Macro Wrap-Up

An Unequivocal Tax Cut

October 27, 2017 — Ricardian equivalence could very well be the most elegant principle in economics. Named after 19th century economist David Ricardo,[1] it holds that government deficit spending does not have much effect on the economy. In its strictest form, every extra dollar the government spends is offset by one fewer dollar of spending by households. According to the theory, folks pull back on spending because they know their taxes will be higher in the future. Although it is called Ricardian equivalence, it was famed economist Robert Barro who developed and popularized the theory in the 1970s. Over forty years later, it remains controversial. Critics admit its logic, but dispute the real world evidence. They argue that the idea that people use complex calculations on future deficits to inform their daily spending comes from Fantasy Island. And if people do not cut their consumption when the government adds spending, economic growth should go up, at least initially.[2]

One person who was skeptical about Ricardian equivalence was … David Ricardo.[3] He thought the available data didn't support his theory. Markets seem to agree with him. It seems that every time news comes out that tax reform is becoming more likely, the U.S. stock market rallies and bonds fall. Many in the FX community have credited the recovery in the U.S. dollar to these expectations as well.[4] However, if changes to government spending and revenues were in fact economically neutral, then these markets shouldn't react as if they had just had too much Vitameatavegamin.[5]

One thing to keep in mind is that markets and economists are concerned with different things.[6] Economists worry about aggregate demand and people's overall welfare. The stock market on the other hand cares more about corporate earnings. It could be that stock market participants believe that deficits, especially ones created by corporate tax cuts, are simply transfers from the government to corporate earnings and the effect on growth is irrelevant.[7] The bond market, however, is more concerned with inflation than with corporate earnings, and it seems just as reactive to budget news. It could be argued that deficits hurt bonds by damaging sovereign creditworthiness. However, default swaps have generally remained steady. Market participants seem to have (perhaps misguided) faith that tax cuts and government spending raise inflation and growth. Many times in emerging markets, and even in Europe during sovereign crises, equity markets have punished countries for excessive deficit spending, but not in the U.S. during this cycle.[8] For example, during the European sovereign debt crisis, Greek equities typically fell on news of its worsening deficit situation.[9]

The U.S. Senate and House recently passed a budget resolution that would allow up to $1.5 trillion of deficit spending over the next ten years.[10] Some market participants had previously thought that any tax reform plan would be revenue neutral. The budget resolution allows Republicans to use the reconciliation process to pass a filibuster-proof tax reform plan, so long as it doesn't create a shortfall greater than the $1.5 trillion number. That means tax reform could pass with only Republican votes, which, in normal times, would make it very likely to become a law.[11] Market participants have been closely following how the drama plays out within the Republican Party – if they will in fact have enough votes.

That focus, however, does not mean that markets are completely ignoring the details. ("Oh great, here comes a laundry list of the proposals and potential market impact.") Bigger corporate tax cuts will help stocks. While the debate over state and local tax deductibility is very important to people who work in states like Connecticut, it is probably not a big market mover.

> A reduction in the cap on 401(k) plan deductibility might discourage some investment into equities, but probably would not cause a major market shake-up.[12]

One proposal that has gotten less attention is the potential limit on interest deductibility for debt held by C corporations.[13] Many companies rely on these deductions to reduce their taxes. Any loss of interest deductibility would hurt heavily indebted companies, particularly relative to companies who haven't borrowed as much. This provision may be watered down by applying it only to future debt, but it would still have an effect on companies' capital structures.[14]

The biggest difficulty in evaluating the details of the proposals is that we are a long way from a final bill. Some estimates have the current tax cuts at $5 trillion[15] which means lawmakers have to find a lot of revenue[16] to get to the $1.5 trillion reconciliation number. Markets have plenty of other things to digest right now, including the strong economic data in the U.S., and much of the rest of the world. For markets, uncertainty on the tax provisions is okay, as long as something passes in the end. And give market participants a break, once in a lifetime everyone is entitled to fall madly in love with deficit spending. Even Ricardo knew that.

