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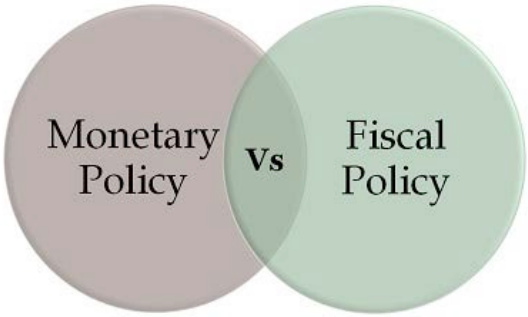
When asked on August 15th on "Fox & Friends" about his goals for tax reform, President Trump replied, to "put H&R Block out of business." Tax simplification is a favorite spurious term of politicians, as it is something that almost everyone can get behind.

We see this term used all of the time including, as recent examples, The Student and Family Tax Simplification Act (H.R. 3393), Seniors' Tax Simplification Act of 2017, Small Business Owners' Tax Simplification Act of 2017, The Sales Tax Simplification Act of 2016, the Tax Filing Simplification Act of 2016, etc. However, despite all of this purported simplification, H&R Block and most of its peers are miraculously somehow still in business. Go figure.

Adding "tax simplification" to the name of a piece of legislation is akin to adding ".com" to a company name back in 1999. It seems to instantaneously add popularity and credibility to any proposed legislation, despite the fact that none of them ever seem to actually simplify tax filing, and instead the name merely provides cover for someone's political agenda or proposed social policy.

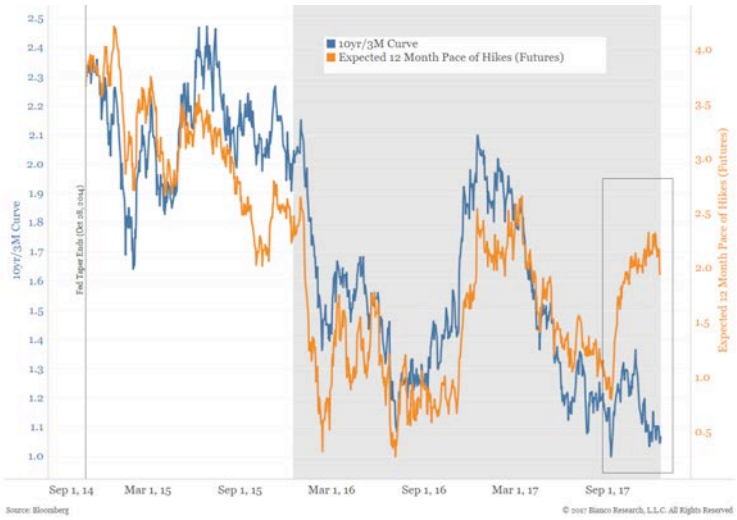
President Trump's original working title for the tax "reform" just passed also included the term "tax simplification" but, since it ultimately did virtually nothing to simplify the tax code for most individuals other than to reduce the number of people who are likely to itemize, the name was ultimately changed to the "Tax Cuts and Jobs Act".

However, rather than this being a refreshing example of political realism and honesty, this term too is more euphemism than anything else, as an estimated 25% of taxpayers will actually see their taxes go up in 2018, and an estimated 75% of taxpayers will see their tax rates move above 2017 levels in 2027. "Taxpayer" is an important term in understanding this dynamic, as only 55% of American workers pay any federal income tax whatsoever.



Further, it is debatable whether or not this legislation will have anything more than a modest and short-term impact on job growth, particularly at a time when the country is already on the verge of running out of qualified workers, and the Federal Reserve is actively draining monetary stimulus from the economy to help keep it from over-heating. Of important note, monetary stimulus has historically had a much larger and more sustainable impact on the economy than has fiscal policy.

