October 6, 2017

Fed Sweepstakes & Tax Wrinkles

Yesterday, the Senate approved 65-32, the nomination of Randal Quarles to Fed governor. He assumes the role focused on banking sector oversight – a position created out of Frank-Dodd legislation and unfilled since 2010.

There are three more voting-seat vacancies yet to be filled by President Trump, with the biggest question being who will become Fed Chair next February. Among those in contention are: Janet Yellen, Gary Cohn, Kevin Warsh, Jerome Powell, Neel Kashkari, John Taylor and Glenn Hubbard.

Predictit.org suggests former Fed governor, and 47-year old rate hawk, Kevin Warsh, remains the odds on favorite at 42%. But rate policy centrist Fed governor Jerome Powell is closing in at second with 36%, fresh off reports that Treasury Secretary Mnuchin is leaning towards Powell. Where Warsh would likely be seeking to be more aggressive with rate and balance sheet normalization, Powell would likely follow a gradualist path, admitting in August that low inflation is a bit of 'a mystery' to him.

Yellen's odds are at 13% and have been in decline since Senator Shelby shared his doubt on her reappointment after speaking with President Trump. Gary Cohn's fall to 11% from ~40% in August reflects the price paid since wading into the Charlottesville controversy as a critic of the President.

Trump's admission to being a "low rate" kind of guy could cause him to settle on Minneapolis Fed President and Uber-dove Neel Kashkari. Although a long-shot at 8%, Kashkari has been a refreshing voice against the rate hawks and die-hard Phillips Curvers on the board. In his last piece written for Medium.com he made the point that the Fed's shift toward a tightening posture since 2015 has likely restrained economic growth, job creation and thereby undercut the Fed's goal of reaching a 2% inflation target. He believes there is still slack in the job market and does not want rate increases until PCE runs at a 2% rate for at least twelve months.

We don't view rate hawks either John Taylor of 'Taylor rule' fame (at 4%) or Glenn Hubbard (at 2%) as realistically in the running. Indeed, with Quarles, they effectively have their hawkish views represented.

In 2016, Quarles publicly argued that the focus on trying to break-up the so-called 'too big to fail banks' was missing the point that the problem in banking was more about a lack of stable deposits and a continuation of the Fed's zero interest rate policy. He additionally made clear that he preferred more a more 'rules-based' approach to monetary policy, even favorably mentioning the "Taylor rule," rather than Bernanke and

Yellen's preference for discretionary monetary policy. We consider Quarles a rate hawk and likely to side with those who argue for a more rapid schedule of rate increases and balance sheet normalization.

In what may be a prelude of bi-partisan support for upcoming tax negotiations in Congress, Quarles' nomination was approved with the support of 14 Democratic Senators, including both senators in the blue states of Maryland and Delaware. Of the 10 red state Democratic Senators up for reelection in 2018, six of them voted for Trump's nominee including: Manchin (WV), Heitkamp (ND), Tester (MT), McCaskill (MO), Donnelly (IN), and Nelson (FL). These are positive signals that if Trump is able to keep the popular pressure on Congress to follow through with pro-growth tax cuts, his efforts may enjoy more a sizeable Democratic bloc to help him surmount potential GOP defections from the likes of John McCain, Bob Corker, Susan Collins, et al.

Tax Wrinkles: We remain confident that tax cuts are in the cards for 2017. Surely, the Fed's plans for a December rate hike and three additional rates increases in 2018 only make sense with the assumption of a robust, pro-growth package being passed in late 2017, early 2018. Failure would simply invite a strong equity selloff.

At this point, we are beginning to see new wrinkles in tax discussions that are not entirely unexpected, but suggest some watering down of the Administration's tax cut proposals may be in play. For example, Republican unanimity on death tax repeal is reportedly breaking down in the Senate. The WSJ reports that Republican senators Mike Rounds (SD), Susan Collins (ME) and John McCain (AZ) are pushing back against full repeal of the estate tax. Presently, a 40% tax rate, applies to estates valued above $5.49 million individually, and $10.98 million per married couple. Rounds suggests he would be more comfortable with doubling or triple the exemption rate, bringing the level as high as $30 million. Because the estate tax holds capital hostage, any reduction to the estate tax, is important and positive for growth. A complete elimination of the estate tax might not occur. But compromise on how much the estate tax threshold is raised could in some sense be a net positive for paving the way to an agreement.

Another feature of the Big Six tax plan that has been taking heat is the elimination of the state and local tax deduction on federal filings. For Republicans in high tax states, this is likely an unpopular proposal that threaten some House seats. For instance, NY Representative Peter King has vowed to make sure such a measure does not survive in the House version of the bill.

Including Illinois and coastal states of CT, NY, NJ, CA, the move would represent a significant tax hit, but also represent a significant "pay for," estimated at $1.8-1.3 trillion in terms of revenues. The math for California is unfavorable as capital gains are taxed at ordinary rates. One Bretton Woods regular estimates it would equate to a ~3% capital gains tax increase at the top.

Still, King's efforts to excise such a measure might be a tactical mistake.

With the real negotiating battle being within the Senate, the proposal might be a stronger bargaining chip if kept intact in the House version. The measure would then likely compel Senate Democrats off the sidelines and into a real back and forth on tax negotiations that could bring a number of Democrats along in supporting a final tax cut bill.

Yesterday, the full House and Senate Budget Committee advanced budget resolutions. The full Senate is expected to move on a budget resolution within a few weeks. In other words, the skids are being greased for tax cuts via reconciliation. This is an important negotiating position vis-à-vis Democrats and also an important failsafe for some kind of tax cuts in 2017. **Bottom line: we remain bullish on equities and near-term bearish on Treasury prices and gold.**

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