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US Public Policy

Reality Bites

Market optimism, meet policymaking reality. Republicans should deliver some major changes. Yet conflicting motives & unintended consequences mean less confidence that policy supports risk appetite over time. We examine tax reform options, border adjustment consequences, & how compromises may emerge.

- **A 'High Risk, High Reward' Agenda:** Execution risks around the policy agenda mean a wider range of outcomes: positive stimulus possibilities are now accompanied by greater risk of gridlock. For example, we think Republicans will ultimately achieve tax reform by forgoing permanence to allow some near-term deficit expansion. This moderates some of their more controversial proposals while preserving tax-rate-cut targets, and is likely risk-positive. However, we concede that risks to this view have risen as internal party disagreements could bog down the legislative agenda. Furthermore, the potential for unintended consequences to blunt the macro positives of tax reform may be underappreciated. While our global strategy team sees more room for risk asset performance in the near term, we note that this policy uncertainty could over time become a catalyst for the 'fade' phase of our outlook. This supports key strategist views: caution on credit based on tight valuations, a preference for EU and JP equities over US, a bullish outlook for USD, and tactical constructiveness on USTs.

- **What's in the Price? Cautious Optimism in Policy:** Most markets suggest confidence that positive-growth policies, like a tax-cut-driven fiscal stimulus and/or increased infrastructure spending, will occur, though that confidence appears to have cooled recently. Tax-rate-sensitive equity sectors appear to be outperforming, while key macro markets reflect growth and inflation expectation levels above those before the election. Some equity market sectors appear to reflect reservations about some tax provisions, like border adjustability, as also reflected in some FX markets.

- **Border Adjustment:** Our base case that the 'Better Way' border adjustability proposal would not survive intact was bolstered in recent days by cautionary statements from key Republican leaders. Accordingly, we consider possible adjustments and alternatives to the proposal that may emerge as a face-saving tactic to satisfy deficit hawks and the administration's desire to disincentivize overseas supply chains.

- **Tax Reform – Unintended Consequences:** We highlight four potential 'unintended consequences' of tax reform that aren't yet part of the investor consensus, in our view.

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The Takeaway: Market Optimism Meets Policymaking Reality

When Donald Trump won the US presidential election, market reaction was strong and positive on the possibility of clearing a path to fiscal stimulus alongside transformative tax, trade and infrastructure policies. On Inauguration Day, however, the stakes were raised. As Trump took the oath of office, his administration transitioned from the thrill of victory to the agony of governing. The days ahead should reveal the mix of sometimes conflicting motivations and disagreements within the Republican Party, which make for fatter-tailed outcomes for markets. **Said differently, we see the US policy path as high risk, high reward for markets. Given optimistic valuations in key sectors, the emerging risk is that investors will see these conflicts and find it increasingly difficult to believe their faith in US policy will be rewarded.**

Consider tax reform as an object lesson. In our view, this is an appropriate approach because tax reform attempts to intertwine the president's central goals and his party's message: tax cuts, boosting economic growth, disincentivizing overseas production, and fiscal conservatism. Yet these goals can conflict in important ways, given the path required to legislate tax reform.

For example, consider the debate over 'border adjustability'. The proposal, included as part of the larger House Republican 'Better Way' tax blueprint, proposes to eliminate corporations' ability to deduct import costs while also eliminating taxes on export revenues. We explain this policy in detail here and here, but we believe the simplest way to think about it is this: relative to the current tax system, it pairs a tariff with an export subsidy. The policy allows Republicans to achieve several of their goals because: i) it addresses the president's desire to incentivize domestic production; and ii) it raises revenue to offset that which will be lost through lowering the corporate tax rate, bolstering the party's fiscal conservative bona fides. The latter is of additional importance, given that tax reform likely requires use of the 'budget reconciliation' process to overcome Democratic filibuster risk in the Senate. A tax reform using this approach is made easier when fresh revenue options are available, limiting the need for fiscally conservative Republicans to consider voting for higher deficits. That ease, though, comes at the risk of near-term economic and corporate disruption, given its potential to boost the US dollar, tighten financial conditions, and rotate wealth from certain sectors of the economy to others. That could easily be manifested in political opposition, perhaps most acutely felt in the Senate, where only three Republican dissenters could hold up the process.

In our base case, Republicans enact tax reform on or around Q3 by 'threading the needle', a situation created by the sometimes conflicting motivations of fiscal conservatism, business-friendliness, and legislative rules. The difficulties referenced above regarding border adjustability are likely applicable to debates over other 'pay fors' being proposed: elimination of corporate interest deductibilty, elimination of most personal itemized deductions, etc. Unless one believes that Republicans will be successful in convincing all affected interest groups and, consequently, nearly their entire caucus of the benefits of these changes, which is not a point we are willing to concede, then final legislation likely must follow one of two paths:

1. **A less ambitious, but permanent tax reform:** To make tax cuts permanent while using the budget reconciliation procedure, any tax action must comply with various laws, including the 'Byrd Rule' and the Congressional Budget Act. Among other things, these rules mandate that actions taken through reconciliation must not increase the deficit beyond the budget resolution window, currently 10 years. Hence, unless spending is substantially cut, which may be difficult given the president's goals (such as maintaining entitlement programs 'as is' while raising defense spending), then Republicans must preserve projected tax revenue at or above current levels. Given the political difficulties in including the 'pay fors' discussed earlier, Republicans would have to accept smaller rate cuts if they wanted those cuts to be permanent.[1 2]