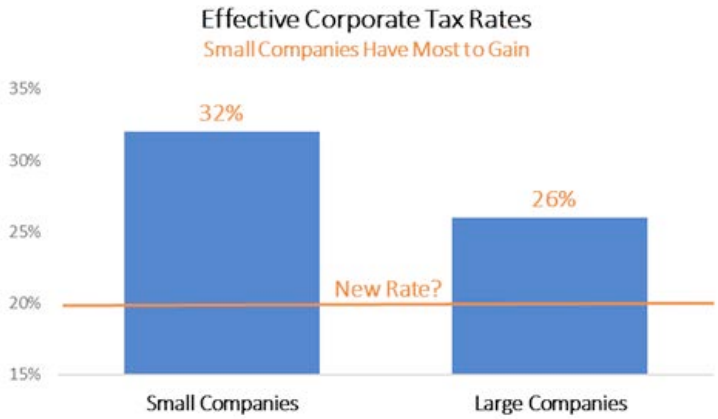
Indeed, a comparison between the number of upcoming short-term interest rate hikes being priced-in by the futures markets (gold line) and the difference between short and long-term rates, [the yield curve/(blue line)], reveals that they are no longer tracking each other, which is noteworthy, as both can be indicators of an impending recession. Their recent divergence is being viewed as a warning from the capital markets of a growing risk that the just-passed fiscal stimulus (i.e. tax reform) package may force the Fed to be so aggressive in offsetting fiscal stimulus with monetary constraint that it may overdo things and cause a recession.



If there was actually a "truth in advertising" standard on Capitol Hill, this bill would be called "The Corporate Betterment and Real Estate and Equity Investor Windfall Act". That said, while this "book" has little to do with its "cover", it is nonetheless a very important bill, with potentially far-reaching implications, particularly in light of what is simultaneously happening on the monetary and regulatory fronts.

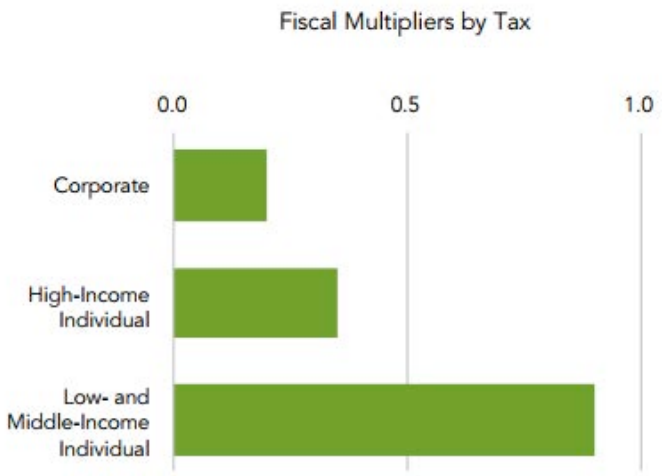
On the surface, the primary benefits of tax reform are going to U.S. corporations and those who invest in their shares. After all, the maximum corporate tax rate drops from 35%, which had been among the highest in the world, to only 21%. However, one must be careful not to overestimate the impact of this nominal rate change on big, blue-chip, domestic companies, who employ legions of tax lawyers and accountants to keep their tax rate down to an average, according to some sources, of only 15%.

Other research firms, like Gluskin Sheff, believe that there will be a more tangible benefit, with the net effective tax rate dropping from 26% to 20.7%. When they combine this change in effective rates with the one-time opportunity to repatriate foreign earnings back to the U.S. at a reduced tax rate (and their belief that much of the repatriated assets will be used by companies to buy back their own shares), Gluskin Sheff believes that the one-year-forward price-to-earnings multiple on the S&P 500 Index could fall from 20.2 to a much more reasonable 17.6 times earnings.



However, the overwhelming beneficiaries of this reduction in nominal tax rates should be smaller companies, who do not have the benefit of massive accounting departments, and which thus averaged effective tax rates of around 32% under the old rules. The tax reform bill should allow for them to experience an effective slashing of their tax rate from 32% to only 20%, with a corresponding boost to their earnings.

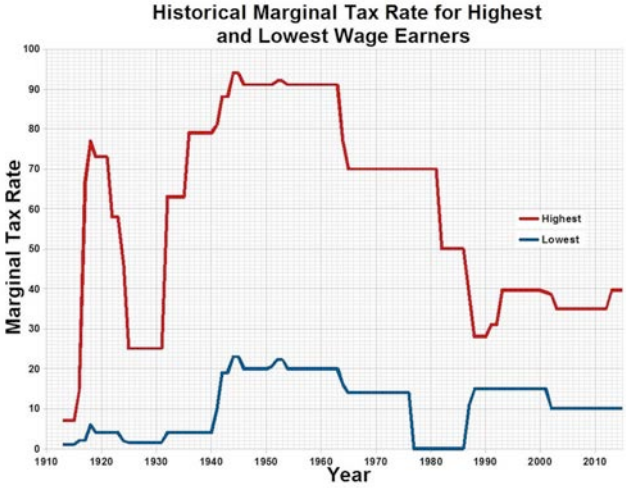
The benefits of tax reform to larger, blue-chip companies tend to be a little less obvious, starting with the fact that companies can now depreciate capital assets in only one year, which is a great incentive for them to invest heavily in productivity-increasing, and therefore earnings-increasing, capital assets. The new tax bill also eliminated the 20% Alternative Minimum Tax for corporations, which was previously used to ensure that corporations paid at least a minimum amount of tax. Its removal should save American companies $40 billion in taxes. The bill also transitions from a "worldwide" tax system to a "territorial tax system", under which U.S. companies would no longer be subject to U.S. taxes when they bring home overseas-derived profits.



