UP AND DOWN WALL STREET—BARRON’S

A Bloodied Trump’s Next Battle: Tax Reform

By cutting his losses on health care, he could be in position to push through the issue many think he should have

By RANDALL W. FORSYTH March 25, 2017 2:41 a.m. ET

Nobody knew that health care could be so complicated.

That typically ineluctable observation from President Donald Trump was proved in spades last week as the American Health Care Act failed to get sufficient support from the Republican majority in the House of Representatives, which had previously voted to repeal the Affordable Care Act more than 60 times.

The stock market was buffeted by the uncertainty over the legislation that was to repeal and replace Obamacare, suffering its first 1% decline of the year on Tuesday, when the AHCA started to encounter serious opposition within GOP ranks. By week’s end, the contentious measure was pulled from a vote in the House, where it was heading to certain defeat.

While health-care stocks gyrated, that wasn’t the real motivator for the overall market. Investors worried that the failure to pass the AHCA could put the entire Trump pro-business agenda in jeopardy, especially corporate tax reform, which would lower interest rates and permit repatriation of profits held overseas to be reinvested in the U.S. or distributed to shareholders in increased dividends or share repurchases.

The decision late on Friday to pull the health bill also means upper-income investors won’t see the benefits that the measure would bring them, including repeal of the 3.8% Medicare tax on dividends, capital gains, and interest for individuals making over $200,000 and couples earning more than $250,000. For the nation as a whole, House Speaker Paul Ryan (R., Wis.) indicated in a press conference on Friday, Obamacare probably will remain the law of the land.

The assumption in Washington and Wall Street was that the AHCA’s failure is a defeat for the GOP. The opposition suggests this represents an ignominious retreat for Trump, who had campaigned on the promise to repeal and replace Obamacare virtually on day one of his term.

But there is an alternative narrative from Chicago, whence hails John Brady, managing director at R.J. O’Brien & Associates. While Obamacare isn’t currently collapsing, why would the Republicans want to remove that albatross from the neck of Senate Minority Leader Chuck Schumer (D-N.Y.) and the rest of the Democratic opposition? The Dems would then own the program in next year's midterm election, by which time the financial strains on it would probably worsen.

The stock market's spurt of 10% since Election Day has been the product of roughly equal parts optimism over the Trump agenda and momentum from the moderately expanding global economy. Perhaps a bit more could be ascribed to the former than the latter. Whatever the case, the underlying pro-growth optimism that Trump brings remains.

The defeat of the AHCA represents the rejection of legislation disliked by both the left and the right. By contrast, who doesn't like tax cuts? Reform would probably attract sufficient support among members of the Freedom Caucus to pass the House and then get through the Senate. Bulls would suggest that this is really what the stock market wants, and that shelving the health-care bill lets the Republicans go on to the issue they ought to have tackled in the first place: taxes.

The decision to set aside the AHCA means that tax reform will be taken up immediately, according to Anthony Karydakis, the chief economic strategist at Miller Tabak & Co. That might lead to a speedier outcome, since Trump's ability to push it through would be only moderately compromised by having cut his losses early and shifting the blame for the defeat to Congress.

Whether that line of thinking holds up after Trump's first and loudest election vow has gone down to defeat at the hands of his own party remains to be seen. Other legislative initiatives also remain, including the nomination of Neil Gorsuch to the Supreme Court. And the AHCA fight offered another benefit: It overshadowed the other controversies swirling around the White House, which don't need recounting here.

Yet Trump was only about half the reason for the stock market's advance. There actually are things happening beyond the two ends of Pennsylvania Avenue.

Corporate profits have been growing steadily. In fact, declares David A. Levy, who heads the Jerome Levy Forecasting Center, the first-quarter earnings reporting season, due to kick off in a few weeks, should "sport the cheeriest profit news of the year."