2. **An ambitious, but sunsetting tax reform:** Conversely, if the Republicans are willing to allow the tax reform to sunset at the end of the 10-year budget window, they have flexibility to cut rates to levels nearer their current ambitions while curbing some of the most contentious 'pay fors'. Consider, for example, the possibility that Republicans could use a budget resolution to pair a lower revenue number with even larger declines in later-year expenditure numbers. This could be consistent with news reports that Trump and Republicans are exploring substantial cuts to the size and scope of the federal government.[3] In this case, and when compounded with dynamic scoring (see FX Strategy: Border Adustability: How US Tax Reform Could Be a Boon for USD, December 19, 2016), one could, compared to current law, increase near-term deficits while lowering deficits in the later part of the budget window, achieving both near-term fiscal stimulus and long-term revenue-neutrality versus the baseline.[4]

Exhibit 1: A difficult midterm election for Senate Democrats

	Not Up	Up in 2018
Republicans	44	8
Democrats	23	25*

Source: Morgan Stanley Research, University of Virginia Center for Politics
Note: *Includes two Independents who caucus with Democrats

Given that the president's populist appeal is at least partly built on a message of making bold changes to boost economic growth, and an implicit faith that this will lead to better outcomes, we think Republicans will ultimately opt for number two. Republicans might find this approach has merit in that, if it 'works', voters may reward them in the midterm election (in which they already have a numerical advantage), putting a filibuster-proof Senate majority in reach and, with it, the opportunity to make tax cuts permanent.

Hence, as of now we think Republicans still have enough room to maneuver to deliver a stimulus in line with our economists' expectations, supporting GDP growth of about 2.0% in 2017 and 2018 (see 2017 US Economic Outlook: A Shot in the Arm, November 27, 2016).

Yet the risks are meaningful that these tensions lead to one of two outcomes that may disappoint markets:

1. **Tax reform changes too much, too quickly:** Emboldened by the need to hold the line on deficits following the challenging optics of permitting deficit growth in the FY17 budget resolution, albeit with the intention of that permission being short-lived, deficit hawks could exert their authority over the tax reform process. In order to satisfy their demands while working within the confines of the budget reconciliation process, tax reform includes all currently proposed tax expenditure curbs and other revenue raisers in the House 'blueprint'. Others may be considered in addition, given the potential need to satisfy dynamic scoring demands (see US Public Policy: Taxes: Knowing is Half the Battle, December 15, 2016). These tax changes, border adjustability and limits to interest deductions in particular, risk

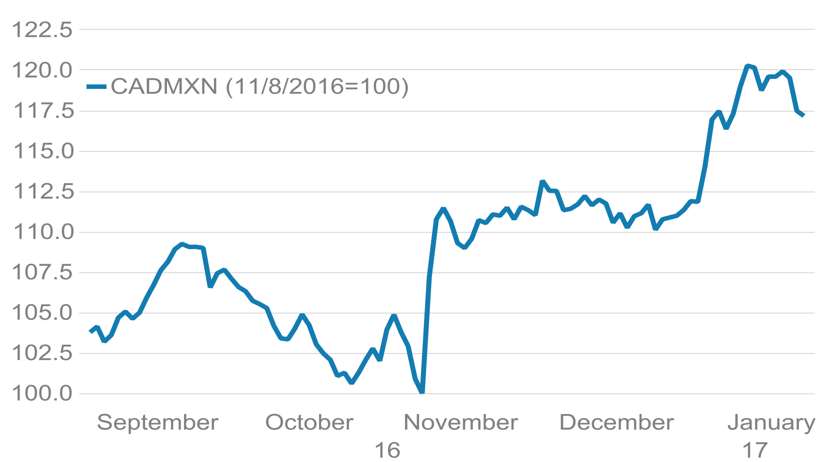
corporate finance disruption, a rotation of wealth from certain sectors of the US economy to others, and potentially tighter conditions from a stronger US dollar. Hence, there are several outcomes that could lessen the economic incentives created by reforms.

2. **Tax reform 'failure' becomes an option:** As if the politics of tax reform weren't complicated enough, there's rising risk that it becomes collateral damage of the debate over how to repeal the Affordable Care Act (ACA, or 'Obamacare'). Rising displeasure among Republicans about the risk of increasing the uninsured if they repeal ACA without immediately replacing it could delay this legislative process, and tax reform as a consequence.

Hence, considering optimistic valuations and rising execution risks, we think it would be naive to assert that this policy path is definitively positive for risk markets. Rather, we think it prudent to recognize that investors may see these maneuvers and come to a less-than-optimistic conclusion—a return to gridlock and negative unintended consequences are meaningful risks. This would align with the 'sparkle and fade' theme of our global strategy team, whereby we envision investors' optimism being exhausted over the course of the year, leading to suboptimal performance in key markets:

- **FX strategy: USD strength; CADMXN downside:** Border adjustability represents a potential large shock to import and export competitiveness, boosting USD through purchasing power parity (PPP). The adjustment may fall short of textbook expectations about border adjustability, given that PPP only holds over the long term, and other important assumptions (goods priced in foreign currency, currencies are free floating, financial flows are unchanged, import and export prices adjust fully) may not be fair to make (see FX Strategy: Border Adjustability: How US Tax Reform Could Be a Boon for USD, December 19, 2016). Still, we expect USD to rise 10-15% on a trade-weighted (TWI) basis in our base case. Furthermore, the near 18% appreciation in CADMXN since the election suggests that the market is pricing Mexico to be disproportionately harmed as the US pursues increased trade protectionism. This means downside for the pair should border adjustability be put into practice, given its application to imports from all countries equally.

