THE POSSIBILITIES OF TRUMP'S U.S.

Drawing from his business background, Trump may treat the U.S. as a business. We take a look at what "Trump Inc." may look like.

- The best-case scenario is phased in tax cuts, few trade disputes (if any), and regulatory reform with spending restraint elsewhere to minimize the increase to the budget deficit. This could generate in excess of 8% additional GDP.

- Scenarios including more trade barriers, including border taxes (read tariffs) and higher deficits are far less stimulative, and would have negative long-term consequences.

Fortuitously, President-elect Trump really likes debt. This is a good thing, because—as it stands—his tax plan requires gobs of it. His administration inherits a significant debt load that may limit his ability to execute some of his more ambitious fiscal plans. To turn Trump Inc. into a successful operation, he will have to work through a balance sheet in disarray, and an income statement in dire need of growth. Granted, it is not all bad news for the President-elect. The balance sheet reflects the effects of the Great Recession and the subsequent slow growth environment, but it is still salvageable. The income statement could also be worse. The deficit has shrunk in recent years—in 2015 it was 34% lower than in 2014.

But there are significant reasons to be skeptical in the near-term. Already running a deficit, Trump Inc. needs to cut costs and increase its income streams. Several solutions, such as using a "border adjustable" tax rate and lowering the repatriation tax on cash held by U.S. businesses overseas, are under consideration. But these ideas may not meet the cash flow stimulus required—the plan targets businesses and U.S. tax burden rests predominantly on individuals, not corporations (See Table 1).

THE INCOME STATEMENT

With 75% of Trump Inc.'s income coming from individual income taxes (not corporate taxes), altering the personal tax code will have significant ramifications for government revenue (Table 1).

Much of this will depend on how "pass-through" income is treated. Pass-through income is business profit treated as personal income when in other corporate structures it would be earnings and taxed at the corporate level. The House GOP tax plan, "A Better Way", calls for a 25% top marginal rate on pass-through income, but would also require businesses to pay "reasonable compensation" to avoid having all of the income taxed at the lower rate. What is "reasonable"? Good question. The plan does not specifically outline a "reasonable" salary.

Corporate taxes constitute about 10% of the overall tax base. Therefore, the proposal to lower the corporate tax rate would have relatively little impact on the budget deficit. The Tax Foundation (TF) estimates that the proposal to repatriate overseas cash at an 8-10% rate would raise $200 billion in taxes over a 10-year period. While this could possibly provide a lift to business investment, repatriation would do relatively little to boost revenue. A reduction of the corporate marginal rate to 20% from the current 35% has been proposed, and may discourage the use of pass-through income entities. Regardless, the current state of the U.S.' income statement is obvious. The two principal drivers of revenue are individual taxes receipts and corporate tax receipts.

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But the driver of tax revenue may change if some of the recommendations from the House GOP plan are implemented. The mechanism of transferring (at least some of) the tax burden would be a so-called "destination based" tax. This works through the use of a tax that is "border adjusted" to make everything sold in the U.S. effectively have the same tax rate. Instead of taxing based on whether it was U.S. produced, consumption would be taxed—the taxation would shift from production to consumption. Given the level of U.S. imports versus U.S. exports, this could raise revenues for Trump Inc. significantly – as much as $1.2 trillion over the next 10 years according to the Tax Policy Center (TPC).

Not an insignificant sum, but it will more than likely be deemed illegal under World Trade Organization rules because it effectively acts like a tariff. Also part of the plan, a proposal to repeal itemized deductions (excepting charitable and mortgage interest) and personal exemptions will be a boon of $3.2 trillion to the revenue stream over the next decade.

U.S. Income Statement (Table 1) **Source: Bureau of the Fiscal Service** **U.S. Department of the Treasury**	
(In billions of dollars)	**2015**
Revenue:	
Individual income tax and tax withholdings	2,545.2
Corporation income taxes	339.8
Excise taxes	101.7
Unemployment taxes	49.1
Customs duties	33.6
Estate and gift taxes	19.1
Other taxes and receipts	202.9
Miscellaneous earned revenues	42.6
Total Revenue	3,334.0
Net Cost of Government Operations:	
Total net cost	3,858.8
Unmatched transactions and balances	5.1
Net operating (cost)/revenue	-519.7

Initially, the combination of personal and corporate tax breaks will have a relatively small effect on the income side. The TPC estimates about an $11 billion revenue loss in 2016. However, this reduction becomes more pronounced in subsequent years, troughing in 2018 with a loss of more than $339 billion, a figure that includes all the positive feedback-loops associated with lower taxes. Over 10 years, the income loss is estimated at $2.5 trillion by the TPC and almost $4 trillion by the TF. Even the lower of the two figures is astounding.

