



MORNING BRIEFING

January 12, 2017

Blockchain & Border Taxes

See the [collection](#) of the individual charts linked below.

(1) Comforting Financials. (2) Rays of sunshine. (3) Lots of Financial industries basking in the sun. (4) Timely split from REITs. (5) Blockchain: The future is now, and so are the cost savings. (6) Bitcoin: Blockchain's evil offspring? (7) Jackie interviews Jim Lucier, Capital Alpha's tax wizard, on border tax. (8) Border tax proposal is an onion. (9) Kind of like a VAT. (10) The end of dodging taxes? (11) How corporate tax reform could boost dollar and lower interest rates.

Sector Focus: Financials Shine. It's always comforting when a stock rally is confirmed by the S&P 500 Financials sector, which has been on fire since Election Day, rising 17.4% as of Tuesday's close and besting the S&P 500 by 11.4 percentage points ([Fig. 1](#)). There are many reasons to believe the good times are just getting started. Financials stands to benefit from a steepening yield curve, less regulation under a Trump administration, and cost savings from the implementation of blockchain. Were that not enough, the stock market rally since Election Day should renew retail interest in trading and bolster confidence in corner offices enough to propel mergers and acquisitions.

Analysts have begun to factor some of these positive trends into their earnings estimates. The sector's forward earnings has risen by 4.3% over the past 13 weeks, compared to the 2.5% increase in the forward earnings estimate for the S&P 500 as a whole, according to Joe's calculations ([Fig. 2](#)). The improvement in certain industries is even more impressive: Investment Banking & Brokerage (12.9%), Regional Banks (6.1), Diversified Banks (5.6), and Asset Management & Custody Banks (3.8). Let's have a closer look at this sector, which may continue to shine and outperform this year:

(1) *Best upward revisions.* The S&P Financials sector has enjoyed robust net earnings revisions (NERI) activity recently, improving from 0.6% in October to a 12-year high of 12.6% in December, when it was the highest of all the S&P 500 sectors ([Fig. 3](#)). The improvement is broad-based, with analysts increasing their earnings forecasts for most industries in the sector except for various insurance-related areas.

(2) *Yield curve helping.* The industry's earnings prospects have been bolstered by the widening spread between the two-year and 10-year Treasury yields. The difference stands at 119bps, an improvement from the low of 76bps this past summer in the wake of Brexit ([Fig. 4](#)). The widening spread has helped companies in the S&P Diversified Banks, Regional Banks, and Consumer Finance industries ([Fig. 5](#), [Fig. 6](#), and [Fig. 7](#)). Higher rates are boosting the S&P Life & Health Insurance industry players ([Fig. 8](#)). Meanwhile, record stock prices and more retail interest in stocks are benefitting the S&P Asset Management & Custody Banks and Investment Banking & Brokerage industries ([Fig. 9](#) and [Fig. 10](#)).

(3) *No tears for REITs.* Separating Real Estate from the S&P Financials sector in September couldn't have come at a more fortuitous time for Financials. The forward earnings estimate was revised downward for Real Estate by 7.6% over the past 13 weeks (as of January 5), making it the weakest performer of the 11 S&P 500 sectors. Here's the sectors' performance derby for the percentage change in forward earnings over the past 13 weeks: Energy (18.4%), Financials (4.5), Tech (4.3), S&P 500 (2.3), Health Care (0.7), Utilities (0.7), Materials (0.7), Consumer Staples (0.3), Consumer Discretionary

(-0.1), Industrials (-0.3), Telecom (-0.4), and REITs (-7.6) ([Table](#)).

Joe figures that taking REITs out of the S&P Financials sector lowered the sector's forward P/E to 12.2 from 13.8 the week before the change. The post-election rally has quickly lifted Financials' P/E to 14.1 as of January 5. That's well above the post-recession low of 7.8 in September 2011, but there's still room to run before hitting the record-high P/E of 18.0 in 1998 for the Financials ex-Real Estate ([Fig. 11](#)).