Exhibit 2: CADMXN not pricing in border adjustment



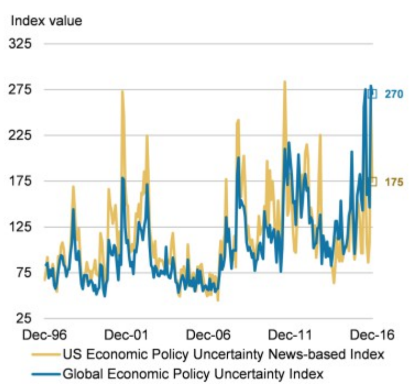
Source: Macrobond, Bloomberg, Morgan Stanley Research

- **Equity strategy: Low upside for US, preference for EU, JP:** A stronger USD could hurt earnings. For example, our US equity strategists believe that for every 10% appreciation in USD vs. EUR, S&P 500 companies would experience a 6% decline in EPS. Furthermore, the experimental nature of border adjustment and curbs to interest deductibility could lessen the benefits of a lower tax rate. That uncertainty could also be reflected in lower P/E multiples (see 2017 US Equity Outlook: The Tension Between Higher Earnings and Lower Multiples - Will You Know When to Get Out? November 28, 2016). Hence, while our cross-asset strategy team believes global equities will continue to perform in the near term, they prefer expressing that view through EU and Japan markets over the US.

- **Credit strategy: Tough risk/reward skew for corporate credit:** Corporate credit leverage remains high, and optimism that tax reform, if executed, could alleviate this problem is overdone, in our view. If interest deductibility goes away, capital structure shifts would likely take years to materialize, while the headwind to earnings could be immediate. Furthermore, if animal spirits are rising, that should drive more debt issuance, all else equal, not less. Given heightened uncertainty coming late in a cycle when valuations are rich, investors should improve portfolio quality, not chase yield.

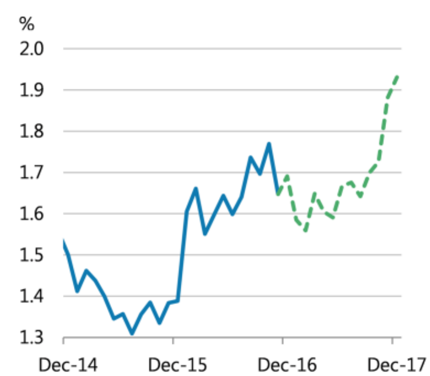
- **Rates strategy: UST – Upside for yields is limited if the Fed does not hike again soon:** Economic data in the US since the election have certainly supported a more optimistic viewpoint despite the undercurrent of economic policy uncertainty (see Exhibit 3). Equity market performance also suggests that bonds should not be in favor, by and large. In short, the economy appears healthy and financial conditions appear loose. To the extent this momentum continues, we could see 10y yields rising to 2.75% at some point this year. But, our Rates team thinks upside to yields is limited and forecast the 10y yields ending the year at 2.50%. For now, investors will focus on the March FOMC meeting. Tightening may not be supported by the incoming readings on core PCE seen by our US economists (see Exhibit 4). Additionally, our US economists do not see a consensus of FOMC participants favoring a March hike, the probability of which is currently priced around 20%. Our Rates team therefore favors fading this probability by owning the 2- to 5-year sector on the curve over the coming weeks.

Exhibit 3: Global (PPP adjusted GDP weights) and US economic policy uncertainty indexes



Source: Morgan Stanley Research, Baker Bloom Davis
Note: The Baker, Bloom and Davis news-based index of economic policy uncertainty for the US is based on the frequency of newspaper references to policy uncertainty.

Exhibit 4: Core PCE inflation, 2015-2016, and MS 2017 forecast

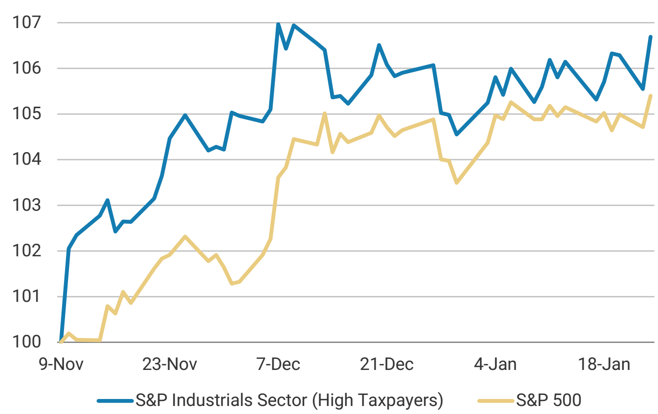


Source: Federal Reserve, Morgan Stanley Research forecasts

What's in the Price? Cautious Optimism

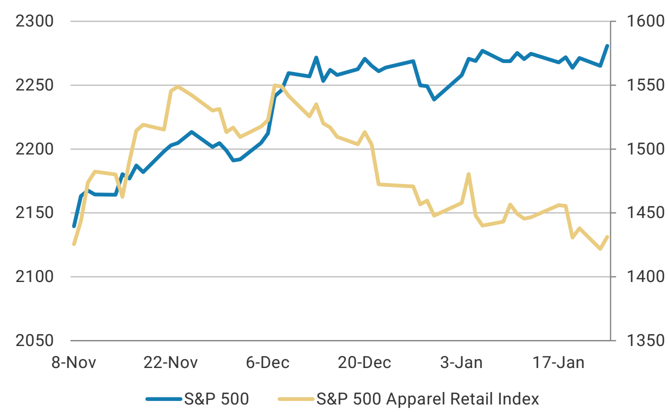
While post-election enthusiasm for the US policy path appears to have waned in recent weeks, we think markets still generally reflect the potential positives of US policy, albeit with some specific reservations about the risks of that path. Consider US industrial sector stocks, which tend to carry high reported effective tax rates. The sector has meaningfully outperformed since Election Day. This may reflect optimism about lower tax rates and base-broadening effects from corporate tax reform, both relative positives for these types of firms (see Tax to the Future, September 13, 2016). It could also reflect expectations of regulatory relief and fiscal stimulus. One contra-indicator could be the underperformance of the retail sector, which could experience a negative fundamental impact if border adjustment were to come to fruition. However, a weak holiday season and questions about future viability of brick and mortar stores could also have contributed to underperformance.