The tax bill also allows for the aforementioned repatriation of $2.6 trillion of foreign-derived profits currently held overseas, with a one-time 15.5% tax rate on cash and an 8.0% rate on capital equipment.

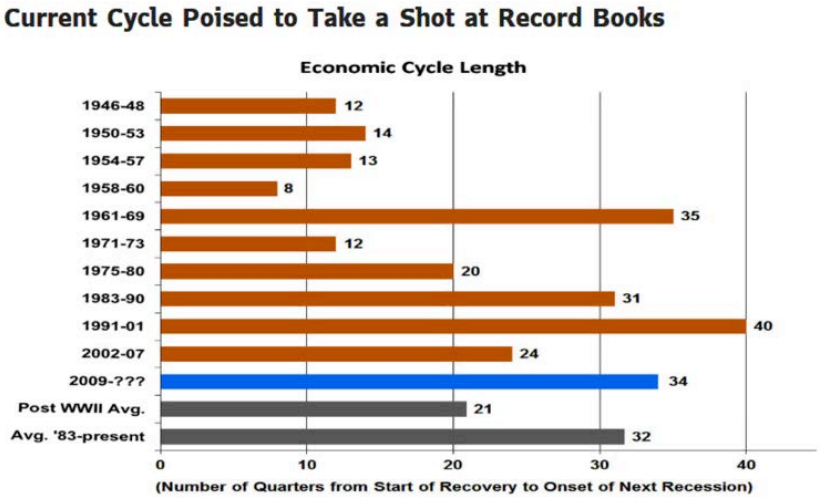
While there seems to be little doubt that the tax bill should greatly benefit corporate profits, and growth investors as a result, the argument that it should be significantly beneficial to the economy at large is much more difficult to support. There are a variety of reasons why this is the case, including how the benefits of tax reform are distributed. Specifically, the majority of benefits accrue to those who are least likely to spend them.

If economic stimulus and job creation were the true objectives of the legislation, the primary beneficiaries should have been low and middle-class individuals who would be expected to spend over 90% of every incremental dollar received/kept, as opposed to corporations, who are likely to use savings for stock repurchases and dividend increases, and high income individuals, who are likely to save or invest most of it.

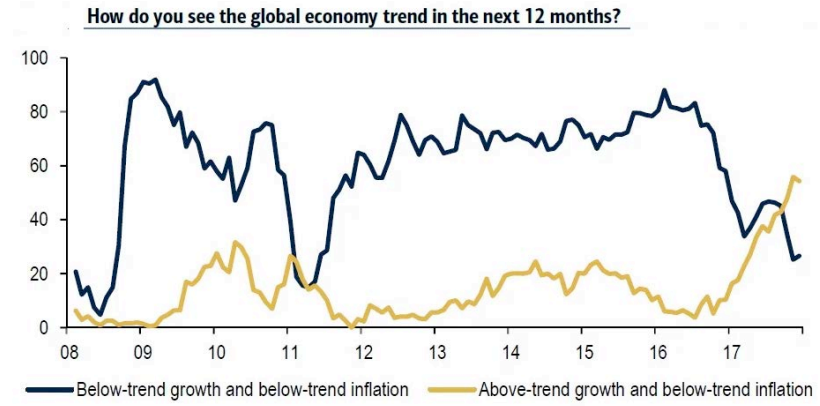


Our point is not that corporations and/or the affluent need to pay more in income taxes. To the contrary, the Federal Government has long proven itself as a very poor allocator of capital, and history has proven that the economy suffers when the job-creators and risk-takers are disincentivized to take entrepreneurial risks, particularly since almost all job creation in the U.S. takes place on a small company level. No, our point is that it is no more a job creation bill than it is a tax-simplification bill. After all, U.S. corporations are already sitting on a record $2.3 trillion of cash reserves, which means that they are certainly not waiting for tax reform before they could afford to do more hiring.

