

MACROCOSM

Trump Gives the BAT the Boot

Monday, April 17, 2017

Donald Luskin

In a confusing week of pro-growth flip-flops, the White House takes the reins on tax reform.

The “Trump Correction” we called for right at the stock market top in early March (see [“A Trump Correction at Last?”](#) March 3, 2017) continues to muddle along. So far for the S&P 500 it’s barely resulted in a 3% retracement from all-time highs. We think it will drift a little deeper to take a little more froth out of the over-optimism that had built up around new-President Donald J. Trump. *Exactly what we predicted has indeed happened – the seemingly dangerous populist is turning into a seemingly*



more conventional politician. The truth is somewhere in between those “seemings.” But for now, it feels to us like markets are experiencing the disappointment that comes at the climax of the [Beauty and the Beast](#) myth: *now that we have our handsome prince, we kind of miss our scary beast.*

We urge clients to be on the lookout for a buying opportunity, and to not assume that Trump’s

mojo is no longer risin’ or that he’s *handed the government over to Goldman Sachs* – or that the GOP Congress can’t get anything done, especially tax cuts, to which we will return in a moment. Let’s take a realistic look at what’s actually been happening.

- *We’ve just had two very conspicuous displays of achievement by Trump and the GOP Congress.*
- On Monday, [Neil Gorsuch was sworn in](#) as an Associate Justice of the US Supreme Court – overcoming powerful Democratic brinksmanship – setting the stage for a conservative restoration of property rights and a reversal of deference to regulators on the high court that could last a generation.

Update to strategic view

US MACRO, US STOCKS, FX: The Trump Correction we predicted at the top grinds on – overexuberance in March is being bled off, but the realities are excellent underneath a confusing news-flow. Last week Trump reversed himself by not naming China a currency manipulator and by speaking well of Yellen. Flip-flops, yes, but both predictable and both removing major economic risks, and artfully timed to follow his Gorsuch and Syria triumphs. Also last week, we think Trump definitively separated himself from Ryan’s “border adjustment tax” scheme, setting the stage for a White House-driven tax reform initiative. Reform is always complicated, all the more so this time as it may open up a large arbitrage gap between corporate and individual rates. While the White House works it out, it pretends to be putting Obamacare repeal first. We counsel patience. The confusion on tax reform proves it is very much alive.

[\[Strategy dashboard\]](#)

- Trump's rapid, decisive and measured [response to Syrian atrocities](#) left [even Democrats having to applaud](#) an humanitarian intervention, and demonstrated that Trump is not soft on Russia.
- Even the seeming stumble-bum circus of [White House Press Secretary Sean Spicer's Hitler gaffe](#) this week was so politically useful as to [make us wonder](#) if it were not intentional. After this, *nobody* will be making any comparisons to Hitler – of which [Trump himself had been the main target](#).

With these accomplishments in his pocket, Trump has done what public company CEO's do in earnings season – it's the political version of "managed earnings." Trump has seized the moment to break a few campaign promises that needed to be broken anyway.

- [The Treasury's semi-annual Foreign Exchange Policies report](#) was released Friday, and China was not named a currency manipulator. It wasn't even a close call. China only met one of the three criteria, while the other five countries examined all met two.
- Trump promised repeatedly in his presidential campaign that he would brand China a currency manipulator on his first day in office. So that promise was broken on his *second* day in office when he failed to do so, but now it's very much official.
- And [Trump said on Wednesday](#) he thought the US dollar is "getting too strong."
- Those would seem to be contradictory policies – but we predicted Trump would take both positions (see ["Our Contrarian View on the Dollar"](#) January 5, 2017). Indeed, [Trump has said](#) the same thing about the dollar before, so we don't understand [all the alarm](#).
- Combined with [Trump's tweet](#) that China's help with North Korea would soften his anti-trade stance, a great Sword of Damocles has been removed from the global economic outlook. *Trump's pro-growth agenda is now far less corrupted by anti-growth protectionist tendencies. This was predictable (we predicted it) and it is great news now that it has happened.*
- Also last week [Trump said](#) Janet Yellen is "not toast" when her term as Fed Chair ends in January 2018. He said, "I like her, I respect her."
- This apparently reverses [Trump's criticisms of Yellen](#) during the campaign, but we predicted this, too (see ["Yellen Gives Conservatives Something to Cheer"](#) February 17, 2017).
- It, too, removes a Sword of Damocles. *Before, there was the risk Trump would appoint a conservative ideologue like John Taylor who would jack up rates in pursuit of an anachronistic concept of normalization.*
- So let the headlines roll – ["abandoned promises."](#) ["stunning u-turns."](#) ["flip-flops"](#) and ["flipping the House in 2018."](#) *This is all good. This is all very good.*