Exhibit 5: High taxpayers outperformed



Source: Morgan Stanley Research, Bloomberg
Note Index to 100 on November 8, 2016

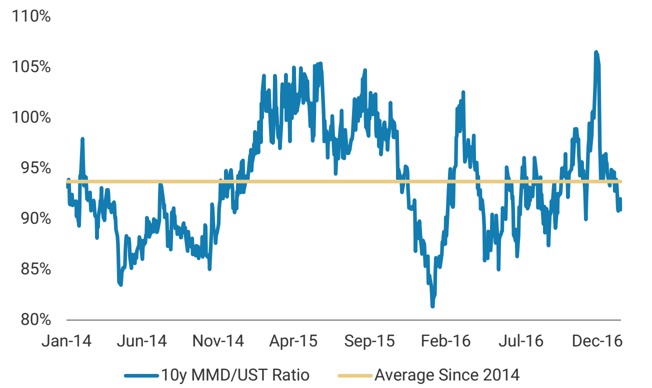
Exhibit 6: Apparel Retail underperformed, possibly on border adjustment concerns



Source: Morgan Stanley Research, Bloomberg

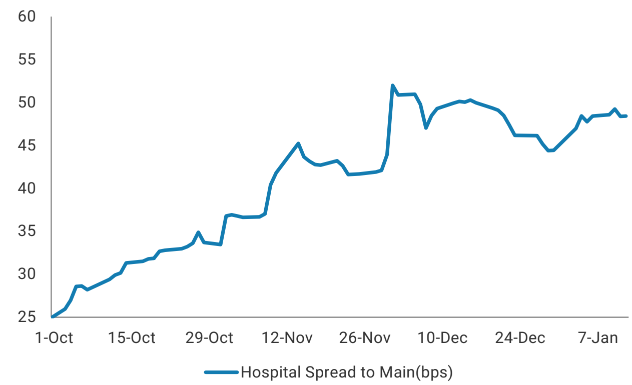
Fixed income markets are likewise sending mixed—but mostly positive—messages. Consider the municipal market, where the basis between tax-exempts and taxables has widened in recent weeks. This reflects declining concern about the potential for limitations to tax deductions and exclusions, despite a variety of Republican plans that suggest such tactics (see Tax to the Future, September 13, 2016). Muni Hospitals spreads moved 10bp wider to the broad muni market after the election as investors priced in higher pressure on hospitals on the assumption that the ACA repeal has the potential to increase the number of uninsured patients. Also consider the TIPS market, where a spike in breakevens reflects an expectation of higher growth and inflation. This may contrast with the potential for negative unintended consequences of tax reform, like tighter financial conditions from a more aggressive Fed tightening and/or USD strength.

Exhibit 7: Steady muni ratios show little concern with tax reform risk



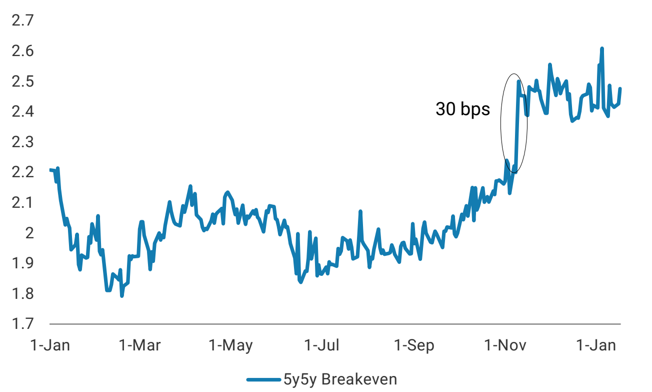
Source: Morgan Stanley Research, MMD

Exhibit 8: Muni Hospitals spread to Main Muni Index



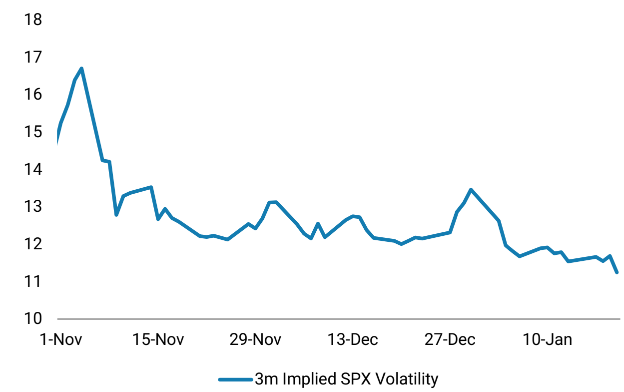
Source: Morgan Stanley Research, Bloomberg, S&P Dow Jones Indices

Exhibit 9: 5y5y breakevens jumped 30bp on Election Day



Source: Morgan Stanley Research, Bloomberg

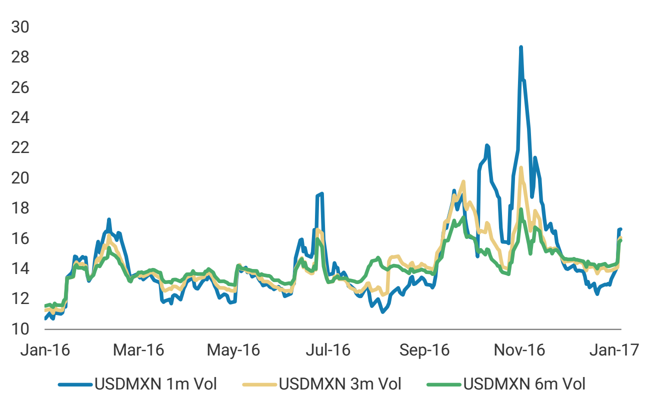
Exhibit 10: Equity volatility around the election is declining