(4) *Future blockchain boost?* Looking forward, one thing that could help cut costs and boost earnings at financial firms is the adoption of blockchain. The ledger system should make record-keeping easier, faster, and cheaper. The future is arriving quickly. In a major step forward, the [DTCC](#) recently announced that it will use the blockchain technology developed by a startup, Axoni, to track credit-derivatives payouts between big banks by early next year. The project will be led by IBM, and the group will work with banking industry consortium R3.

"Across all credit derivatives, DTCC has roughly one million credit-default swap contracts in its trade-information warehouse database, with a face value of \$11 trillion. It tracks who owes who, and when payouts are due. DTCC's internal estimate was that using blockchain could cut the costs of credit-derivative trade warehousing by close to half, or by tens of millions of dollars," explained a 1/9 [WSJ article](#). Hopes are high that blockchain technology can be used in various areas on Wall Street. DTCC is exploring the use of blockchain to track repo transactions, and Greenwich Associates estimates that banks spent more than \$1 billion on blockchain projects last year, the [WSJ article](#) noted.

(5) *Same technology, different motive.* Ironically, blockchain is also the technology behind cryptocurrency bitcoin, which earlier this year soared through the \$1,000 level for the first time since 2013. On Tuesday, it settled at \$904.79 ([Fig. 12](#)). There's growing unease that the currency is being used for malevolent purposes.

Islamic militants in the Middle East allegedly used bitcoin and online payment services to fund terrorist activities in Indonesia, according to an official from the Indonesian Financial Transactions Report and Analysis Center. The amounts transferred weren't disclosed, but it was said that they did so to make it harder for authorities to track the transactions. "The agency said Islamic militants sent the money to their terror cells across Indonesia, largely in Java, through PayPal and bitcoin exchanges. Since internet access is limited in rural areas, they would have to change virtual money back to cash to pay for the real-life transactions," a 1/10 [WSJ article](#) reported.

Meanwhile, in China, the government appears to be concerned that its citizens are using bitcoin to get money out of the country undetected. "According to *Tencent Finance*, the State Administration of Foreign Exchange (SAFE) is exploring how bitcoin can be used to circumvent capital flight. The news website cited unnamed sources close to regulators," noted a 1/6 [article](#) on Coindesk.com. An [article](#) on Coindesk.com the following day noted that the People's Bank of China (PBOC) met with bitcoin exchanges, seeking to restrict how the exchanges could seek new users. Citing an article in *Caixin*, Coindesk said the PBOC won't permit the exchanges to "mention the depreciation of the yuan in connection with marketing or otherwise promote their services offline." Moreover, the exchanges "were advised to comply with know-your-customer (KYC) and anti-money laundering (AML) laws, and to refrain from using automated trading bots to boost volume."

Yes, the force can be used for good or for evil.

Trump World: Border Tax, One More Time. Understanding the cash-flow border tax is a bit like peeling an onion. It has many layers, and just when you think you've finished exploring all the issues,

another layer appears. Like peeling an onion, the complexity of it all is enough to warrant a tear or two.

In an effort to delve ever deeper into this hot topic, Jackie rang James Lucier, co-founder and managing director at [Capital Alpha Partners](#), a non-partisan research shop that analyzes the policies coming out of Washington DC and their impact on financial markets. Jim leads Capital Alpha's energy, environmental, and tax practices research. He has studied tax issues for more than 30 years. Jim's interview is available in its entirety via [podcast](#) and [transcript](#), and the *Reader's Digest* version is below. We'll try not to make you cry.