Many private and Wall Street economists are looking for the tax bill to increase economic growth by about one-third of a percent per year for the next two years, while the conservative-leaning Tax Foundation expects an annual economic boost of 1.7% per year to domestic growth, and increases in wages by an average of 1.5% per annum.



The Treasury Department, whose estimates assume that President Trump's infrastructure spending, welfare reform and deregulatory agendas are also passed in their entirety, is projecting average annual growth of an impressive 2.9% per year, while the bi-partisan Congressional Budget Office is predicting average annual growth of 1.9% per year.



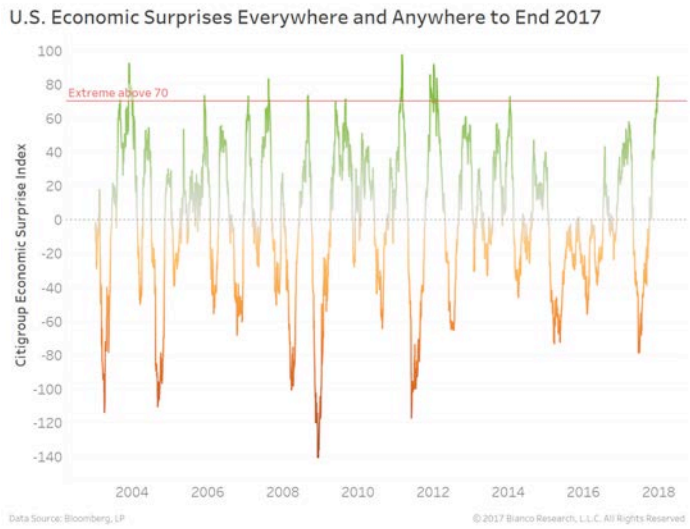
Source: BofA Merrill Lynch Global Fund Manager Survey

Frankly, for the economy to grow at any of these rates would be quite remarkable, when you consider that the current economic expansion is about to become the second longest running in U.S. history.

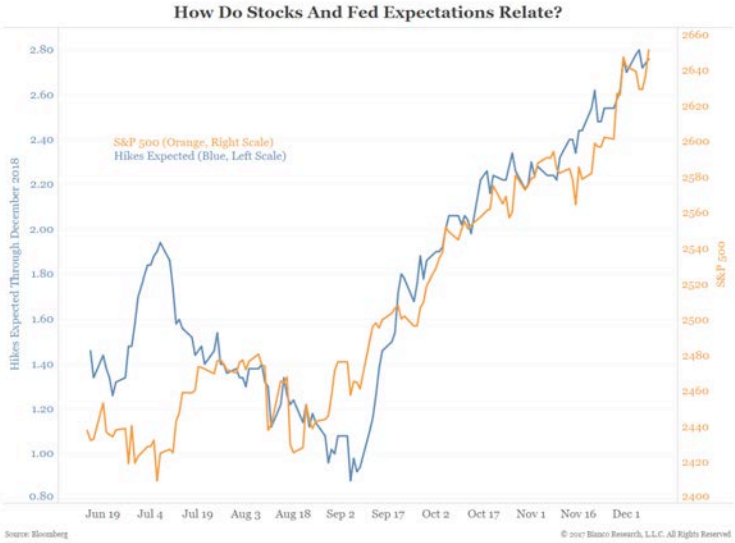
Even so, that is exactly what seems to be on the verge of happening. However, we suspect that this acceleration has relatively little to do with tax reform, and is instead a function of the global recovery and President Trump's less-well-known, but much more substantive deregulatory agenda.

Indeed, according to the non-profit Competitive Enterprise Institute, the cost of corporate compliance with the regulatory burden that existed at the time of the Trump election cost American businesses $1.885 trillion per year, which is higher than the combined total corporate <u>and</u> individual federal income tax burden of $1.820 trillion.

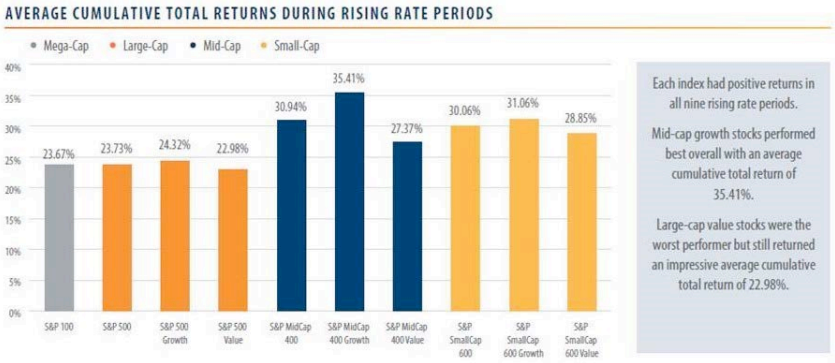
The fact is that, tax reform bill or not, we are witnessing a synchronized global economic recovery from the financial crisis, and that its pace of advance seems to be surprising even the most bullish of analysts and economists. Current estimates are for the global economy to reach its fastest pace of growth since 2011, and that this acceleration will lead to the most aggressive monetary tightening in more than a decade.



