Heartwood
Investment Management

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Investment Insight

Weekly Insight

Is the ~~‘Trump trade’~~ ‘higher yield’ trade back?

Donald Trump’s ‘tax framework’ has been finally unveiled and cautiously welcomed by financial markets. Even before this announcement investors have recently been showing a little more confidence in the so-called ‘Trump trade’. Since early September, the US dollar has appreciated on a trade-weighted basis and the ten-year US treasury yield has risen to a two-month high. Within US equities, those areas of the market that are perceived to benefit from pro-growth Trump policies – smaller companies, financials and cyclicals – have also started to outperform.

In fact, to our mind this modest turnaround in performance has been premised less on Trump’s ability to accomplish his agenda and rather more around expectations of higher yields. Markets have had to play catch up. The US Federal Reserve has decided to overlook the recent run of disappointing inflation reports and continue with its current programme of tightening, including its announcement of beginning balance sheet tapering. The Fed’s tightening intentions, while gradual, were reinforced this week by Chair Janet Yellen.

Nonetheless, as the Fed has kept to its tightening script, the absence of any fiscal response has left investors disappointed. Since the failure of US healthcare reform earlier this year, Trump’s presidency has been overshadowed by questions around policy execution. Many investors see tax reform as the catalyst to greater economic growth. This week’s announcement has partially reincarnated a few of those animal spirits.

A boon to US corporate profitability?

Details of the proposed tax framework remain vague and there is still a long way to go before we see any legislation being passed by Congress. A few highlights include:

- Simplifying personal income tax bands to three (12%, 25% and 35%) from seven bands.
- A reduction in the corporate tax rate to 20% from the current level of 35%.
- A one-time tax on untaxed foreign profits and tax-free repatriation of future foreign profits.
- Limits on deductions for interest costs for corporations.

Ostensibly, and if the above proposals are enacted, reduced corporate tax rates and a ‘holiday’ on repatriated future foreign earnings should boost the profits of the largest US companies. Just as important, though, is the impact these changes could have on smaller- and medium-sized companies which often have a higher tax burden. According to research house T.I.S., smaller companies create more than two-thirds of new jobs in the US economy. Therefore, lowering the effective tax rates for smaller companies would increase profit margins, in turn feeding through to higher wages. All of these trends could meaningfully impact domestic growth prospects and, indeed, surveys show that optimism remains at multi-year highs among small businesses.

According to some observers, Trump views the US stock market as the key barometer of his presidency. The Trump Administration assumes that tax reforms will achieve a notional GDP target of 3% or more. This, in turn, is expected to fund the proposed tax cuts. Investors appear to be giving Trump the benefit of the doubt and there is a growing confidence that tax legislation in some form will be implemented (albeit more modest than early campaign promises), especially in light of upcoming Congressional elections in 2018.

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However, many questions remain. Will these tax proposals deliver the inclusive growth that certain parts of the US electorate voted for in 2016? And, importantly, will they deliver the margin of growth sufficient to fund any potential tax giveaway? Closer to home and this side of the Atlantic, there is another political party promising a less-business-friendly but easier fiscal stance, with the same objective of using higher levels of growth to fund it. Time will tell if Trump can keep the US stock market on his side.

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