Source: Morgan Stanley Research, Bloomberg

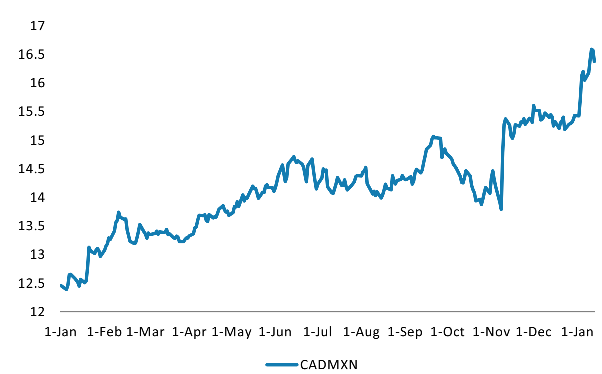
There is one key exception in the FX markets. As was the case throughout the run-up to the US election, a key exception to market optimism on the US policy path is the exchange rate between the US dollar and Mexican peso (USDMXN). In addition to the peso's further weakening in recent weeks, volatility in the currency pair remains elevated, reflecting heightened uncertainty from trade protectionist threats both implicity (border adjustability) and explicitly (NAFTA renegotiations and lingering tariff threats).

Exhibit 11: USDMXN vol expectations elevated since the election



Source: Morgan Stanley Research, Bloomberg

Exhibit 12: MXN is being disproportionately affected, potentially showing a belief in targeted tariffs rather than border adjustability



Source: Morgan Stanley Research, Bloomberg

Taxing the Border: Adjustments and Alternatives

Todd Castagno

Our base case that the 'Better Way' border adjustability proposal would not survive intact was bolstered in recent days by cautionary statements from key Republican leaders. President Trump himself recently criticized the measure as "too complicated". The Senate is a primary choke point, as it only takes three Republican defectors to derail reform. Perhaps a telling sign, Senate leadership has yet to fully weigh in on the specifics of the House tax reform draft, appearing to take a wait-and-see approach instead.[5]

House leadership is entrenched on keeping their border adjustability feature, given that it fulfills a key trade policy objective and is estimated to raise $1.2 trillion in revenue over 10 years to fund lower corporate tax rates. However, if votes cannot be secured, then leadership may have to pivot. We explore adjustments and alternatives to the fully adjustable destination-based cash flow tax proposed:

Phase-in of the border adjustment: A gratuitous transition period may ease tension in the business community and serve a policy objective by incentivizing immediate onshoring of production by allowing companies to front-run the border adjustments. However, such a transition would negatively impact budgetary scoring and likely require deficit financing or a corresponding phasing-in of lower corporate and business tax rates. A long transition period would subject the reform effort to the election cycle and potential unwinding if political power shifts.

Partial border adjustment: Another potential option would be to keep the broad structure of the destination-based cash flow tax, but limit the effective rate of the border adjustment by allowing partial deduction for imports and to partially tax exports. President Trump's adviser Tom Barrack recently suggested a reduced border adjustment at 10%, versus 20%.[6] However, this limitation would likely add complexity to an already complex system and would have negative implications for revenue neutrality. It would also distort the economic underpinnings of a pure destination-based cash flow system.

Targeted tax on outsourcing: Policymakers could also pursue a targeted approach by applying an import tax on US multinationals that shift production abroad and import back into the US marketplace. President Trump appeared to support such a policy when he recently said, "So a company that wants to fire all of its people in the United States and build some factory someplace else and then thinks that that product is gonna just flow across the border into the United States, that's not gonna happen. They're gonna have a tax to pay, a border tax -- substantial border tax". Combined with a lower corporate rate, this 'carrot and stick' approach may help to achieve policy objectives. However, we see perhaps even more difficulty securing votes for a targeted tax than broader border adjustability.

Income tax and VAT hybrid system: Perhaps the most practical and sensible, but most politically inconvenient, approach is a hybrid taxation system consisting of a business income tax supplemented with a traditional sales-type destination VAT tax. This would put the system on par with nearly all other industrialized trading partners. The sales-type VAT would act as a national sales tax and would be easier to design and administer than the untried subtraction-based VAT in the House GOP proposal. However, Republicans have long opposed adding another layer of tax due to fears that it will eventually result in a revenue grab and will increase government bureaucracy.

Tax Reform – Possible Unintended Consequences

We highlight four potential 'unintended consequences' of tax reform that aren't yet part of the investor consensus, in our view. These aren't necessarily our base case, but worth illustrating as risk factors the markets could begin to countenance as policymaking gets into full swing in Washington.

