Sprott Asset Management USA, Inc. December 2017

Just Get Something Done!

The Tax Cuts and Jobs Act of 2017 has become a microcosm of contemporary American politics. Bravado and obligatory motion have dulled senses and marginalized rational analysis. The tax bill in its current form has morphed into movement for movement's sake, largely devoid of coherent economic policy. As Obamacare has demonstrated, this brand of legislative action can inflict damaging unintended consequences and become a legislative albatross for an entire political party. Given heightened market expectations for tax reform, Republicans may have just sowed their own undoing, leaving financial markets ripe for disappointment in 2018.

Few policy objectives hold more economic promise than simplifying the U.S. tax code. Legitimate efforts to address the bleak fiscal future for the U.S., such as the 2010 Simpson-Bowles National Commission on Fiscal Responsibility and Reform, always cite domestic tax reform as a critical component of sustained federal solvency. No matter how noble a goal tax reform may be, necessary tradeoffs in the ultra-polarized U.S. political climate make ***comprehensive*** tax reform virtually impossible in any environment short of outright crisis. Absent such an involuntary and total reset, tax cuts as discreet policy tool are geared to offer the most utility in economic conditions such as recession, high unemployment, strong population growth and a balanced foreign trading environment (facilitating overseas deficit financing). Ironically, the present-day U.S. economy is characterized by virtually opposite conditions: unemployment is historically low at 4.1%; U.S. output is in its ***ninth*** year of expansion; population growth has declined from its historical 2%-rate to roughly 0.5%; and the U.S. capital account is already severely strained.

Despite President Trump's banner proclamation of a massive tax cut for the middle class, our analysis suggests the bill's schizophrenic jiggering essentially amounts to a glorified corporate tax cut. By leveling the (global) taxation playing-field for U.S. corporations (while ignoring steep VAT burdens making statutory obligations for overseas corporations significantly higher than even the top U.S. nominal 35% corporate rate), and facilitating repatriation of "trapped" overseas profits, the legislation purports to foster U.S. economic growth, stimulate domestic capital investment and invigorate U.S. jobs markets. Of course, this glowing appraisal is shared by few economists and strategists ***outside*** the Trump administration. Most independent assessments, such as the Joint Committee on Taxation (Congress's nonpartisan scorekeeper) estimate the tax bill may increase GDP between 0.5% and 1.0% cumulatively over a 10-year period, ***while boosting the federal budget deficit by $1.0 – $1.5 trillion,*** a tradeoff hardly worth its steep price (see Addenda for additional third-party scoring).

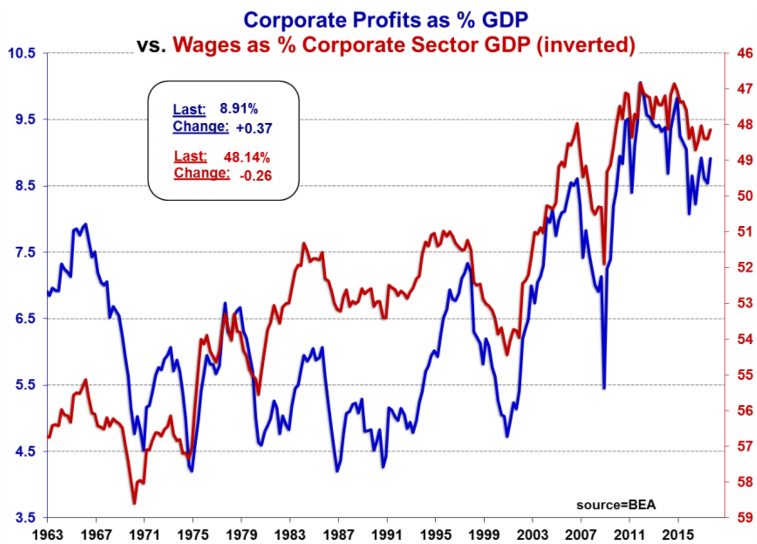

Figure 1: Corporate Profits as Percentage of GDP versus Wages as Percentage of Corporate Sector GDP (Inverted) (1963-Q3 2017) [Meridian Macro]

We believe the corporate focus of Trump tax cuts is misguided for two reasons. First, lowering corporate tax rates will only exacerbate the economic stratification already plaguing the U.S. economy. As shown in Figure 1, above, corporate profits as a percentage of GDP hover near all-time highs precisely as wages as a percentage of GDP have dwindled toward historic lows.