There is also a cost side to an income statement, and here there is little concrete information. Trump Inc.'s latest business plan would be spending neutral. Normally, this would be a good thing: Trump Inc. would grow, and spending the same amount would allow the bottom line to grow over time. However, given the deep cuts to revenue, the lack of spending cuts will cause the deficit to grow. Over a 10-year period, the TPC expects the deficit to increase by $3 trillion cumulatively after the macro feedbacks. Without offsetting spending cuts, the health of the income statement is likely to deteriorate, or at best not improve much, over the next decade.

THE BALANCE SHEET

Over the first 10 years, the TPC sees the GOP's tax cuts adding about $3 trillion in debt after the benefits flow-through. The U.S.' balance sheet (Table 2) is already in need of repair, and this is where the income statement losses of Trump Inc. become an issue. Primarily, the balance sheet problems are due to the lack of cost cutting combined with tax cuts. Why? The tax cuts reduce revenues and increase the deficit. This means the debt load and interest payments on the debt become increasingly more painful. Furthermore, the additional debt overhang weighs heavily on long-term U.S. growth.

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The problem for the balance sheet is that there are so few levers to pull. Without running a balanced budget, it will be impossible to maintain the current level of Federal debt, never mind reduce it. Instead, under the most optimistic scenarios, the debt-to-GDP level will creep higher by 11%, as GDP growth does not keep pace with the need to finance the deficit.

U.S. Balance Sheet (Table 2)
Source: Bureau of the Fiscal Service U.S. Department of the Treasury

(In billions of dollars)	**2015**
Assets:	
Cash and other monetary assets	305.1
Accounts and taxes receivable, net	117.8
Loans receivable, net	1,216.00
Inventories and related property, net	320.6
Property, plant, and equipment, net	893.9
Debt and equity securities	104.4
Investments in government-sponsored enterprises	106.3
Other assets	165.7
Total assets	3,229.80
Liabilities:	
Accounts payable	68.3
Federal debt securities held by the public and accrued interest	13,172.50
Federal employee and veteran benefits payable	6,719.30
Environmental and disposal liabilities	411.6
Benefits due and payable	213.9
Insurance and guarantee program liabilities	177.5
Loan guarantee liabilities	36.3
Other liabilities	652.3
Total liabilities	21,451.70
Contingencies and Commitments	
Net position:	
Funds from Dedicated Collections	3,247.70
Funds other than those from Dedicated Collections	-21,469.60
Total net position	-18,221.90
Total liabilities and net position	3,229.80

The truth about the balance sheet is that tax cuts and corporate reform will not be enough to clean it up, or even begin to repair it. The plan's tax cuts have a directly negative impact—especially if interest rates rise. The balance sheet is the product of the evolution of the income statement. With the income statement continuing to run in the negative, the chance of repairing the balance sheet over time is slim.

But the balance sheet is also deceiving. Debt held by the public does not measure the entirety of the national debt, because the government owes itself about 20% of the debt outstanding. It also obscures the "off-balance sheet" liabilities of Social Security and Medicare, which at about $41 trillion, demand attention (Table 4). On the asset side, there is no accounting for the federal government's land holdings and associated mineral rights. In other words, not all assets or liabilities are captured on the standard balance sheet of the U.S.

PRESIDENT-ELECT TRUMP'S U.S. TURN-AROUND TEAM?

Running deficits and growing an economy are two wildly different things. The fact that the tax changes are expected to cause persistent deficits does not preclude significant economic growth. For instance, the TF predicts the U.S. economy will add 6.9 to 8.0% in GDP more than it would have otherwise.

As the TF points out, the Congressional Budget Office predicts that the U.S. economy will grow 19.2% from 2016 to 2025 without changes. Adding the two together, the U.S. economy will be about 27-28% larger in 2025 than it is today. That is about a 2.5% growth rate year over year during the period, an improvement from the 1.75% expected. In other words, the tax plan will add about 0.75% growth per year to the U.S. economy over the next decade. The benefits are likely to be front-end loaded as lower taxes boost consumption, investment and savings before being absorbed into the economic base.