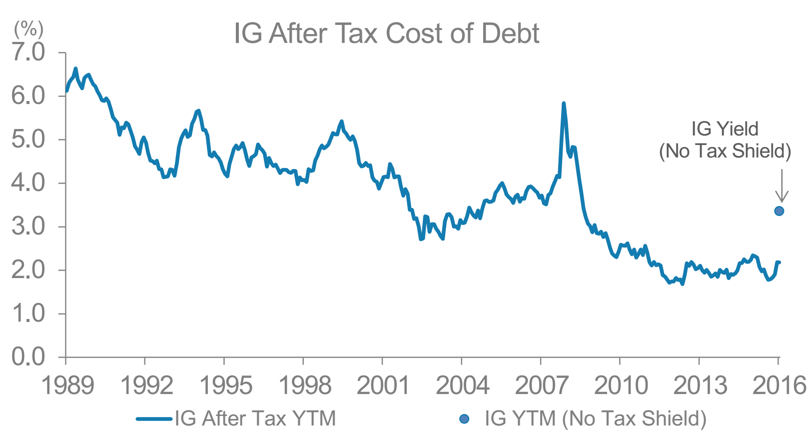
1. Corporate Tax Reform Cuts Interest Deductibility, Making Current Leverage Levels Even Less Manageable

We note two strains of optimism around corporate tax reform. The first is a belief that limiting the deductibility of net interest expense will prove to be a positive for corporate credit by incentivizing lower leverage. The second is the hope that corporate tax reform will ignite growth, thereby extending the cycle. We see the potential for disappointment on both points.

First, although firms may tweak their capital structures, we think that any material changes would take place over many years, not months. Rather, the hit to earnings could be immediate (the tax rate would have to fall to ~20% for the median high yield issuer to break even, given the loss of interest deductibility, all else equal).

In addition, if we are in fact heading into an environment of better growth and less regulation, this should drive more debt issuance in the near term, not less. Even if the tax shield goes away, the cost of debt is still relatively low versus historical levels—and thus could fuel spending on capex, M&A, and stock buybacks, especially if animal spirits are rising.

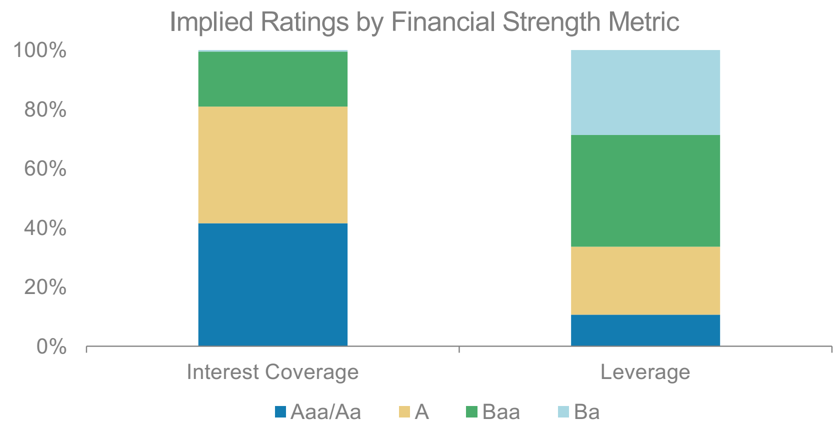
Exhibit 13: Even assuming the loss of the tax shield, the cost of debt is still reasonably low



Source: Morgan Stanley Research, the Citigroup Index LLC. Note: Assumes a tax rate of 35% to calculate after-tax cost of debt

Most importantly, leverage is already at very high levels. And for much of this cycle, many have argued that the high leverage is manageable because rates are so low. As we show below, and outlined in Uncovering Rising Interest, January 20, 2017, based only on leverage, many of the largest IG issuers would be rated quite a bit lower on average than they are today. In a sense, the ratings agencies are giving companies with too much leverage a pass because of elevated interest coverage (among 'other' factors). Therefore, if the ability to deduct interest expense goes away, making it more challenging for companies to service their high debt loads, current leverage levels may become less manageable, especially if rates keep rising. We can't see how this is a good thing in the short term, holding all else constant. While leverage may trend lower over many years, our guess is that the biggest decline in leverage will come after the next credit cycle—this is almost always how it works.

Exhibit 14: In some cases, low rates are justifying better ratings than what leverage levels would imply



Source: Morgan Stanley Research, Bloomberg, Moody's. Note: Based on the top 55 non-fin debt issuers in the Citigroup USBIG Corp Index with an investment grade rating by Moody's

Second, though lower tax rates could fuel stronger growth, we are skeptical that this dynamic would extend the cycle. In fact, quite the opposite—to the extent fiscal stimulus drives increased animal spirits while leverage is already high, and pushes central banks to withdraw liquidity faster, we think that, if anything, this risks an earlier turn in the credit cycle.

Summing up, we are not arguing that corporate tax reform is a bad thing for our credit universe, by any means. We simply believe that the reality may turn out to be less exciting than what markets are pricing in, with some unintended consequences. Corporate tax rates will fall, but likely not all the way to 15%. The tax preference items that could go away, like interest deductibility, are a clear offset to lower tax rates. Border adjustability would be a net cost for companies, with obvious winners and losers. Certain tax changes could lead to lower leverage over many years, but pressure already highly levered balance sheets in the short term. And finally, better growth could lead to less central bank support, which credit markets have relied on for many years. In our view, uncertainty has rarely been higher in this cycle and credit valuations have rarely been richer. We think this combination argues for improving the quality of portfolios into this rally, not chasing yield.

2. Border Adjustability Backfires, and Stagflation Takes Hold

Proponents of border adjustability assume that the dollar will adjust to offset an effective tax on imports. But if the dollar fails to adjust fully—as our FX strategists believe—net importing companies will have to raise prices to avoid losses. The effect may also be compounded by the fact that US importers won't immediately benefit from lower import costs as most of these goods are already priced in USD. Given that many companies lack comparable domestic supply chains, higher costs could be passed onto consumers—an inflationary result.

This could put the Fed in a difficult spot, particularly if consumers respond to higher prices by cutting back on spending, causing growth to falter. Our US economists, though constructive on the consumer, also contend that the household sector remains one that is cautious and very much price-intolerant (see US Economics and Equity Strategy: 2017 US Consumer Outlook, January 4, 2017). Rising inflation and unemployment would be a bad combination for risk appetite.

