: S&P 500 Reaches Five-Month High

More news has emerged during the last month about another round of tax cuts. On June 26, House Ways and Means Chairman Kevin Brady said in a Washington Post interview that he hoped to soon unveil a framework for additional tax relief and see votes held in the House during the fall.[1] Brady expects the various tax reforms to be parceled into three or four separate bills, instead of a single piece of legislation.[2]

Soon thereafter, on June 29, National Economic Council Director Larry Kudlow told Maria Bartiromo:

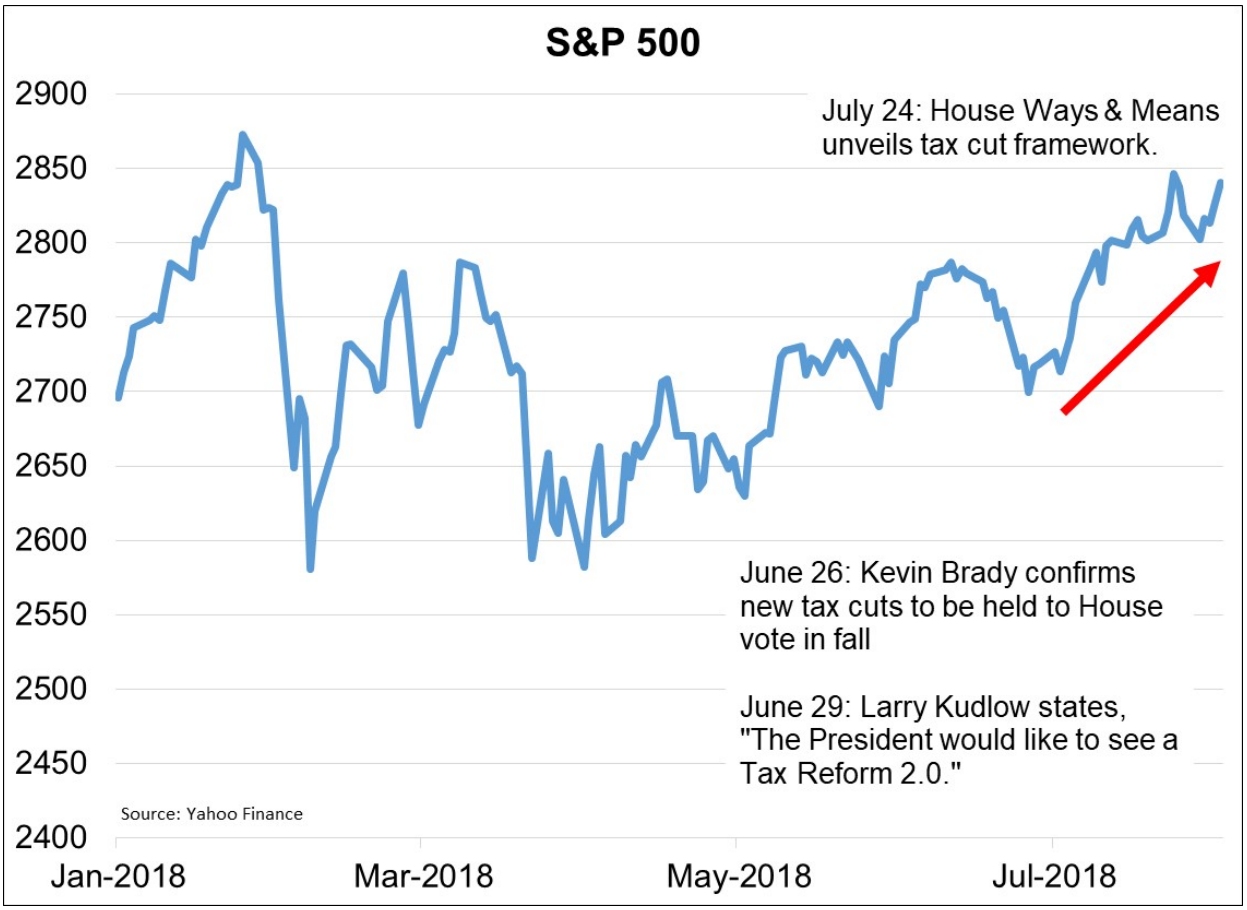
> "The President would like to see a Tax Reform 2.0 -- some of the leaders on the Hill, Kevin Brady and so forth. We're all discussing it. We'll wait for specifics to be released later in the year. It may be more of a guideline, a directional signal of what we intend to do. But, yeah, there's stuff we can do. And I hope we get to it."[3]

On schedule, the Ways and Means Committee released on July 24 a "listening session framework for Tax Reform 2.0". The framework is meant to be a starting point for

[1] "Brady Plans Next Phase of GOP Tax Cuts", by Michael Cohn, June 27, 2018, Accounting Today.
[2] Ibid.
[3] Larry Kudlow interview with Mari Bartiromo, June 29, 2018, Fox Business News.

conversations between lawmakers and constituents about key aspects of another round of tax relief. According to the release, Brady and Republican members of the Committee are hoping to: 1) make permanent the individual income tax cuts and pass-through deductions contained in last December's tax legislation; 2) create new retirement savings plans; 3) create new family savings plans, such as universal savings accounts and expanded 529 accounts; and 4) increase write offs for startups.[4]

On the heels of the framework's release, stocks hit post-February highs. Based on the S&P 500's closing price on July 25, the S&P 500 jumped nearly 1.4% compared to its close on July 23.