(1) *Change is needed.* Sometimes, it's important to take a step back before moving forward. So we started with a look at why corporate tax reform is necessary. The current statutory US corporate tax rate, at 35%, is the highest in the world, Jim explained. Most other countries have a tax rate closer to 20%. The US also has the "world's leakiest tax system," which means that cadres of lawyers have dreamt up ways to avoid taxes. Companies use intercorporate debt to shield their US earnings from taxation, patent portfolios are sent overseas, and intellectual property payments are used as a tool for earnings stripping. Finally, most other countries have territorial tax policies, like the value-added tax (VAT), whereby goods, including imports, are taxed when they are sold but exports are not taxed. It's one of several factors that has encouraged companies to move manufacturing outside of the US. The political pressures to fix this convoluted system have been mounting, and certainly contributed to the election of Donald Trump.

(2) *Will it happen?* While President-elect Trump has proposed cutting the federal statutory tax rate to 15%, it's House Leader Paul Ryan who has a detailed [plan](#) on how to achieve a 20% corporate tax rate on a revenue-neutral basis. His plan includes eliminating the deduction for the cost of goods sold for imported goods, eliminating the net interest expense deduction, and allowing the immediate deduction of capital expenditures. It also allows for the repatriation of earnings from foreign subsidiaries on a tax-free basis.

Jim believes there's a 75% chance that we'll see some form of corporate tax reform passed and a 40% chance that tax reform will include a border adjustment. Those odds have improved dramatically from a year ago, or even six months ago, when the plan would have been a nonstarter, he said. Before the election, a border-tax plan would have been considered too radical to gain passage. Economists would argue that a border tax wouldn't incentivize companies to keep manufacturing in the US because any benefit to producing goods domestically might be offset by a rise in the dollar. And lastly, the border tax looks a lot like a VAT, a retail sales tax, which companies, like retailers, might pass on to consumers through higher prices. That normally would be deemed regressive and considered politically unpopular.

But then Trump arrived on the scene. "Donald Trump is really the counterintuitive candidate, in his emphasis on making America great again, rebuilding American manufacturing, focusing first on domestic US employment," explained Jim. "The fact that he's tapped into such a vein of support, in particular from blue-collar voters in the US, suggests that maybe this idea of a border-adjustable tax could be sold as [a way to support] US domestic employment and US domestic manufacturing industries. If so, then Trump is probably the only salesperson who could make it happen."

Trump has a good partner in Paul Ryan, who has spent a lot of time working with individual congressmen in small groups to sell his vision. "When [Ryan] was chairman of the budget committee, he came up with these budgets that were very radical by historical standards. But he got Republicans to support them by virtually planning ahead a year in time and meeting with members of the Republican conference in groups of twos and threes, and literally selling it, personally ... He's done basically the same thing with the tax reform exercise. They have spent a lot of time meeting with members, building consensus, selling the individual Republican members on the House side. I think he's got a strong team

there.”

The nation’s fiscal health may provide the urgency needed to get tax reform passed. “On Capitol Hill there’s a real sense of nervousness about the coming demographic tidal wave, as Americans get older and sicker as they move into their retirement years, to put a positive spin on it. The debt and deficit and fiscal situation in the United States is obviously going to become much more challenging over time. We’ve already moved to a government debt-to-GDP ratio that’s north of 70%, and we’ll be at 100% before too long ... With this situation coming at us, like the proverbial train coming down the tracks, to use another metaphor, I think members of Congress realize that this may be the last best chance to do some significant structural tax reform in the US on a reasonably revenue-neutral basis while we still have, as a nation, the balance-sheet flexibility to do it.”

And don’t underestimate the pressure put on Congress by the market’s recent rally. “The markets are really, really betting very heavily that tax reform succeeds. That means that Paul Ryan and Donald Trump and the other members of Congress, including New York Senator Chuck Schumer, who is the Democratic leader in the Senate, all of these guys are under a lot of pressure to deliver right now because the markets have already baked in, I think, a favorable result,” concluded Jim.

(3) *How to pay for it.* Certainly, not everyone will be happy, but Jim’s betting that a tax cut to 20% will be just what it takes to get companies to compromise. Companies know that the reduction in the tax rate can only occur if the leadership can find offsetting ways to massively increase revenue. The Tax Foundation estimates that taxing imported goods and services raises north of \$1 trillion dollars in revenue. “You need big revenue-raisers ... to make revenue-neutral tax reform even remotely possible,” Jim explained.