A key issue with the GOP blueprint is the inadequate proposed treatment of business losses. Net exporters and capital-intensive firms in abnormal growth stages would incur more frequent and greater taxable losses relative to today's income-based tax system. It is conceivable that a net exporter may never generate domestic taxable income. A recent Treasury study estimates that nearly 50% of firms would have incurred losses under a destination-based cash flow tax system.[7] The GOP blueprint proposes that operating losses be carried forward indefinitely with a compensating return for inflation. However, this is likely insufficient. A policy without immediate rebates or the inability to monetize losses breaks the 'symmetry' of the border adjustment mechanism, where imports will bear the full burden of the import tax, but exports will only recognize a partial subsidy. It could also lead to perverse corporate behavior, such as M&A activity and the creation of joint-venture entities motivated by import-export balancing.

3. A Stronger Dollar Leads to Lower S&P 500 EPS, Despite Repatriation-Fueled Buybacks

Further dollar strength could weigh on EPS in 2017—our equity strategists estimate that a 10% rise in USDEUR impacts S&P EPS by about 6%. A larger question for markets, therefore, is whether repatriation-fueled buybacks can outweigh the EPS impact of a stronger dollar.

4. A Stronger Dollar Leads to Stress in Emerging Markets and China

If USD rallies close to the textbook case (25% on a trade-weighted basis), US importer and exporter prospects may be relatively unchanged and the US economy may not be as significantly impacted in the aggregate. However, such a sharp rise in USD risks destabilizing emerging markets, and China in particular. We have written that the PBOC would allow USDCNY to rise under a border adjustment scenario but less than the 10-15% rise we expect for the broad USD (see FX Strategy: How US Tax Reform Could Be a Boon for USD, December 19, 2016). We expect that it would be successful in dealing with capital outflow pressure by tightening the capital account further and using intervention as necessary. However, it's possible that a significant rise in USD would cause severe stress in China, leading to substantial capital outflows and increasing the likelihood of a large devaluation. For broader emerging markets, a sharp rise in USD poses risks for companies with large amounts of USD-denominated debt (see 2017 Global EM Fixed Income Outlook: Alpha Trumps Beta, November 29, 2016). EM stress, particularly from China, could easily spill over into global financial markets and cause a fall in risk appetite and even recession.

US Public Policy – Summary of Key Views

Exhibit 15: Summary of key policy views

Topic	Policy Goal	Relative Prob.	Potential Market Impacts
Taxes (Corp.)	20-25% Corporate rate (base case)	🟢	Roadblocks - either from deficit hawks or special interest lobbyists - bias the corporate tax rate higher. We see rates of 20-25% as most likely. A higher rate (i.e., 25% vs. 20%) may disappoint relative to market expectations. Domestic-oriented consumer firms, who have relatively few tax breaks, would tend to benefit most. Financial services firms should benefit from lower taxes, although tax rules for financial services companies remain unknown.
	Immediate expensing of capex	🟡	Immediate expensing of capex benefits capital-intensive industries with long-lived assets, such as in telecommunications and energy. However, limits to interest deductibility may blunt this benefit.
	Limit net interest deductibility	🟢	Interest deductibility remains on the table, in our view, as limiting interest deductibility would raise revenue to offset the cost of tax cuts. Limiting interest deductibility could incentivize modestly lower leverage long term, though be disruptive to high yield issuers in the near term. Also, improved animal spirits could support gross issuance in the near term even if tax incentives decline.
	Reduced repatriation tax	🟢	Repatriation may bias corporate issuance down. However, we think it is unlikely that repatriation proceeds would be used to buy back corporate debt; if anything, stock buybacks are more likely.
	Full border adjustment	🔴	Although full border adjustment is unlikely, a partial border adjustment provision is possible. Border adjustment would be negative for importers, especially retail. The impact of manufacturing sectors would be mixed, given that many companies import intermediate parts.
	Partial border adjustment	🟡	
Taxes (Ind.)	33-35% individual rate	🟢	As top marginal rates go lower, we'd expect more aggressive limits to itemized deductions and exclusions/exemptions. A cap strikes us as more probable at this point than an across-the-board repeal of these preference items.
	Cap on itemized deductions	🟡	
	Reduced taxes on investment income	🟢	We think reduced taxes on dividends and capital gains are likely. Reduced taxes on corporate bond interest - as outlined in the House GOP blueprint - is less certain. If implemented, it could change the relative value of muni interest and equity dividends.
	Limit mortgage interest deduction	🟡	We tend to think that limits to the home mortgage interest deduction will be minor, given the president's own affinity for real estate. However, an effective cap (via a hard dollar cap on itemized deductions, for example) is possible. At this point, we do not think these proposals would change the near-term trajectory for the housing market.
Health	ACA repeal & delay	🟢	Timing, strategy evolving; a repeal by itself would be negative for hospitals. Although Congress has set up an ACA repeal in the current budget resolution, we do not sense that the Republicans have a consensus on how to proceed with replacing the ACA.
	ACA replacement	🟡	
	Drug price controls	🟡	Trump may push to include some mechanisms to limit drug prices in Obamacare replacement legislation. Although Medicare direct negotiation seems unlikely to pass Congress, dual eligible cuts are possible.
	Medicare reform	🟡	
Infrast.	Tax credits for private investment	🟡	We remain skeptical that an infrastructure package changes spending in 2017 materially; we think it's likely 2018 business. That said, we could see a private infrastructure tax credit plan appear in comprehensive tax reform. The impact on muni issuance is uncertain over the long term; we do not think 2017 muni supply will be impacted.
	New public infrastructure plan	🟡	
Trade	Renegotiate NAFTA	🟢	Anti-dumping laws and voluntary export restraints would likely be aimed at certain products, and not have a broad-based impact on the USD.
	VERs, anti-dumping tariffs, etc.	🟢	
	Across-the-board tariff	🟡	Indications suggest a preference to target particular industries through existing laws and WTO litigation, as opposed to an across-the-board tarriff.
Banks	Key regulatory appointments may ease requirements	🟢	7 key agency or committee chairs (2 FOMC, 3 CFTC, 1 OCC and 1 FDIC), including Vice Chair of Supervision, are up for appointment. More predictable stress tests and a change in the Vice Chair of Supervision could pave the way to greater release of excess capital. Republican plans to submit the CFPB to greater oversight could reduce CFPB activity, which could reduce expenses as well. New regulatory leadership also raises questions about how actively the US will push frameworks such as "Basel IV" or the Fundamental Review of the Trading Book.
	Minor changes to Volcker Rule	🟢	Incoming Treasury Secretary Mnuchin alluded to recent Fed staff papers highlighting possible liquidity implications from the Volcker Rule as currently designed. A full repeal is unlikely, but minor modifications are possible.
	Limit net interest deductibility (Bank impacts)	🟢	Eliminating interest deductibility does not impact bank tax rates, but we expect it will lower EPS through loan losses. Limits to interest deductibility can pressure Corporate and CRE investor cash flows, driving loan loss provisions up and loan growth down.
	Glass-Steagall 2.0	🔴	A full remake of financial regulation appears unlikely at this point. Neither a renewal of Glass-Steagall nor a full repeal of Dodd-Frank are in our base case.
	Dodd-Frank full repeal	🔴	