What We Are Watching

FOMC Meeting (Wednesday)

According to the projections published after the last FOMC meeting in September, the majority of committee members expect to raise rates one more time in 2017. The most likely timing for such a move would be the December meeting, as the Fed has shown a strong preference for announcing policy changes at the quarterly meetings featuring a press conference and updated forecasts. While U.S. economic data has experienced some hurricane-related volatility over the last couple of months, there has been little evidence of any meaningful slowdown in growth. Inflation numbers have remained subdued, but policymakers continue to argue that inflation readings will most likely move up in the future. In short, there is little reason to expect a change in tone at this week's meeting, as FOMC participants likely continue to see a December hike as appropriate.

Bank of England Meeting (Thursday)

The statement published after the last Bank of England (BoE) meeting in September struck a distinctly hawkish tone, indicating that "some withdrawal of monetary stimulus is likely to be appropriate over the coming months." Inflation has risen above the BoE's 2% target, and members of the Monetary Policy Committee (MPC) appear to have grown more concerned that this could persist if policy remains too loose. Economist forecasts and market pricing now point to a high probability of a rate hike at the November meeting. If the BoE chooses instead to wait for more evidence before hiking, it could lead to weakness in the pound and a rally in U.K. fixed income. If the central bank hikes as expected, market participants are likely to focus on the statement and post-meeting press conference for information on the likelihood of further rate hikes in the months ahead.

U.S. Employment Report (Friday)

The employment data published each month by the Bureau of Labor Statistics (BLS) mostly reflects information gathered during a "survey week" around the middle of the month. The U.S. mainland was struck by two major hurricanes between the August and September survey weeks, and disruptions related to the storms were likely responsible for the estimated loss of 33,000 jobs in last month's report. Weekly jobless claims suggest that business operations in the most significantly impacted states (Florida and Texas) have mostly recovered in recent weeks, suggesting there may already be a bounce back in job numbers in the October report (note that the national employment numbers do not include Puerto Rico, where the recovery from Hurricane Maria is likely to be much more protracted). Other components of last month's data were actually quite solid, with unemployment falling to just 4.2% and average hourly earnings growth accelerating to 2.9% YoY. The BLS indicated that they saw no evidence of hurricane impact (positive or negative) in those series. If this month's data supports that notion, showing a recovery in job growth alongside low unemployment and rising wages, it would paint a very positive picture of the U.S. labor market.

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1 Ricardo wrote such page turners as *The High Price of Bullion, a Proof of the Depreciation of Bank Notes.*
2 Some economists argue that tax cuts are more effective than spending increases in creating growth because the private sector is more efficient at using capital.
3 You can read more about it on his Wikipedia page - https://en.wikipedia.org/wiki/David_Ricardo.
4 Financial Times: "US stocks and dollar bolstered by tax reform hopes," 10/20/17
5 "I Love Lucy" was a popular TV show in the 1950s. It starred Lucille Ball and Desi Arnez as Lucy and Ricky Ricardo.
6 At least in theory they are. Maybe real world evidence would indicate otherwise.
7 Equity markets seem only to worry about deficits when there is a real chance of default or capital flight. Otherwise it focuses on growth. Right now the odds of a U.S. default are remote.
8 For example, South Africa released its mid-term budget on Wednesday, which forecast a wider than expected deficit. The rand fell over 1% weaker on the news (Source: Bloomberg: "Rand Falls to Six-Month Low as S. Africa Projects Wider Deficits," 10/25/17)
9 Source: BBC: "Greek stocks fall 5% on debt talk concerns," 11/1/12
10 *The Wall Street Journal*: "House Approves Budget Plan, Paving Way for Tax Action," 10/26/17
11 A 1974 Congressional Budget Act created the reconciliation process. Reconciliation allows Congress to pass changes in revenues (taxes) with a simple majority instead of having to overcome a filibuster which would require 60 votes to break in the Senate. The Byrd Rule which was amended in 1990 can stop reconciliation if it creates a significant increase in the budget deficit over a ten year period. Yes, that is why the Senate passed the specific budget they did with the $1.5 trillion number.
12 The 401(k) reduction is very unpopular but it still may be in the final bill.
13 Most big companies are C corporations as opposed to S corporations which have no more than 100 shareholders.
14 Foreign taxes and repatriation could have a bigger effect and were discussed in a weekly last year. The border adjustment tax is no longer being considered.
15 CNBC: "$5 trillion question for Trump tax plan: How to pay for it?," 9/28/17
16 Probably around $3.5 trillion