Given how far the economic pendulum has swung in favor of capital-over-labor in recent years, is this really the right time to pursue economic growth through tax cuts on record corporate profits? ***We would suggest $1.5 trillion in direct federal funding for education, job training, R&D and infrastructure programs would be a vastly more productive use of national resources than incurring the like-sized deficit implicit in the Trump corporate tax cut.***

Second, there is precious little supporting evidence that reducing corporate tax rates and offering tax holiday on overseas profits will actually stimulate either incremental capex or increased hiring. One particularly poignant rebuke of the Trump administration's tax-cut reasoning occurred at a gathering of the Wall Street Journal's CEO Council on 11/16/17. With White House Economic Council Director Gary Cohn seated on stage, a WSJ editor asked a room of 100-or-so CEO's for a show of hands, "If the tax reform bill goes though, do you plan to increase your company's capital investment?" When virtually no hands were raised, Cohn nervously blurted out, "Why aren't the other hands up?" This awkward scene quickly went viral as vivid demonstration of how out of sync the Trump tax plan is from current corporate priorities.

During the past eight years, ZIRP and related productivity declines have decimated corporate capex in favor debt-fueled share repurchase. As shown in Figure 3a, below, from the equity-market lows of Q1 2009 through the first half of 2017, the corporate sector had repurchased 18% of total U.S. equity market capitalization, while institutional investors had liquidated 7% of total equity market cap. Figure 3b, below, demonstrates these repurchases were funded almost entirely through issuance of low-coupon debt in a ZIRP world. Given the fact that corporate spreads remain near all-time lows and liquidity remains abundant, we are skeptical that a reduction in corporate tax rates will have meaningful impact on capex or hiring plans.

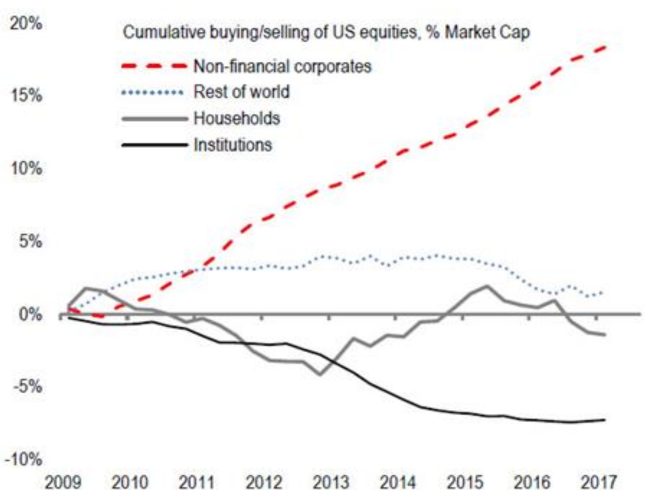

Figure 3a: Cumulative Buying/Selling of U.S. Equities by % of U.S. Market Capitalization (Q1 09-Q2 17) [Thomson Reuters; Credit Suisse]

