SkyView Investment Advisors:

The End of One Stop Shopping – The Handover

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Since the end of the great recession, investors focused importantly on one key driver to the economy and financial markets—monetary policy. Commentary before and after each quarterly meeting of the Fed and FOMC generated a good living for economists over this decade. And both Ben Bernanke and Janet Yellen became television stars as a result of the "Press" conference that followed.

With the arrival of the Trump administration, Janet Yellen and monetary policy will need to share the spotlight with the rebirth of fiscal policy and its broader group of fiscal policy stars. The result will be a more diversified focus by investors as they try to perceive the forces that will effect both the economy and financial markets. The question for investors will be how smooth will this hand over be. So far investors assume a smooth handover---an assumption that may lead to disappointment.

Not So Easy

Key to maintaining investor optimism will be legislative follow-up in congress. The focus of investors will move to the legislative process which can only be compared to the manufacture of bologna—and you really do not want to watch. For example, the last major tax reforms in 1986 took 2-3 years to enact. Since the 1986 tax reforms, changes to the tax code reflected mainly modest changes and adjustments to corporate and personal marginal tax rates.

With bipartisanship nearly an obsolete word, tax reform will face a great deal of legislative friction before final passage. Friction will arise not only between the two parties but also within the republican party. In the latter case, budget hawks may create push back to potential deficit increases. In the case of proposed spending increases for infrastructure spending, the chances for easier passage seems likely since both parties support such spending. However, such passage will likely follow after the time consuming enactment of tax reform.

Legislative Friction

The new fiscal proposals will not likely garner the 60 votes needed in the senate to apply cloture for a vote. Using the alternative, senate republicans will use the speedier budget reconciliation process that requires only a majority vote. The downside, budget resolution acts must be re-enacted every 10 years if not sooner.

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Only one tax and one spending bill can use this process in each fiscal year budget resolution. Therefore, repealing and replacing Obamacare and enacting tax reform will be considered sequentially, one for FY'17 and one for FY'18. Since the repeal and replacement of Obamacare will be for FY'17, consideration of tax reform will be delayed until the new healthcare legislation passes. Because of its complexity, this will take time. Then throw in the confirmation debate for supreme court nominee Gorsuch and you have the potential that investors face a real bologna factory in congress.

Sources of Additional Tax Legislation Friction

Overall, the tax reform proposals will create much friction from multiple sources as they represent "Revolutionary" changes. Simply put, if congress enacts most of these tax reforms, many businesses and industries will be forced to significantly revise their operating and financial strategies. While businesses may not like current tax laws, nonetheless they developed reasonable comfort with their business and financial strategies to best deal with them. While they might not admit it, most corporations may prefer the known to the unprecedented changes tax reform proposals would likely bring. This will cause major sources of friction to legislating tax reform.

Real Estate Industry Opposition

A congressional committee estimates the proposed higher standard deductions would reduce the number of tax payers itemizing their deductions from 35% to only 5%.

Personal tax reform would substantially increase standard deductions and the number of taxpayers using them. A congressional committee estimates the proposed higher standard deductions would reduce the number of tax payers itemizing their deductions from 35% to only 5%. For many tax payers, this change would eliminate the tax incentive for owning a house. Hence, the friction from the residential real estate lobbyists.

Farmers Opposition

Eliminating interest expense deductibility would make it difficult for farmers to finance their seasonal needs.

Another source of friction will come from the proposal to eliminate the deductibility of interest expense for non-financial "C" corporations. This proposal would bring meaningful changes for both business and investors. One not obvious source of opposition for this proposed reform, farmers, would result in a major political roadblock. Farmers borrow in the spring to plant their crop. Eliminating interest expense deductibility would make it difficult for farmers to finance their seasonal needs. Their opposition would show up with senators and representatives primarily from the red states—importantly mainly republicans.

Greasing Cash Repatriation and Its Investment Implications

Broader congressional agreement should enable shifting the U.S. from global to territorial taxation. This change would eliminate the U.S. taxing foreign sourced income—ending dual taxation. In doing so and combined with a sharply reduced corporate tax rate, it would eliminate the tax incentive for U.S corporations to relocate their headquarters outside the United States.

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One other broad area of congressional agreement would lower the tax on repatriating all past foreign earnings and make it mandatory to do so. At the same time, applying a territorial taxation to all future earnings would eliminate incentives to retain cash outside the united states for tax reasons. These proposed tax reforms could lead to the repatriation of over $1 trillion of cash. If that proves to be the case, the leading companies in technology and healthcare would be among the biggest benefactors. Repatriated cash will lead these firms to increase their capital investments; stock repurchases; acquisitions and dividend payouts— probably all four.

Financing Tax Reform – Destination Based Cash Flow Tax

Proposed tax reforms would reduce Federal revenues roughly $1 trillion over 10 years. To offset this revenue reduction, the house proposal calls for what can be labeled a border tax. Very simply, cash flow from goods and services exported from the U.S. would not be taxed. Conversely, the cash expense of imported goods and services could not be expensed for tax purposes. When fully implemented, the proponents expect the border tax to nearly replace all the revenues lost from tax reform.

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In order to make the border tax work, varied off-setting adjustments, such as a 25% appreciation of the dollar, must happen. These necessary adjustments can be shown working themselves out neatly on an excel spreadsheet. What cannot be shown on the spreadsheet will be the unintended consequences resulting from such massive changes. Americans will likely game the new system to offset the changes and upset these neat spreadsheet calculations. The adjustment process would likely prove to be bumpier and longer than forecast.

A great deal of controversy surrounds this proposal—with smart observers on both sides of the debate. In our view, this proposal represents the most revolutionary of all the tax reform proposals. As it is designed to do, legislative processes tend to resist such revolutions. We expect that will be the outcome for this border tax.

Tax Reform vs Tax Rate Cut

Without a border tax, the question then will be whether tax reform turns out to be simply a tax rate reduction. If so, a substantial budget deficit increase will likely result. To avoid such an outcome, requires strong congressional and presidential leadership to gain speedy passage of tax reform not just tax rate reductions.

Investment Conclusion

The slow legislative process might dampen the stocks of material producers and other industries that would benefit from increased infrastructure spending.

Based on the recent performance of equity markets, investors seem to be assuming a fairly smooth and timely process to enact tax reform legislation. Even with strong congressional leadership, such expectations may lead to disappointment. If so, then sectors and industries that benefitted from such expectations would likely come off their recent highs. Included in that group would be cyclicals, companies with substantial export business; domestic companies with high tax rates; as well as small and mid-cap companies. The slow legislative process might also dampen the stocks of material producers and other industries that would benefit from increased infrastructure spending. Once fiscal policy proposals reach enactment, investors will likely turn back to these industries and companies with more realistic but still favorable expectations.

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