



Top chart shows the yearly growth of US federal government revenues and US real GDP during the Reagan administration

## An uncertain path lies ahead

Forecasting valuations is proving to be a very challenging task this year, since market sentiment seems to depend on two theoretical assumptions: taxes and tariffs, the known unknowns. The rhetoric on import tariffs by President Trump has sensibly diminished recently, so we will assume they were an electoral campaign tool that might not materialize. Therefore, we will focus our considerations on the tax cut debate by looking at analogies from the past and by drawing various potential scenarios, their magnitude and impact on asset prices.

### The Reagan analogy

The Economic Recovery Tax Act (ERTA) of 1981 under the Reagan administration lowered the top marginal tax rate on individual income from 70% to 50%, reduced other marginal tax rates by 23% over a three-year period and enacted a number of other provisions that reduced tax payments from individuals and briefly of companies too – the corporate tax reductions in ERTA were partially offset later by the provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Back then, the underlying motivation for the ERTA was that such tax and incentive interventions would increase the flow of resources into production, and therefore boost economic growth out of a time when the US was experiencing a mild recession through the 70's. The public debt to GDP ratio rose from 26% in 1980 to 41% in 1988, which put in absolute terms represents

an increase from \$710 billion to \$2 trillion, an almost threefold rise. During that period of time, real GDP rose for eight years at 3.3% CAGR (7.9% in nominal terms); such trend was possible because the US economy was coming out of a decade of relatively lower economic expansion, which coupled with a 7% unemployment rate provided ample room for growth. The graph shows how real GDP growth fell sharply to -2% in 1982 in real terms, approximately one year after the introduction of the ERTA tax cuts; while indeed various factors contributed to this anomalous economic result, it is rather evident that the consequent reduction in federal revenues played an important role in worsening the annual budget, which reflected in what seemed to be a temporary glitch in the steady-state of growth of the US economy. In turn, this stimulus likely contributed to put a larger debt burden on the government, a fact that Reagan himself confessed was his greatest political regret.

Much debate has happened around how the tax burden has shifted among percentiles of population, and much more so than any consideration of the long-term effects of the tax reform on rebooting the US economy. Statistical evidence from the IRS shows that in the Reagan era, the top 10% percentile ended up contributing more over time than the lowest 50% percentile, mainly via the increase in capital gain realization (which produce tax revenue for the government) for the wealthiest brackets of population in an environment with lower taxes.

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## The current situation

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The Trump administration aims at intervening mainly on businesses via a tax break on repatriating capital and by lowering the corporate tax rate; from past experience we know these stimuli will lead to short-term budgetary constraints before they have the chance to produce the desired effects of higher corporate profits, increased disposable income and savings, higher employment and ultimately a boost to the nation's economy.

Needless to say, the conditions in which the US finds its economy today are hugely different from those of the 80's. Total debt to GDP ratio is currently at 105%, while unemployment rate is around 4.8%; Western economies, including the US, are also in the 9th year of recovery since the global financial crisis, which logically leaves little room to a further stint of growth, even from an increase in federal revenues from future taxes. In addition, the fiscal cliff represents another limit to growth: this is a legislative limit on the amount of national debt that the federal government can borrow, which includes debt in the hands of the public and in intra-government accounts – raised to approximately \$16.7 trillion in 2013. As all reforms need to be discussed by the Congress, we believe ratification of the tax reform might be less smooth than expected. In the previous analogy, short-term pressure on the federal budget amounted to \$40 billion from 1981 to 1983; an estimate of a future decrease in federal revenues for the 2018-2020 period sees consensus around the following numbers: new tax rate at 25% > \$450 billion, 20% > \$680 billion, 15% > \$910 billion. These numbers would translate into 2.4%, 3.6% and 4.8% of GDP respectively; extended over a period of eight years, the lowest tax rate applicable (15%) would create a final effect of roughly 11% or \$2.4 Trillion on the US budget.

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## Investment Conclusion

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Considering the lack of visibility on execution of the reforms announced by the Trump administration, we are keeping our current asset allocation unchanged.

These are only theoretical assumptions, because statistical data show that the 80's tax cuts contributed to a larger debt burden on the government. We believe the US can handle \$500-700 billion in new debt but not larger; Treasury Secretary Steven Mnuchin gave little insight on the tax reform, but given the numbers and the budgetary constraints the US is facing we will assign the following probabilities to various levels of the new Corporate Profit Taxation Rate (CPTR): 25% CPTR at 30% probability, 20% CPTR at 50% and 15% CPTR at 20%. We define below the potential market reaction for each scenario, including the effects of the one-time reduction in tax repatriation.

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## Our view on the market

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The tax repatriation plan as proposed by President Trump will have an estimated one-time positive contribution to the S&P 500 earnings of 3% (\$4/share), which we consider will have little to no long-term impact on asset prices as it is not a recurrent income addition.

A tax reduction by 10% – our base case scenario – will instead add \$8 or 7.4% of EPS for the index with a longer effect on earnings than the one of the tax repatriation. From the lows we saw between November and February the market has risen by 14%, a move that we interpret as the market pricing in two years of accumulated tax reductions, which would imply an expected CPTR of 20% in 2017. The bull case scenario of a CPTR of 15% will be an added positive development with a potential for a market increase of 4.6% – an additional 2.3% EPS per annum over two years. The bear case scenario is a 5% reduction to a CPTR of 25%, which we believe would push the market down by 5.5%, reflecting an earnings loss of \$2.75% per annum.

We do not think we can add value to our clients by speculating on political events, which usually have a binary effect on financial markets.

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