The United States' economy is expected to grow by more than 3% for three consecutive quarters for the first time in twelve years, and expectations are for the global economy to expand by approximately 4% in 2018, which should bring with it falling unemployment, higher wages, improved trade, increased capital spending and a modest boost in inflation. Indeed, the International Monetary Fund is expecting for the inflation rate in the industrialized world to reach 1.7%, which would be the highest inflation rate in six years.



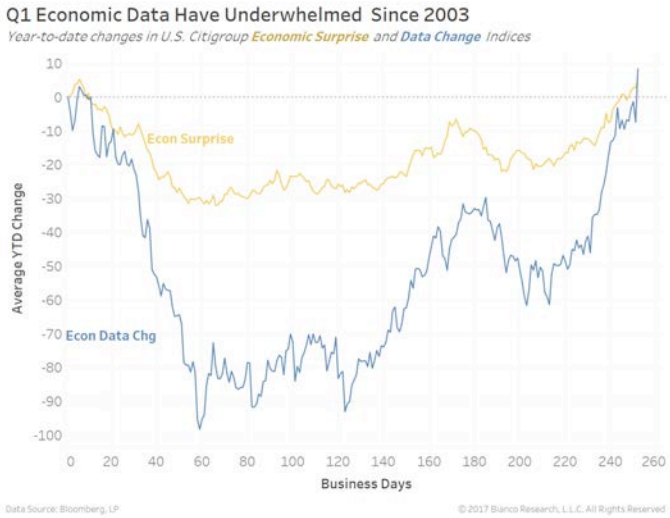
Such good economic news is normally quite bullish for the equity markets in general, as stronger growth increases consumer demand and gives companies pricing power for their goods and services. It also gives C.E.O.s the confidence (particularly in light of the immediate expensing of capital investments) to invest in new technology and productivity-enhancing equipment, which has historically been great for both profit growth and profit margins. As bullish as this confluence of factors has traditionally been for large, multi-national stocks, it has historically been even more beneficial for the stocks of smaller and mid-capitalization companies.



Wall Street research suggests that such a benign environment for equities can continue until such time when interest rates become restrictive on an inflation-adjusted basis, which JP Morgan defines as the Fed Funds Rate minus the Core (excluding food and energy) Inflation Rate. By their calculations, rates do not become restrictive until this calculation reaches 1%, which might not be reached for at least another year or two.

Ironically, what is probably the biggest implication of the tax bill is both non-intentional and more monetary in nature than it is fiscal. To explain, the greatest risk associated with the Federal Reserve's plan to raise short-term rates and drain monetary liquidity is that it could very likely cause a recession, if they are too aggressive in their withdrawal of monetary stimulus. However, in our opinion, the tax bill essentially enables the Federal Reserve to normalize policy with a greatly-reduced risk of economic contraction by replacing monetary stimulus with fiscal stimulus, and by doing so, transferring over a trillion dollars of debt financing from the Federal Reserve to the taxpayer.

While this is potentially very beneficial for equities, it could have quite negative implications for investors in the bond markets. To explain, bond prices traditionally have a sort of safety net that protects them from the risk that the Fed might be too aggressive (which would push interest rates and inflation lower, thus lifting bond prices higher). From our perspective, the tax plan largely eliminates this safety net by allowing the Federal Reserve to pursue potentially very restrictive policies without much risk of recession, which significantly raises inflation-related risks to bond investors.



In contrast, we expect for 2018's equity-related risks to be more geopolitical in nature than economic. That said, there is a potential, near-term exception to that perspective, particularly in light of how very overdue equity prices are for a corrective decline. Specifically, both private and government economists have had issues since 2003 in making proper seasonal-adjustments to first quarter economic data, which has, in turn, caused economic data to come in weaker than expected, and catalyzed a series of first quarter equity market declines. This seems to us to be a potential risk again in 2018, despite the fact that we are quite bullish on equities for the year as a whole.