(4) *Importers worried.* As we’ve discussed before, retailers won’t like the inability to deduct the cost of their imported goods sold from revenue. “You have to think about the retail industry as a low-margin business that’s very competitive and has a limited ability to pass price increases onto the consumer. They are quite nervous about having a tax in effect placed on their cost of goods sold,” said Jim.

Refiners won’t like the inability to deduct the cost of their imported oil. The US imports about 7 million barrels of crude oil a day, making it the country’s third-largest net import. The first two are transportation and computers & technology. If the tax change goes through, refiners could pass the tax on to consumers, which would mean higher prices at the pump. But they might not have to raise prices if much of the tax increase is offset by a stronger dollar.

He explained: “One of the things economists have studied for a long time is the effect of floating exchange rates, to adjust to varying price levels in different countries. If you do a border adjustment the way that we’re proposing here, where you effectively put 20% tax on imports, but also apply an equal and opposite 20% tax credit on exports, economic theory would suggest that the dollar also strengthens by about 20%. In static terms, retailers or refiners would have a lot to worry about, [but] I think that exchange-rate effects will probably mitigate quite a few of these tax increases.” The dollar has already strengthened by 5.4% since the election. Perhaps some of that gain anticipates the tax change or expects stronger economic growth from a more efficient tax system.

(5) *Tax dodgers on alert.* Multinational companies that have used the discrepancies in the international tax system to lower their tax rates face big changes as well. Some companies in the tech and pharma industries have been parking their intellectual property in foreign countries with low tax rates. Under the Ryan proposal, sales these companies make in the US would be taxed, but their foreign sales would go untaxed by the US.

"I think that the [proposed tax changes] would end many tax-avoidance strategies used by sophisticated multinationals, including those with a lot of intellectual property. On the other hand ... they could adapt to [the changes] well," said Jim. "They would, number one, not have this issue with unrepatriated foreign earnings because what they make from their patent portfolios in a foreign country would be excluded from the US tax system. On the other hand, if they tried to bring stuff back into the US from overseas, they would be paying taxes on it, so they do have that incentive to locate their production, their R&D, other opportunities in the US, to basically serve the US market that way. They would have a much more rational tax system, at the end of the day."

The Ryan proposal, with a 20% corporate tax rate, should also reduce the incentive for companies to move their headquarters overseas in search of a lower tax rate. Likewise, it may reduce the number of foreign company acquisitions of US companies. Right now, foreign companies have an advantage when making acquisitions of US companies because they can pay more than a US acquirer since they pay lower taxes.

(6) *Good-bye, leverage.* Industries that depend on debt financing--like power utilities, commercial real estate developers, and private equity shops--won't be happy about the elimination of the deduction of net interest expense proposed in the Ryan plan. However, the pinch from this proposal may also fade as the debt markets adjust, just as the currency markets are expected to adjust. "The economic argument is that over time, once you do tax reform, interest rates will also rebalance. They will reflect the new supply and demand conditions for credit." The elimination of a tax subsidy could reduce the amount of debt sold, and that could drive down interest rates.

(7) *International backlash?* One of the biggest questions around the Ryan proposal is whether the World Trade Organization (WTO) will oppose the changes. The WTO's rules were written with the European tax model in mind. It permits countries to collect sales tax on goods that are sold in their own countries but not on exports. The idea was to eliminate multiple layers of tax that would accrue on an item that was manufactured in multiple countries before resulting in a finished good.

"The destination-based, cash-flow tax [in the Ryan plan is] clearly, absolutely not consistent with WTO rules as they're written ... [However,] structurally, it's close enough," concluded Jim. "The definition of the tax base is close enough to a VAT that this should really be considered the equivalent. Ultimately, the issue of whether or not the WTO is going to reject this or not is something of a red herring. The US does have a good, substantial case on the merits, that yes, this is economically the equivalent to the VAT. It should qualify. Frankly, times change. You wrote that definition of border-adjustable taxes, which qualify under WTO rules, 30 years ago." In addition, there's the growing attitude that America needs to do what's best for America, and, if countries do object, it will be many years before the WTO case is resolved.