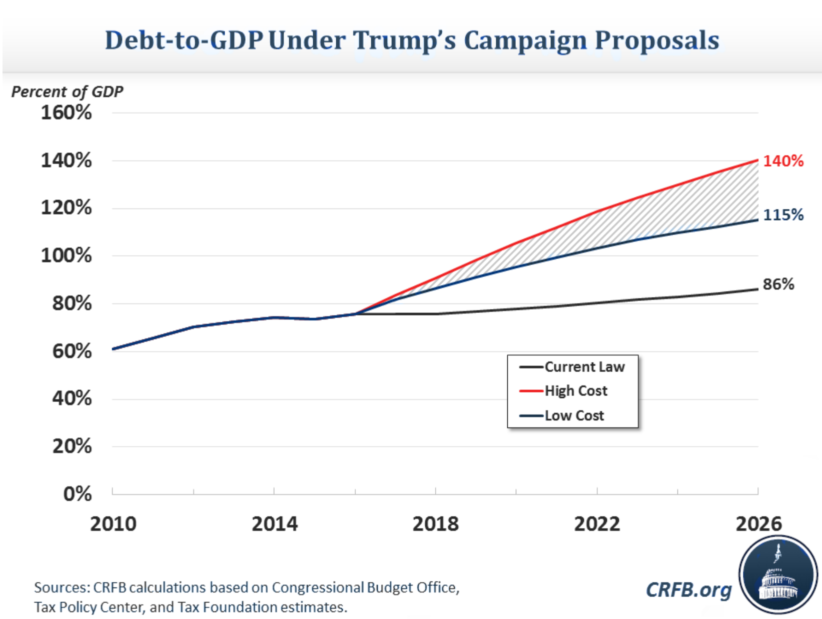
The other sides of Trump Inc.'s turnaround plan may not go over as well. Trade policies, immigration and infrastructure could negate some of the purported tax benefits. Given the overall lack of clarity, it is difficult to estimate the potential effects. Deregulation of certain industries, including the financial and energy sectors, could spur pockets of growth, but these would accrue over a longer time horizon.

Using the TF's estimates, corporate tax reform is by far the most important driver of growth—contributing 4.5% of the 6.9% low-bound estimate. Individual tax reform spurs the remaining 2.4%. Simply lowering corporate taxes would increase the long-run level of GDP by 4.1% according to the same analysis.

The plan may succeed if the potentially harmful pieces of it are dropped or de-emphasized. For instance, President-elect Trump's plan does not include (at the moment) border adjustability, while the House GOP plan does. Trump's proposed pass-through income tax rate is 15% while the House GOP is at 25% with some odd language surrounding the amount allowed to be taxed there. On most fronts, the two plans are close. But the GOP's plan has a much lower expected revenue loss—mostly due to the border adjustability. To compensate for losing that revenue source, Trump Inc. may have to do more cost cutting or pledge to do so later.

OPERATIONAL LEVERS

Does Trump Inc. have levers to pull? There may be a few, but many would be incredibly unpopular. Deregulation, tax reform and incentivizing business investment and innovation are levers Trump Inc. could pull to increase underlying GDP. The matter of how best to execute (and how to avoid a rapid increase in the national debt) is another question entirely (See Table 3).



Taxes are the main lever in terms of efficacy of all types. Deemed repatriation (forced repatriation of cash held offshore) would allow capital to be allocated in the U.S. without paying full corporate taxes. It would also force the capital to be allocated (to a degree) by forcing the taxation. The reduction of pass-through rates and the corporate rate in general would encourage additional investment (though there would need to be the demand for the goods to justify the investment) or further equity buybacks and large, one-time dividends.

Scaling in personal tax cuts slowly would encourage the additional cash flow to act more like an income gain than a balance sheet item. The additional consumption is more likely to encourage repatriated dollars to flow to investments in additional capacity and labor. This increases the multiplier effect of the tax breaks to stimulate economic activity, and reduces the deficit costs in both the short and longer-term. With the consumer such an integral part of the economy, execution and messaging around the personal tax cuts will determine how well the fiscal plan works.

