Flash Note
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What you probably do not know about the US tax reform. Fed & US Treasury.

For decades, US firms have been "de-equitizing", favoring debt over equity as a source of funding. The result was a weaker capital structures all across the board. The tax reform spur (at least in some sectors) a reversal of that trend. Something that we label as a positive shift.

- The bill caps deductions for interest expenses equal to 30% of EBITDA until 2021, and beyond that year the regime will be even more strict (meaning a more restrictive earnings if you use debt as the main source of funding).

- As a result, companies will tend to pay down debt and favor equity financing for new investments. The sectors most likely to be impinged upon by the cap on deductions are Telecommunications, Health Services, materials and mining.

- Long-Term effects: More stability in the economy as leverage will likely be reduced.

- Short-Term effects: Equity holders face the risk of being diluted as firms issue new shares to fund the expansion. (that is one of the reasons why we consider the S&P offers little value)

What could be the FED's reaction (and the 10Ys US Treasury?)

I'm one of those who believes that the US Output Gap (difference between actual and potential growth) is higher than many estimate. We consider that the output could be near the ~1%. We forecast a 2018 GDP growth of >2.5%-3.0% (which means a 0.5%-1.0% above its potential growth at about 2%). Well. When a fiscal stimulus is implemented when the output gap is positive this may cause the Fed to act aggressively (at least, more than market could expect today), simply because overheating pressures are higher in such circumstances. I would not like to be in the shoes of Mario Draghi, who will be hardpressed to tighten interest rates, at a time when I doubt that some European countries can afford it.

If what I say is true (positive output gap, and a Fed being now behind the curve), long rates could easily react on the upside. In fact, today, the 10Yr UST offers marginally real rates (2.4% vs 2.2% inflation expected).

The upshot is that long yields in the US Treasury bond could eventually break out of their range in the last 4 quarters. The implications for the Fx are also clear, though I'm going to spare you the inconvenience of explaining them again (specially when the market ignores the facts).