With all that to set the scene, let us turn to the main event – the prospect for tax cuts.

Recommended Reading

[Safety, Liquidity, and the Natural Rate of Interest](#)

Marco Del Negro, Domenico Giannone, Marc P. Giannoni, Andrea Tambalotti
Federal Reserve Bank of New York
March 2017

[The Impact of the Border Adjustment Tax on the States](#)

Alan Nguyen and Mary Kate Hopkins
Americans for Prosperity and Freedom Partners
April 2017

[The new age of Ayn Rand: how she won over Trump and Silicon Valley](#)

Jonathan Freedland
The Guardian
April 10, 2017

[The Obama Administration's Zelig](#)

Victor Davis Hanson
National Review
April 11, 2017

[The French town that shows how Marine Le Pen could win](#)

Anne-Sylvaine Chassany
Financial Times
April 10, 2017

[Trump makes nice with Koch brothers](#)

Kenneth P. Vogel and Josh Dawsey
Politico
April 9, 2017

[C-day and military money](#)

JP Konig
Moneyness
April 10, 2017

[Trump Names Hassett to Head Council of Economic Advisers](#)

Michelle Jamrisko
Bloomberg
April 7, 2017

[\[Reading home\]](#)

- *Here, too, Trump had very good news for markets, in the form of what might be argued was another flip-flop After months of signals that were weak, intermittent and mixed, it seems to us that Trump has finally let it be known he won't support the GOP House tax reform "blueprint," with its dangerous and protectionist "border adjustment tax" scheme* (see ["The Border Adjustment Tax and Its Victims"](#) February 10, 2017).
- [In a televised interview on Tuesday](#), White House Office of Management and Budget Director Mick Mulvaney – himself until a couple months ago a Representative from South Carolina, and a founding member of the Freedom Caucus – said “the House can go and do what they want to do. We [the White House] are going to formulate our own policies.”
- Then [in a televised interview on Wednesday morning](#), Trump repeated [his January critique](#) of the BAT: “When I hear border adjustment, 'adjustment' means we lose.”
- Trump’s complaint that the dollar is too strong was made the same day in [a different interview](#), and it was another blow against the BAT – which, [its supporters claim](#), will make the dollar stronger.
- To be sure, Trump has not walked away entirely from embedding protectionism in the tax code. In the Wednesday interview he went on to speak favorably of a “reciprocal tax” or “mirror tax” that would match, case by case, tariffs imposed on US exports by other nations. But he conceded that if these ideas got in the way of tax cuts, “we could keep trade and we could keep certain things separate. We may put it in the tax code or we may keep it separate.”
- We see targeted tariffs as anti-growth – but at least they are targeted, unlike the BAT, which would have embedded protective tariffs and export subsidies in the deep-tissue of the tax code (see ["For Free Traders, Trump's Corporate Tax Cut Is the Better Way"](#) January 18, 2017).
- *The big win here is that the BAT appears dead now.*
- So now we can move forward. As we expected, after the failure of the American Health Care Act in the House, Trump is taking policy control back from Speaker Paul Ryan, with whom it had been trapped in the BAT box canyon. [Management-team transitions are disturbing](#). Such internal politicking is a necessary move in solving the Rubik’s Cube of tax reform (see ["Does AHCA Kill Tax Reform?"](#) March 27, 2017).
- This was missed last week in [the media's glee](#) at the apparent demotion of White House Chief Strategist Steve Bannon – arguably another lieutenant whose policy leadership has not produced results.