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U.S. FINANCIAL STATEMENT SNAPSHOT (Table 3) (Source: Bureau of the Fiscal Service, U.S. Department of the Treasury)		
(In billions of dollars)		
FINANCIAL MEASURES	**2015**	**2014**
Net Cost	**($3,858.80)**	**($3,837.00)**
Tax and Other Revenue:	$3,334.00	$3,066.10
Unmatched Transactions & Balances	$5.10	($20.40)
Net Operating Cost	**($519.70)**	**($791.30)**
Assets:		
Cash & Other Monetary Assets	$305.10	$264.90
Loans Receivable, Net	$1,216.00	$1,125.70
Inventories & Related Property, Net	$320.60	$318.40
Property, Plant & Equipment, Net	$893.90	$878.30
Other	$494.20	$478.00
Total Assets	**$3,229.80**	**$3,065.30**
Liabilities:		
Federal Debt Held by the Public & Accrued Interest	($13,172.50)	($12,833.60)
Federal Employee & Veterans Benefits Payable	($6,719.30)	($6,672.60)
Other	($1,559.90)	($1,259.80)
Total Liabilities	**($21,451.70)**	**($20,766.00)**
Net Position (Assets minus Liabilities)	**($18,221.90)**	**($17,700.70)**

Incentivizing business investment is partially contingent on driving greater demand, and the individual tax breaks will be a primary driver. Executed properly and with consideration for one another, the combination could create a dynamic boost to the U.S. economy.

Deregulation, while unpopular with certain groups, is a potentially significant lever, but it is sticky in that it pulls slowly over time. Deregulation will likely give a boost to business investment, but only slowly on net. This will be more of a medium term benefit.

Infrastructure spending is not mentioned here because it is unclear the extent, purpose, and target of any plans. Also, at this point in the economic cycle, a program of any significance would probably be more inflationary than anything else.

POTENTIAL OUTCOMES

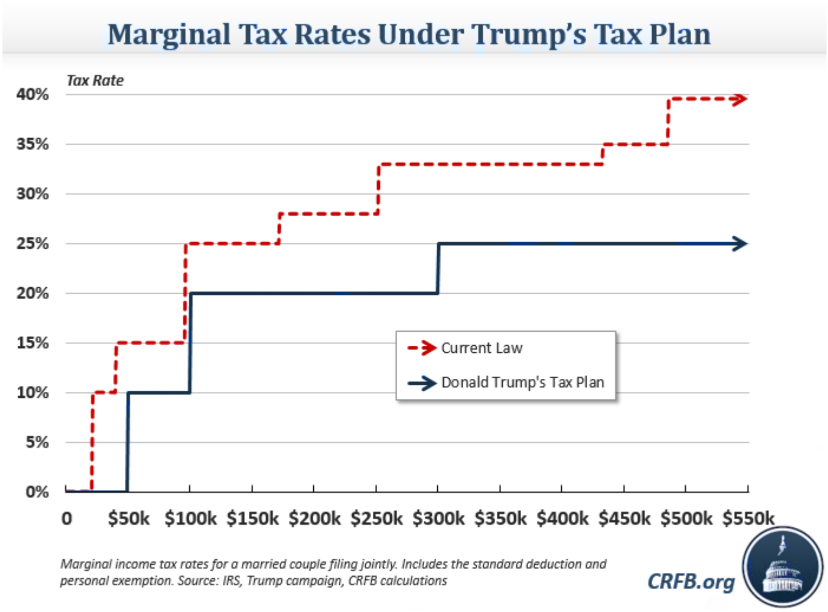
This is where any analysis becomes muddled to the point of speculation. But we can venture a few broad generalizations and caveats to provide context.

Of note, without more substantial spending cuts then are currently being proposed, the projected GOP and President-elect plans will cause the budget deficits to expand regardless of the efficacy and how well they are implemented. This will in part be compensated by GDP gains of 0.75% per year generated by the tax cuts, but the deficit will run at approximately twice that rate.

The **best-case** scenario would involve the proposed tax reform without the border adjustable tax rates (likely illegal anyhow, but a trade-war starter if implemented). A lack of border adjustability taxation creates a problem on the revenue side, but revenues could be raised using a less combative, trade oriented tactic. Repatriation would accompany the creation of longer-term demand via either the individual tax cuts or a separate incentive. The tax cuts would be phased in slowly to encourage consumption or savings, generating a stable deficit environment. Any infrastructure program would be set aside until a recession hit, and job creation became necessary and needed.

