

Dear Investor:

Please see our attached Market and Economic update for September.

There is one question that's nagging me and I decided to focus on it for this monthly update:

Will we get tax reform in the next 60 days?

The market is hitting new highs as we speak, some of it driven by improving fundamentals such as earnings and positive economic data, but don't discount the fact that Wall Street is counting on corporate tax reform as well. While the market has not priced in a cut to 15%, it probably has already discounted a 25% corporate rate, and if this doesn't happen we can expect a 5-7% correction before year end. Keep in mind the market has not had a 5% correction in over 270 days, which is one of the longest periods on record since 1950.

If this continued bull run hinges on tax reform, how do we handicap it? Here are some recent comments from KPMG, which has a significant team dedicated to projecting tax reform outcomes:

Despite disagreements elsewhere, the President and Congressional Republicans here remain largely united on their vision for tax reform. But, most of the hard decisions—not only how to pay for it, but also how to clear the legislative hurdles to make voting on a package even possible, still lie ahead.

The President's debt limit and budget deal probably helps the GOP focus on tax reform, and his speech reassured many that his vision for tax reform remains largely in the Republican mainstream.

But even with funding for the government now extended through December, it is not clear that Congress can negotiate and pass a budget in time to pass tax reform this year (or perhaps at all). Without budget reconciliation, Congress will need 60 votes to pass tax reform—a prospect that is decidedly dubious with only 52 Republican votes.

Congress returned from its five-week summer recess to a lengthy to-do list: funding the government beyond September 30, raising the debt limit, and providing hurricane relief, as well as other pressing matters, such as reauthorizing the Federal Aviation Administration and funding the Childhood Health Insurance Program.

Still, the GOP had hoped to make large strides on advancing a tax reform deal. But further, unpredicted developments may have slowed progress.

First, to the delight of tax reform negotiators, President Trump delivered a speech on September 6 emphatically supporting efforts to push tax reform this fall. But then, 24 hours later, the President stunned many Republicans, when he struck a deal with Democratic Party leadership that provided \$15 billion in hurricane relief along with a three-month extension of government funding and suspension of the debt limit. Republicans went along and the package easily passed in the House, although it thwarted their plans to push the government funding and debt limit issues beyond the November 2018 elections.

These events illustrate the complex relationship between the President and Congressional Republicans. Which leads to the question: Can the Republican Congress successfully work together with the President to reach a tax reform deal? Despite disagreements elsewhere, the answer seems to be that President and Congressional Republicans remain largely united on their vision for tax reform.

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Here are some points to consider as the weeks ahead unfold:

- 1. The debt limit and budget deal may help the GOP focus on tax reform.** Most Republicans weren't pleased to have been circumvented in the negotiations. But the deal may have cut weeks or even months off of the negotiations process. The GOP can now focus on passing a long-term budget and talking tax reform.
- 2. The President's vision for tax reform remains in synch with the Republican mainstream.** President Trump's September 6 speech explicitly called for adoption of a territorial tax system, repeal of the estate tax, lower corporate rates, and a decoupling of taxation of small business income from individual tax rates. These are all key items in Republican tax reform orthodoxy.
- 3. Hard decisions on paying for tax reform.** Despite general conceptual agreement on tax reform, many critical details are still unresolved. Neither the Big Six key tax reform policy makers nor the President has said how they would propose to offset the cost of the tax cuts under discussion. It's not clear whether that is possible with adjustments to the current income tax system without a new source of revenue, like a VAT. And if the tax reform bill isn't revenue neutral over the long term, then it can only pass if it gets 60 votes in the Senate; with only 52 Republican senators, that's highly unlikely.
- 4. Congress must pass a budget resolution for Fiscal Year 2018.** As a practical matter, Congress will need to pass an FY18 budget resolution to have a realistic chance to enact tax reform. That will require that Congress agree to spending and revenue targets, which could prove difficult. Without getting bogged down with procedural technicalities, if there's no FY18 budget, then the GOP will need those 60 Senate votes to pass tax reform. And as noted above, that's dubious.

Will we get tax reform in the next 60 days?

Interests seem mostly aligned between the President and Congressional Republicans, but hurdles remain around funding the reforms and securing the required votes to proceed. Unfortunately, let's just stick with "maybe", and if we don't and the market corrects, we believe it will be another buying opportunity in a bull market that has a few years left.

Please call or email me with any questions.



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