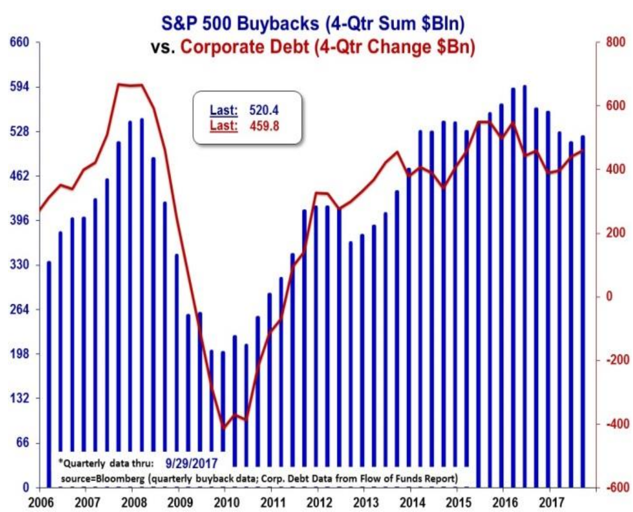

Figure 3b: S&P 500 Share Buybacks [Trailing 12-Mos.] versus U.S. Corporate Debt Growth [Trailing 12-Mos.] (2006-Q3 2017) [Meridian Macro]

With respect to repatriation provisions of the 2017 Tax Act, we are similarly skeptical such a tax holiday will catalyze any significant corporate behavior outside share repurchases, shareholder dividends and executive bonuses. After all, the vast majority of American corporations' $2.6 trillion overseas cash hoard is already invested in dollar-denominated instruments (so no need to disturb), the reduced tax obligation was deemed (not voluntary) and the prevalence of interest rate swaps has long facilitated easy domestic monetization of these balances should any compelling corporate opportunity have presented itself in prior years (it did not).

Historically, tax holidays on overseas profits have hardly inspired imaginative corporate governance. By way of example, the Senate Permanent Subcommittee on Investigations published on 10/11/11 an in-depth analysis of the 2004 repatriation tax holiday. In return for reducing the tax rate on repatriated funds from a maximum 35% to roughly 5%, the 2004 legislation had specified that repatriated funds should be earmarked for activities such as hiring workers or conducting research and prohibited using the money for executive compensation or buying back stock. Nonetheless, the IRS reports that the 2004 tax bill motivated 843 companies to bring back $312 billion. The 15 companies returning the most overseas profits in the 2004 episode proceeded to cut a net 20,931 jobs between 2004 and 2007, slightly decreased their spending on R&D, accelerated spending on stock buybacks, and, most preciously, granted their top five executives average pay increases of 27% from 2004 to 2005 and an additional 30% between 2005 to 2006.

All-in-all, the Tax Cuts and Jobs Act of 2017 seems to us to be the wrong policy, for the wrong reasons, at the wrong time. Contrary to President Trump's depiction of a Christmas present for the middle class, we expect tens-of-millions of Americans to be angered by the bill's capricious sacrifice of longstanding and coveted deductions for mortgage interest and state-and-local taxes on income and real-estate. We believe President Trump's signature on the Tax Act will likely mark an inflection point for U.S. financial markets, as awkward realities of a deeply flawed bill displace general investor optimism over tax cuts. Finally, growing recognition that the 2017 tax bill will contribute an additional $1.5 trillion to the ever-deteriorating U.S. fiscal positon should further pressure the U.S. dollar, already suffering its worst annual performance since 2003. In our opinion, gold markets are likely to take notice.

Sincerely,

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Addenda

Two Neutral Accountings of the Tax Cuts and Jobs Act of 2017

The Initiative on Global Markets at the University of Chicago Booth School of Business oversees a panel of 38 distinguished academic experts to explore "the extent to which economists agree or disagree on major public policy issues." We find it notable that ***all 38 members*** of this bipartisan and geographically diverse panel (of Nobel-laureates-and-Bates-Clark-medalist types) agree not only that the Trump tax plan will increase the national debt as a percentage of GDP, but also that the contemplated tax-cuts will fail to generate sufficient economic growth to pay for themselves. Indeed, only one of the 38 panelists felt the tax plan might result in a "substantial" increase in GDP (22 disagreed and 15 were uncertain). Who are we to disagree with the conclusions such an august group?