If all else fails, the US could consider going to a VAT system. However, the Ryan plan would be easier to administer than a VAT tax, and it looks similar to a traditional corporate-income-tax system. Also, there historically has been opposition to a VAT because it's a straight-forward sales tax. Liberals don't like it because it weighs heavily on low-income tax payers, and Republicans don't like it because it's a "hidden" tax that tends to get increased over time. "Once Democrats realize it's a money machine, and Republicans realize it's regressive, then maybe we'll get it," said Jim.

A cash-flow tax would avoid the VAT tax problems and be much simpler to implement. We'll keep in touch with Jim to see whether the folks in Washington DC can pull it off.

CALENDARS

US. Thurs: Jobless Claims 255k, Import & Export Prices 0.7%/0.2%, Weekly Consumer Comfort Index, Yellen, Evans, Harker, Bullard. **Fri:** Retail Sales Total, Ex Autos, and Ex Autos & Gas 0.7%/0.5%/0.3%, PPI-FD Headline, Core, and Core Less Trade Services 0.3%/0.1%/0.2%, Business Inventories 0.6%, Consumer Sentiment Index 98.6, Baker Hughes Rig Count, Harker. (Bloomberg estimates)

Global. Thurs: Eurozone Industrial Production 0.5%*m/m*/1.5%*y/y*, Germany GDP 1.8% *y/y*. **Fri:** China Trade Balance \$47.6b. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) ticked down to 3.20 this week after climbing to 3.27 last week--which was the highest reading since June 2015. Bullish sentiment slipped to 58.6% after increasing the prior nine weeks from 41.7% to 60.2%, which was the most bulls since July 2014. Bearish sentiment fell to 18.3% this week--representing the fewest bears since August 2015. The correction count advanced for the second week to 23.1% from 20.6% two weeks ago, which was the lowest since June 2014. The AAll Bull Ratio rose for the third week last week from 58.0% to 64.7% over the period. Bullish sentiment rose for the third time in four weeks, from 43.1% to 46.2%, while bearish sentiment fell from 32.3% to 25.2% the past three weeks.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus forward revenues and earnings rose to record highs last week. The forward profit margin forecast edged up to a 28-month high of 10.8% from 10.7%, nearing the record high of 10.9% in September 2015 and up from its 24-month low of 10.4% in late March. Forward revenue growth for the S&P 500 was steady at 5.6%. That's the highest since May 2012 and up from a seven-month low of 2.7% in late February. Forward earnings growth was steady at 11.6%; that's the highest since October 2011 and compares to an 11-month low of 4.8% in late February. Valuation was steady at 17.2 and slightly below mid-December's 22-month high of 17.3; that compares to February 2015's 12-year high of 17.4 and a 15-month low of 14.9 in January 2016. S&P 500 forward revenues and forward earnings are enjoying a tailwind now from easier *y/y* comparisons for Energy and improving prospects for Financials, but currency translation looks likely to remain a challenge. Looking at last week's results ex-Energy, the forward revenue and earnings growth rates fall to 3.9% and 8.4%, respectively. The ex-Energy forward profit margin improves to 11.4%, which is close to its record high of 11.5% in August 2007.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue forecasts rose last week for 8/11 sectors, and forward earnings rose for all 11. Energy, Financials, and Tech were the only sectors to have forward revenues edge down *w/w*. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. The forward P/S ratio rose for 10/11 sectors (all but Consumer Staples) and the forward P/E rose for 6/11. Excluding Real Estate, Financials' P/E is near a six-year high after surging to 14.1 from 12.0 before the election, Health Care's P/E of 14.5 and P/S of 1.56 have been rising recently, but remain well below their 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.47 compares to a record high of 1.56 in early May, and its P/E of 31.7 is down from a record high of 57.5 then. Higher *y/y* margins are expected for only 5/11 sectors in 2016, but is expected to improve for 9/11 sectors in 2017. Here's how they rank based on 2017 forecasts: Information Technology (to 20.2% in 2017 from 19.2% in 2016 and from 18.7% in 2015), Real Estate (16.6, 22.4, 21.2), Financials (15.8, 14.6, 14.8), Telecom (11.1, 10.8, 11.3), Health Care (10.8, 10.4, 10.4), Utilities (10.7, 11.0, 10.7), S&P 500 (10.7, 10.1, 10.2), Materials (10.2, 9.3, 9.3), Industrials (9.1, 8.8, 8.8), Consumer Discretionary (7.5, 7.2, 6.9), Consumer Staples (6.9, 6.6, 6.5), and Energy (4.5, 1.3, 4.6).

