March 1, 2017

U.S. Tax Cuts, De-Regulation and Yes, Border Adjustment

- President Trump's speech to the joint session of the U.S. Congress has revived confidence that the unified Republican government will pass substantial U.S. personal and corporate income tax cuts this year, likely before the August recess. This is in line with our long-held views, yet recently doubted in markets.
- As one should expect in a national address, Trump did not offer highly detailed policy specifics. Months of debate and actual compromise lie ahead. However, his comments on the imbalance between high "tariffs and taxes" on U.S. exports versus low entry costs for U.S. imports suggest some version of a Border Adjustment Tax (BAT) may help finance domestic stimulus.
- Trump reiterated plans to dramatically reduce regulation on domestic business while pushing a protectionist trade agenda. At the margin, his approach to trade relations and immigration seemed somewhat more growth-friendly than in the past.
- **Market Implications:** Renewed confidence in U.S. fiscal action, and perhaps the specific actions that finance it, should reignite "policy divergence" between the U.S. and other markets. The trade-weighted dollar has rallied 0.7% this morning and global bond yields have jumped. For now, International equity markets have taken this divergence in stride given a more confident global growth outlook. The Citi Private Bank Global Investment Committee continues to overweight USD assets (overweight credit, fully weight U.S. equities) given the pros and cons of the new U.S. policy approach for different global asset classes.

U.S. President Trump made his first speech to a joint session of Congress last night. (Note: After the President's first year in office, this speech is called the "State of the Union Address.")

In this note, we set aside political analysis over the wide-ranging content of the speech, it's tone and it's reception. **On the policy front, we believe the speech largely confirmed our base case assumptions for fiscal action and other economic management issues in the coming year** (please see our February Quadrant: Fast and Furious for details). We see substantial U.S. tax cuts, de-regulation and at least a modest acceleration in government spending boosting U.S. growth late in 2017 into 2018.

Recently, markets have doubted that U.S. fiscal easing would be accomplished this year (see figure 1). This may have stemmed from the emphasis on immediate repeal of the Affordable Care Act ("Obamacare.") which is highly complex and contentious. Changes to the ACA will have a fiscal consequence. It thus needs to be considered alongside other actions on taxation. Given the Republican majority needs to pass tax and spending legislation by a simple majority with a filibuster-proof "tax reconciliation" vote, this likely means that both the ACA and tax reform needs to be considered around the same time. (The reconciliation procedure can be used only once or twice per year under current rules).

In his speech last evening, the President sounded closely aligned with House Republicans on both fiscal action and changes to the ACA. This has boosted confidence in the ability of the Republican majority to pass its agenda.

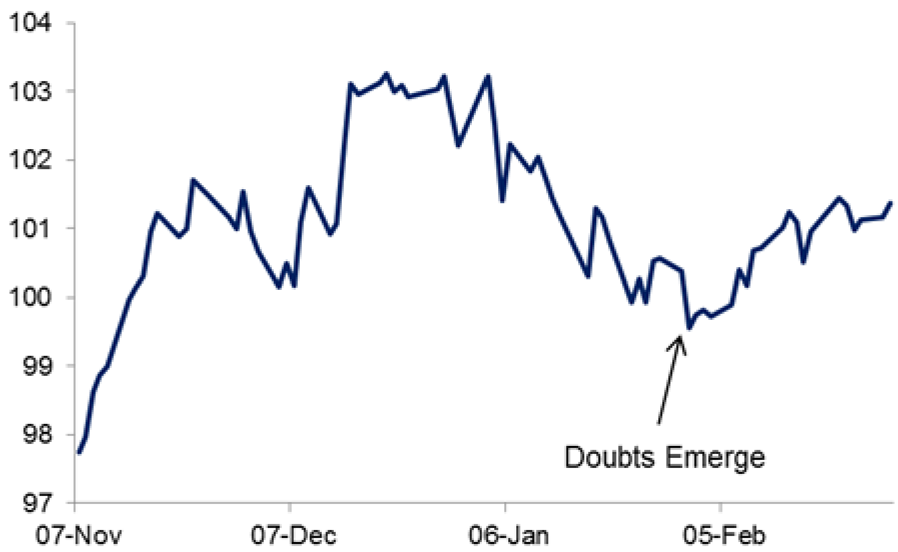
"It Will Be a Big, Big Cut"

President Trump promised a "big, big cut" in various tax rates which will impact near-term growth. "Right now, American companies are taxed at one of the highest rates anywhere in the world...(we will) reduce the tax rate on companies so they can compete and thrive anywhere and with anyone...we will provide massive tax relief for the middle class."