**Contact
TrendMacro**

On the web at
trendmacro.com

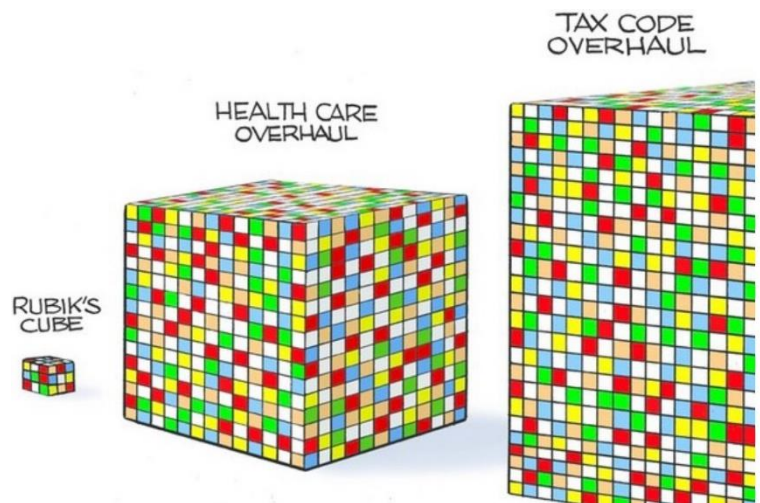
Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[\[About us\]](#)



- Don't be impatient. Tax reform is always especially difficult policy. *In fact, Trump's centerpiece reform idea – to lower the US corporate rate so that it is no longer the world's highest – is especially challenging.*
- Today the top corporate rate is not much different from the top personal rate, so there are no significant tax-arbitrages between various entity-types. *But if the top corporate rate were lowered to say 15%, that would open up a large gap between rates for C-corporations and individuals* (and S-corporations and LLCs that pass through income to the individual rate schedule). Closing that gap by offering S-corps and LLCs the option to retain earnings at the 15% rate complicates the tax code by effectively eliminating the basic idea of the pass-through entity. *Even before the election, this conundrum drove a wedge between Steve Mnuchin (then Trump's campaign finance chair, and now his Treasury secretary), who wanted the tax cut to apply only to C-corps, and campaign advisors Larry Kudlow and Steve Moore who stressed the importance of cutting rates for small business.*
- While this is all being worked out, Trump keeps stringing along GOP activists for whom Obamacare repeal is a fetish object, [continuing to assure them](#) that repeal must come before tax reform.
- We think that's a mere holding action, a diversion. The moment the White House has its tax initiative internally agreed, it will suddenly announce that Obamacare repeal will have to wait (in our view, that is inevitable anyway: repeal is not achievable without 60 GOP votes in the Senate – again, see [“Does AHCA Kill Tax Reform?”](#)).
- So we counsel against letting the breathless media coverage of the Trump administration, or the administration's own confusing emanations, create either unrealistic expectations or unrealistic disappointments.
- *We have not changed our core expectation that significant tax cuts will be forthcoming this year.* The seeming confusion and all the mixed signals and conflicting posturing about it are proof that it is very much alive and a work in progress.

Bottom line

The Trump Correction we predicted at the top grinds on – overexuberance in March is being bled off, but the realities are excellent underneath a confusing news-flow. Last week Trump reversed himself by not naming China a currency manipulator and by speaking well of Yellen. Flip-flops, yes, but both predictable and both removing major economic risks, and artfully timed to follow his Gorsuch and Syria triumphs. Also last week, we think Trump definitively separated himself from Ryan's “border adjustment tax” scheme, setting the stage for a White House-driven tax reform initiative. Reform is always complicated, all the more so this time as it may open up a large arbitrage gap between corporate and individual rates. While the White House works it out, it pretends to be putting Obamacare repeal first. We counsel patience. The confusion on tax reform proves it is very much alive. ▶