GLOBAL ECONOMIC INDICATORS

OECD Leading Indicators ([link](#)): In November, the OECD's composite leading indicators (CLIs)--designed to anticipate turning points in economic activity relative to the long-term trend--continued to point to growth momentum picking up in several advanced economies. CLIs in the US (to 99.3 from 99.2), Canada (100.1 from 100.0), and France (100.6 from 100.5) confirm signs of growth momentum that had flagged in October's assessment, with similar signs now emerging in Japan (99.9 from 99.8). Germany's CLI (100.4 from 100.3) anticipates growth gaining momentum, while the UK's (99.4 from 99.2) is showing tentative signs of growth gaining momentum but remains below trend, and "uncertainty persists about the nature of the agreement the UK will eventually conclude with the EU," according to the report. Stable growth momentum is anticipated for the OECD (99.8) area as a whole, as well as the Eurozone (100.4) and Italy (100.1). As for the emerging economies, CLIs for China (99.6 from 99.3), Brazil (101.5 from 101.3), and Russia (100.6 from 100.4) are signaling growth gaining momentum, while signs of easing growth momentum are emerging in India (99.9 from 100.0).

UK Industrial Production ([link](#)): UK industrial production in November expanded more than expected, driven by a strong rebound in North Sea oil and gas output--from October's temporary shutdown of an oilfield for maintenance--along with a cold snap boosting heating demand; manufacturing output was also robust. Headline production rose for the first time in four months, jumping 2.1% following October's 1.1% slump. Factory production, which accounts for roughly 70% of industrial production, jumped 1.3%, more than reversing October's 1.0% drop, driven by gains in consumer (2.5%) and intermediate (1.1) goods output; capital goods production fell 0.2% after a 1.4% loss in October. December data show the UK's M-PMI (to 56.1 from 53.6) jumped to a 30-month high as improved domestic and overseas demand boosted output and new order growth. Of the remaining three industrial sectors, mining & quarrying (8.2) and electricity (1.9) were big contributors to November's gain; waste supply, sewage & waste management (-0.1) was little changed.

France & Spain Industrial Production ([link](#)): Output in both France and Spain posted solid gains in November. French production, which excludes construction, rebounded 2.2% in November, recovering from declines of 0.1% and 1.5% the prior two months. Factory output jumped 2.3%, following a two-month decline 2.2%, on widespread strength. Intermediate (3.5%), consumer nondurable (3.3), and consumer durable (2.3) goods production all recorded impressive gains; capital goods output rose 0.5%, building on October's 1.3% rebound. Spanish industrial output, excluding construction, climbed 1.7% in November after a 0.1% gain and a 1.3% loss the prior two months. Capital (2.5), intermediate (2.3), and consumer (1.6) goods production were all in the black; energy output dipped 0.4% following October's 2.2% rebound. Both France (53.5 from 51.7) and Spain (55.3 from 54.5) M-PMIs showed manufacturing activity accelerating in December, with the former's index at a 67-month high and the latter's at an 11-month high.

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