Deregulation will play a role in pushing GDP higher than the tax cuts alone, possibly adding 2-3% over the time-horizon. This would lead to a U.S. economy in excess of 8% larger over 10 years than it would have been – and on a sustainable path.

In the **base-case**, the fiscal package is likely to be a muddling of the best and worst case. Since border adjustability is a revenue-generating cornerstone of the GOP plan, it is unlikely to be removed without significant spending cuts or a new method of raising tax revenue. Border adjustability is tempting, because it is more tariff than tax driven, making it easier for GOP fiscal hawks to accept. The tax regime will remain near where the GOP and President-elect Trump are now with significant cuts to both individuals and corporations. The debate around the pass-through income tax may escalate, but that is the only major point of contention there. Spending cuts will be difficult to come by in any quantity, especially given the proposals to increase defense spending. Again, this will lead to gains in GDP (excluding the consequences of border adjustability, a stronger dollar, and any retaliation) of around 8%, but in this case the gains come with a much larger debt to GDP ratio as the deficits from less receipts and more spending far outstrip gains in GDP.



The **worst-case** scenario would see smaller than expected tax cuts, border adjustability, and a large infrastructure package with little in spending cuts or other offsetting mechanisms. This would generate a smaller boost to growth, hurt trade relations, strengthen the U.S. dollar, and stoke inflation for only a minimal GDP growth return. And it would still have negative ramifications for Trump Inc.'s balance sheet by raising the deficit and debt levels.

IN THE END

The base-case is most likely to come to fruition with both the GOP and President-elect Trump. There will be growth, but the near-term growth could be stifled and reversed in the long-term without substantial spending cuts. Penn Wharton models shown that a poorly designed stimulus, after creating jobs in the near-term, would reverse before a decade had passed. With the U.S. deeply in debt and little being proposed to rein in the Medicare and Social Security costs ($41 trillion), the long-term prospects become drearier if a fiscal stimulus is improperly executed. That said, there is the potential to breathe life into an economy restrained by debt, demographics, and regulatory burden.

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SUSTAINABILITY MEASURES-OFF-BALANCE SHEET (Table 4)	2015
Social Insurance Net Expenditures:	
Social Security	($13,440)
Medicare	($27,940)
Other	($108)
Total Social Insurance Net Expenditures	**($41,487)**

Adding 0.75% annually to growth over a decade sounds unimpressive, but it is a 43% boost over the current potential GDP growth rate of around 1.75%. It comes, however, at the cost of a higher deficit and further increase in the U.S. debt level. Tax reform and deregulation are unambiguously positive for growth in the near-term, but trade wars and debt are not. Avoiding one and minimizing the other will likely determine whether Trump Inc.'s turn-around succeeds or fails.

INVESTMENT IMPLICATIONS

The investment implications rest on the delivery of the fiscal package. Deemed repatriation should be a positive for equities due to the increased sustainability of dividends and buybacks. Tax reform is a similar story with a step function change in earnings estimates. An increase in earnings would make stocks more attractive on a valuation metric level such as price to earnings (EBITDA would be unaffected). The individual tax breaks should positively affect the revenues of consumer driven business, a positive for equities. Deregulation will primarily affect the expense lines of certain industries including energy and finance, boosting earnings.

Inflation expectations will likely cause more volatility and a possibly higher interest rate environment, but a strong dollar and Fed tightening policy should counteract at least some of the pressures. It will be a battle between the inflationary fiscal policy, and front-end tightening of the fed funds rate and a strong dollar. Commodities may benefit from fiscal demand, but the strong dollar will counteract this to a degree.

A breakdown in trade relations would be unquestionably bad for business and would interrupt supply chains causing ripple effects across industries. It is unclear how interest rates would react—whether a flight to safety would prevail or a reactionary sell-off from sovereign holders would dominate. Interest rates could fall in reaction to other political headlines and outcomes. The severely reactionary nature of the interest rate market makes the positives and negatives more difficult to balance than equities.

Notwithstanding a trade war, a well-executed Trump plan should be a long-term positive for equities and a mixed bag for fixed income and commodities. Asset allocation will remain paramount in this environment. Fixed income continues to play a vital role in fulfilling long-term objectives and providing diversification from other asset classes, while real asset exposures should provide inflation protection for a portfolio. Equities could benefit from the potential success of a Trump Inc. turn-around.

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