🟢 High Probability 🟡 Medium Probability 🔴 Low Probability

Source: Morgan Stanley Research

Further Reading on Policy Impacts

Sunday Start: US Policy – The Thrill is Gone. Michael Zezas et al. January 22, 2017.

Major Pharmaceuticals: Trump risk to drug prices, real vs. perceived. David Risinger et al. January 12, 2017.

North American Energy: Border Adjustment Tax: Making America Great Again with Tax Policy? Evan Calio et al. January 9, 2017.

Business & Education Services: Biggest Gainers from Potential US Tax Reform. Toni Kaplan et al. January 5, 2017.

FX Strategy: Border Adjustability: How US Tax Reform Could Be a Boon for USD. Charles Rubenfeld et al. December 19, 2016.

Consumer Staples: Can Tax Reform Make Staples Great Again? Dara Mohsenian et al. December 16, 2016.

US Banks: Doing Our Taxes Early. Betsy Graseck et al. December 16, 2016.

US Public Policy: Taxes: Knowing is Half the Battle. Michael Zezas et al. December 15, 2016.

N. America Insight: Coal, Gas & Power: Post-Election Playbook: Bullish Gas Outlook, but Structural Headwinds Remain for Coal. Devin McDermott et al. December 15, 2016.

Sustainable & Responsible: A hint of clarity on Trump's EPA. Eva Zlotnicka et al. December 9, 2016.

US Healthcare: Election Implications. David Lewis et al. November 23, 2016.

Accounting & Valuation: Focus on Repatriation: Top Investor Questions. Todd Castagno et al. November 21, 2016.

Steel: Making Steel Investable Again. Evan Kurtz et al. November 14, 2016.

Large and Midcap Banks: Republican Sweep = Less Regulation & Lower Taxes. Betsy Graseck et al. November 10, 2016.

US Election 2016: Losing Interest. Todd Castagno et al. October 4, 2016

US Election 2016: Senate Control Key. Betsy Graseck et al. September 12, 2016.

Endnotes

1 Although Republicans hope dynamic scoring will ease the revenue neutrality requirement, our review of prior dynamic scores from the Joint Committee on Taxation suggests its unlikely that a tax reform package will lead to growth of more than 2 percentage points - far from the 8% estimate put forth by the Tax Foundation (see Taxes: Knowing is Half the Battle).

2 Of course, it is conceivable - if a stretch - to imagine that a large tax reform package is paired with steep spending cuts in discretionary and nondiscretionary spending in such a way that it can satisfy the budget and reconciliation rules. Perhaps this is a rationale behind the Heritage Foundation's "Blueprint for Balance." But we have a hard time believing such a strategy would be practical.

3 Bolton, A. "Trump team prepares dramatic cuts." The Hill. January 19, 2017.

4 This could satisfy, for example, the Republican Study Committee's January 24 statement that "The Budget Must Balance Within 10 Years Without Tax Increases...[in order to] Save Social Security and Medicare." See: http://rsc.walker.house.gov/

5 Senate Finance Committee Chair Orrin Hatch on January 4 noted of the House plans: "I'm studying it, just like everybody else...I want to do what's right and do what's workable. I don't think we're there yet." See: Rainey, R. "Ryan Standing Behind Border Adjustments Amid Industry Criticism." Morning Consult. January 4, 2017.

6 "Trump's inaugural committee chief lowballs the size of a 'border' tax." CNBC. 11 Jan. 2017.

7 Patel, McClellan. "What would a cash flow tax look like for U.S. Companies? Lessons from a Historical Panel." US Treasury Office of Tax Analysis. Jan. 2017

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	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
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Equal-weight/Hold	**1442**	**43%**	**299**	**45%**	**21%**	**702**	**45%**
Not-Rated/Hold	**69**	**2%**	**8**	**1%**	**12%**	**9**	**1%**
Underweight/Sell	**668**	**20%**	**85**	**13%**	**13%**	**286**	**18%**
TOTAL	**3,321**		**663**			**1569**	

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