House Republicans have suggested a plan to tax imports to match VATs in other markets. This will help finance cuts in corporate and personal income taxes. The impact on trade is subject to theoretical controversy. Suggesting unity, Trump said "currently, when we ship products out of America, many other countries make us pay very high tariffs and taxes, but when foreign companies ship their products into America, we charge them nothing or almost nothing."

While Commerce Secretary Wilbur Ross noted, in separate comments, that this did not constitute an endorsement of the policy, in our view, Trump's comments suggested movement toward some form of BAT.

Figure 1. U.S. Dollar Index



Source: FactSet as of March 1, 2017. Note: The U.S. Dollar Index (DXY) is an index of the value of the United States dollar relative to a basket of foreign currencies.

Forget Math for the Moment

In our view, those who say the "math" doesn't work to make tax cuts possible are missing the point. U.S. fiscal math doesn't work now. The federal deficit was $587 billion in 2016, borrowing increased $759 billion, and the same will be roughly repeated this year before any fiscal policy changes.

The U.S. federal debt ceiling will be raised this year like the 109 times it has since 1917.

Trump repeated pledges to raise military spending significantly and increase infrastructure investment by $1 trillion with both "public and private financing," presumably over the 10-year time span common to budget planning.

"Dying Industries Will Come Back to Life"

On trade protectionism the president appeared to promise far too much, yet received bi-partisan applause when he said new American oil and gas pipelines will be built with American steel. "We've lost more than one-fourth of our manufacturing jobs since NAFTA was approved and we've lost 60,000 factories since China joined the World Trade Organization in 2001."

The long history of technological progress and shifts in the composition of U.S. growth bely promises to return to the labor markets of the past (please see our Outlook 2017 and figures 2-3). While there are merits to the argument that international tax differences disadvantage U.S. production, unwinding these would at minimum generate significant transition costs that would limit U.S. economic efficiency and raise U.S. consumer prices.

Figure 2: Employment in Manufacturing and Farming

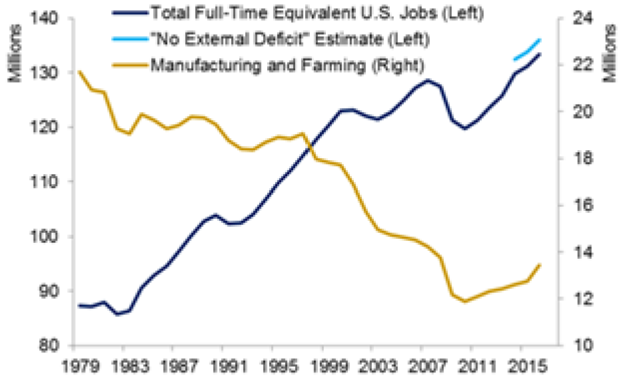
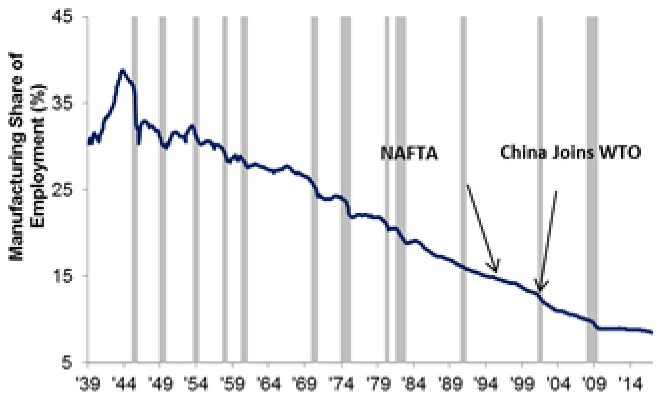