One footnote to the Commerce Department's 11/29/17 revision of Q3 GDP to 3.3% is that actual GDP has closed the output gap with Congressional Budget Office estimates for "potential" GDP. Moving forward, the CBO forecasts potential GDP will grow an average of 1.8% annually, as represented by the y-axis zero level in Figure 4. At its 12/13/17 FOMC meeting, the Fed ratified this potential GDP estimate with its own forecast for long-run GDP growth of 1.8% to 1.9% (post 2020). In addition to this trend growth, the proprietary Penn-Wharton Budget Model suggests the 2017 Tax Bill might add between 0.5% and 0.9% to GDP ***cumulatively*** during the next decade (yellow delta in Figure 4). To give some perspective to just how optimistic Trump administration projections are, their projections ***for 3% to 4% annual GDP growth during the next decade*** are plotted in the pink triangle of Figure 4! ***Yowzer!***

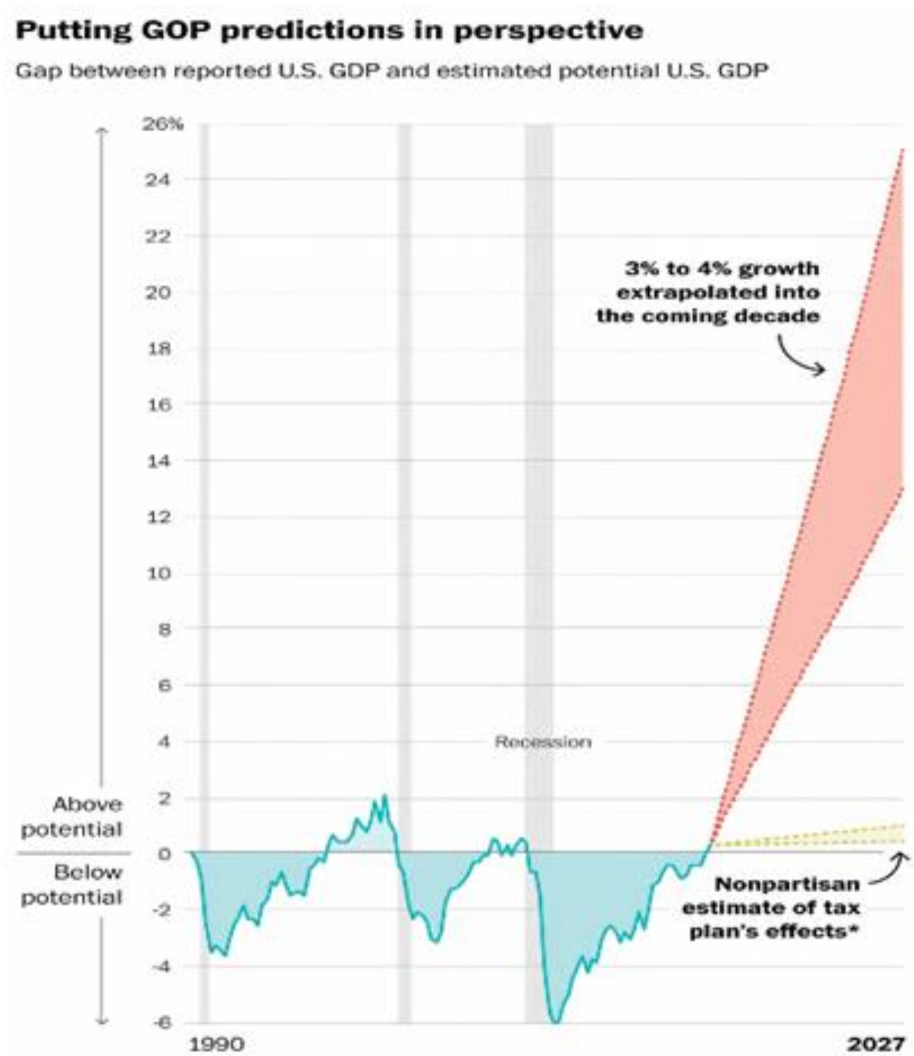

Figure 4: ***Gap between Actual GDP and Potential GDP; Penn-Wharton Model for Incremental GDP from 2017 Tax Bill; and Trump Administration GDP Forecasts (1990-2027)***
[Commerce Department; CBO; Penn-Wharton Budget Model; Trump Administration; Washington Post]

All figures in this report are expressed in U.S. dollars unless otherwise noted.