Reported profits for public companies are likely to enjoy solid gains in the first three months of the year and probably will surprise on the upside, he says. "One key contributor to profits growth will be the strongest voluntary rise in inventory investment that the economy has seen in a few years or will see for a while to come," he predicts in a report to clients.

"Another contributor will be a notable spurt in pent-up capital spending, which will likely continue in the second quarter before flattening out," he continues. But that will represent only a bounce back from last year’s lackluster showing. Capital expenditures slid in the wake of the 2014-15 decline and now are coming back with the usual lag.

Moreover, that might be as good as it gets. After a strong spurt in the current quarter, earnings probably will slow by the summer “without the increasingly unlikely 2017 tax cuts,” Levy writes. “Higher interest rates and a strong dollar are likely to at least hinder growth in housing and exports as the year progresses. The current inventory bounce will not last long and may well be providing its only positive contribution to profits growth of 2017 in the first quarter.”

That said, Levy sees the U.S. stock market moving into bubble territory, which he defines as occurring when asset prices no longer represent rational assessments of the returns the underlying assets can generate, but instead produce expectations that prices will continue to rise. In other words, the Greater Fool theory.

That ascent depends on further reflationary policies, which now are more uncertain, with the apparent denouement of the fight over repeal and replacement of Obamacare. Most Capitol Hill observers had expected the Republicans to ultimately band together to push through the AHCA. Wrong.

Now there are a number of hurdles to clear before tax reform can become law. As noted, there is the confirmation of Judge Gorsuch to the high court. At the end of April, the federal government faces the threat of yet another shutdown, which the Freedom Caucus members may be willing to see come to pass. The federal debt ceiling again is in place and will have to be dealt with, perhaps by summer.

But the promise of tax cuts and tax reform have hoisted the stock market. Perhaps Trump, who spent some time in Atlantic City, decided to fold a losing hand and go on to the next game. Perhaps this legislative loss will prevent the fiscal measures on which the stock market has banked from going forward. Or not. In any case, it always has been a gamble that he would be able to perform the same art of the deal in Washington as he had elsewhere.

Health care is a pressing current expense, but there remains the equally pressing matter of future retirement expenses. For the dwindling roster of corporations that still provide traditional defined-benefit pension plans, low interest rates make it difficult to meet those future obligations because they raise the discounted present value of those promises to pay.

Those low interest rates now are being used by some of those corporations to their advantage.

By issuing bonds with low yields, they can use the proceeds to top up their pension plans, according to a report from Bank of America Merrill Lynch fixed-income analyst Yuriy Shchuchinov.

Presumably, the plans can earn a higher return on that money than the cost of the debt, especially after taxes.

The real game changer, however, is the sharp escalation of fees levied on pension plans by the Pension Benefit Guaranty Corp. imposed by the Bipartisan Budget Act of 2015. Given these higher premiums, it's cheaper for high-grade corporations to issue bonds to fund a pension deficit than to pay PGBC premiums, Shchuchinov writes.

All else being equal, this extra borrowing might be expected to lift long-term interest rates, given the number of companies that might take this tack.

As of the end of February, pension consultant Milliman estimates, the top 100 defined-benefit plans were 81.5% funded, up from 75.6% last August, which reflects the rise in bond yields and the gain in asset prices. But as 2016 ended, only 7% of high-grade-bond issuers with pension data available report plans that are fully funded, while another 14% are 90% to 100% funded. The latter are the best candidates to issue bonds to top up their plans.

Shchuchinov points out that these same pension funds are big buyers of bonds. They are likely to channel this new money into corporate bonds when their plans are fully funded. So the expanded supply of bonds should be met with increased demand from pension funds.

By issuing bonds to fund pension plans, companies are using low long-term interest rates to solve a problem caused by low long-term interest rates.

Bondholders, for their part, are shouldering the future liabilities for pensioners' payments as companies' balance sheets grow more leveraged.

In the process, clever chief financial officers at high-grade companies (and their bankers) benefit the equity holders. Which is what financial engineering ultimately is all about.

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