Fig 3: Manufacturing Share of Employment has Fallen Steadily



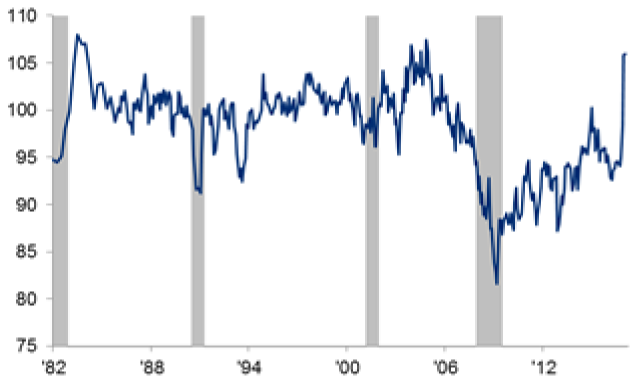
Source: Haver Analytics as of March 1, 2017.

Not Just Raising the Speed Limit, Removing the Traffic Lights

Deregulation is likely to be a large driver of the unprecedented policy experiment the U.S. will engage in during the years ahead. This is discussed in our last two Quadrant reports in detail. The signaling from the administration has already helped generate the largest increase in small business confidence in a four decade history of monthly surveys (see figures 4-5).

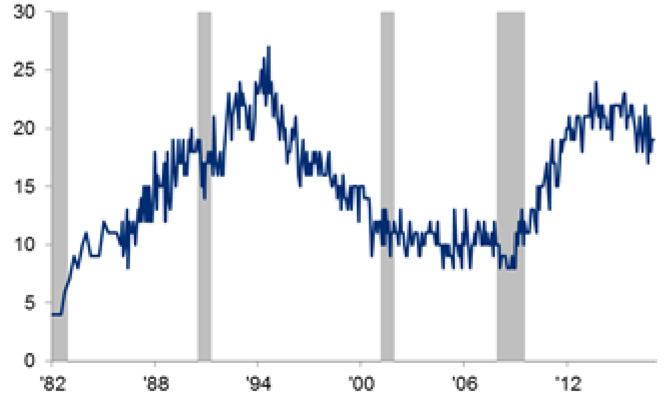
President Trump suggested "two regulations" would be eliminated for each new one added going forward. This seems arbitrary, but also emblematic of the massive change in the approach to doing business in the U.S. Also on the far more growth favorable front from our perspective, he cited a willingness to seek immigration reform with a merit-based application system, citing Canada and Australia specifically as examples.

Figure 4: Small Business Confidence has Maintained its Jump



Source: Haver Analytics as of March 1, 2017.

Figure 5: Percent of Small Businesses Saying "Regulation is Biggest Problem"



Source: Haver Analytics as of March 1, 2017.

Conclusion: Boom Comes First

President Trump and Congressional Republicans will likely pass all of their tax and spending plans on a strictly partisan basis without substantial votes from Democrats. Much of the world will not understand the President's assertion that the U.S. has *not* been putting its interests first. We quibble with the benefits of protectionism; some of China's current economic problems, like Japan's before it, actually bear testament to this. We also have to disagree with views that the present economic recovery has been so weak and incomplete that large scale stimulus comes *with no* risk of generating a boom/bust cycle. Even so, however, boom comes first.

We continue to adjust our investment allocations to this fast moving environment of political change. Last night's speech by the U.S. President does not eliminate the risk of further anxiety over the policy course in the U.S., or especially abroad. However, we still feel comfortable with a fully weighted position in U.S. equities despite their increase in valuation over the past year.

We also favor inflation-protected U.S. Treasury securities over nominal bonds given inflation risks, and see U.S. yields in credit markets as appealing versus other developed bond markets. Substantial policy questions remain for international markets, yet we can consider the impact of the U.S. dollar's rise as raising future return prospects in foreign markets at some point too.

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