The vast majority of House Republicans will very likely vote in favor of and therefore pass the new tax cut bills in the fall. But, unlike last year's tax legislation, these tax cuts will be much more difficult to pass in the Senate because the budget reconciliation process will not be used. A simple majority vote won't be enough, and Republicans will need 60 or more votes in the Senate to avoid a filibuster. As a result, we expect Republicans to use the tax cuts passed in the House as a rallying cry in the midterms.

[4] "Brady Releases Tax Reform 2.0 Listening Session Framework", July 24, 2018, House Ways and Means Committee.

And if Republicans prevail handily in November's elections, then we could see Tax Reform 2.0 enacted in 2019.

Indexing Capital Gains for Inflation

In our view, the recently released framework doesn't include every tax cut that might eventually pass into law – perhaps even its most market-friendly features.

It's important to highlight, for example, a New York Times report on July 30 that the Administration was "studying whether it could use its regulatory powers to allow Americans to account for inflation in determining capital gains tax liabilities".[5]

As the Times explained, "The Treasury Department could change the definition of 'cost' for calculating capital gains, allowing taxpayers to adjust the initial value of an asset, such as a home or a share of stock, for inflation when it sells."[6]

The fact that this idea is being considered shouldn't be a surprise. President Trump's top economic adviser, Larry Kudlow, has been a longtime proponent.[7] And Vice President Pence introduced legislation to index capital gains for inflation over a decade ago.[8]

As for the potential pro-growth impact of the idea, Kudlow reported last year that former Treasury economist Gary Robbins estimates "indexing capital gains for inflation… would, by 2025, create an additional 400,000 jobs, grow the U.S. capital stock by $1.1 trillion and boost GDP by roughly $500 billion".[9]

Trump Disagrees with Fed Rate Hikes

In our letter last month, we stressed how Larry Kudlow was pushing back against current thinking by some Fed members that low unemployment could spark inflation. It was important from our perspective because, as National Economic Council Director, Kudlow was very publicly disputing a key argument for the Federal Reserve to raise interest rates, and he was implicitly warning policymakers to proceed with caution.

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We suggested the possibility that if the US economy faced more serious risks and headwinds, the White House would push strongly on the Fed to back off its tightening

[5] "Trump Administration Mulls a Unilateral Tax Cut for the Rich", by Alan Rappeport and Jim Tankersley, July 30, 2018, New York Times.
[6] Ibid.
[7] "Index Capital Gains for Inflation, Mr. President", by Larry Kudlow, August 11, 2017, CNBC.
[8] Ibid.
[9] Ibid.

campaign. And we asked, “Perhaps there’s a ‘Trump put’ when it comes to excessively aggressive Fed policy?”

More clues suggest there may be, as President Trump told CNBC’s Joe Kernan on July 20 that he’s not happy with the Fed’s interest rate increases.

Kernan asked Trump, “Should [the Fed] be raising rates on the trajectory that is indicated right now?”[10]

President Trump replied:

> “You know, I thought I put a very good man at the Fed. I don’t necessarily agree with it, because he’s raising interest rates. I’m not saying that I agree with it. And I don’t necessarily agree with it. I must tell you, I don’t. I’m not thrilled because, you know, we go up, and every time we go up, they want to raise rates again. And I don’t really… I am not happy about it. But at the same time, I’m letting them do what they feel is best…”[11]

The President also seemed to indicate from our perspective that the strengthening dollar is putting US companies at a disadvantage.[12]

Conclusion: Tax Reform 2.0 Should Help Offset Some Monetary Negatives

As we have explained in recent months, we are concerned about the Fed’s continued interest-rate hiking campaign and the recent strengthening of the dollar. In our view, the Fed should pause with rate increases and avoid inverting the yield curve, which its current policy course suggests will soon occur; and the dollar should be neither too strong nor too weak, but STABLE.

Due in part to rising interest rates and the shrinking Fed balance sheet, the resurgent U.S. economy appears to be facing a fight against not only a higher cost of dollar capital, but also a decline in dollar liquidity. In other words, the dollar is becoming more costly and less plentiful. And in an accelerating economy with more economic activity, like today, we want more dollars – not less.

Further rate increases will likely work to limit or slow growth at the margin even more, and further dollar strength will likely create more risks for emerging markets and downside price pressure on commodities.

The new tax relief being contemplated by the House Ways and Means Committee could help to offset some of the negative economic effects caused by the current monetary policy trajectory. Already, the new information related to Tax Reform 2.0 during the last month seems to have enabled stocks to regain their footing, and their eventual passage could ignite new GDP growth and support more upside in risk asset prices.

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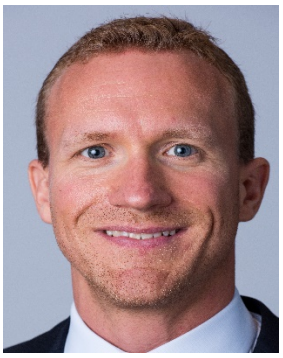
[10] Joe Kernan-President Trump interview, July 20, 2018, CNBC.
[11] Ibid.
[12] Ibid.

But at the end of the day, we believe that monetary policy is still the most important macroeconomic variable, aside from geopolitical stability. More tax cuts can stimulate more growth, but monetary policy will ultimately determine the duration of the recent economic resurgence.



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