Market Bulletin

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Trade, taxes and temporary distortions: growth after the second quarter surge

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In brief

- The U.S. economy grew 4.1% in the second quarter of 2018. This figure was significantly stronger than the expansion average, and the highest rate since 2Q 2014.
- It may be tempting to interpret this as the start of a new U.S. growth paradigm or a warning sign that excessive stimulus is overheating the economy. This thinking oversimplifies the matter.
- Looking at the composition of second quarter growth shows that a sizeable portion may result from changing accounting practices, as corporate tax reform reduces the attractiveness of transfer pricing and leads to an improvement in the trade balance.
- Investors should be neither elated nor concerned with this growth figure. Instead, longer-term growth prospects should continue to be tempered.

The second quarter surge

Recent data from the Bureau of Economic Analysis (BEA) show that the U.S. economy grew 4.1% in the second quarter of 2018, the strongest growth since 2Q 2014 and well above the expansion average. It may be tempting to interpret this as the start of a new U.S. growth paradigm or a warning sign that excessive stimulus is overheating the economy. Investors are looking at the same sky, but are divided: is this the birth of a star, or a supernova? But this binary thinking oversimplifies the matter, and a decomposition of second quarter growth suggests that neither guess is entirely correct. Rather, a sole culprit—trade—may be responsible for the second quarter surge. Understanding how and why this happened, while looking at other major contributors, may shed light on future growth prospects and help to temper sentiment about the present.

Taxes and trade: an unlikely pair

Prior to the passage of tax reform at the end of 2017, the U.S. had the highest corporate tax rate in the developed world **(Exhibit 1)**.[1] The result was predictable, though unintended: American multinational corporations were incentivized to minimize their U.S.-based income to take advantage of more competitive foreign tax rates.

This process was accomplished through transfer pricing, also known as profit shifting: costs were distributed between entities under common ownership for tax purposes. A product designed and manufactured in the U.S. but sold in another country should theoretically count as an export, for example, but may be leased to an offshore affiliate before sale, causing it to drop out of the trade statistics all together.

The corporate benefit of transfer pricing is obvious, with a lower effective tax rate leading to higher margins. But this shareholder value comes at the expense of measured economic growth, which is dragged down by a persistently overestimated trade deficit: in a 2017 working paper, the BEA estimated that profit shifting had added roughly USD 280 billion to the 2012 trade deficit, or 1.6% of gross domestic product (GDP).[2]

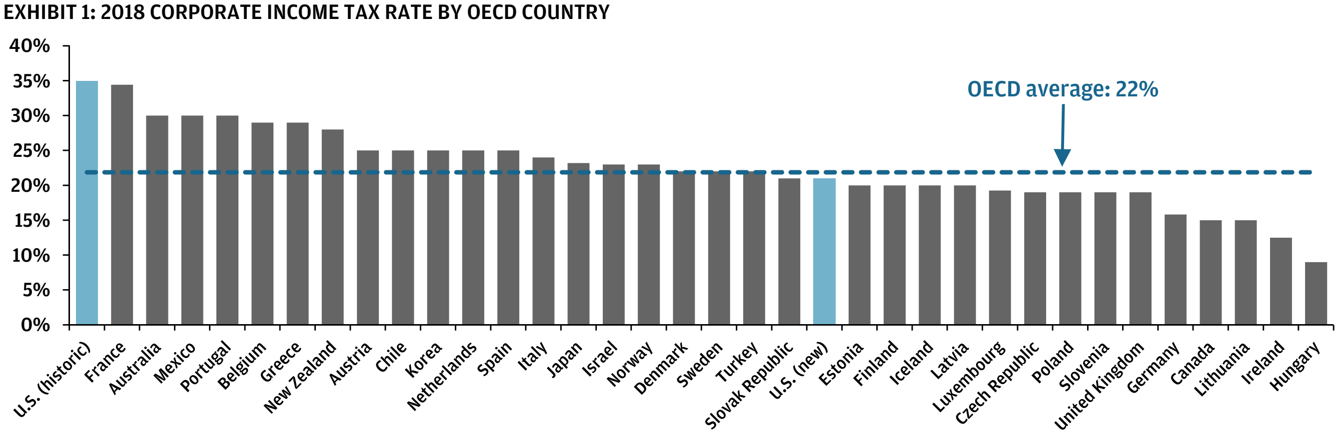
A new sheriff in town: what tax reform may mean for the trade deficit

Tax reform has been a boon to corporate profitability, but it also has broader implications. First, a lower corporate tax rate makes the U.S. a more attractive place for business; and second, an effective minimum tax on income earned overseas reduces the benefit of deliberately overstating foreign earnings. Together, these factors should deter profit shifting and, therefore, positively affect the U.S. trade balance. This would, in theory, present itself in a one-time boost to GDP and one or more quarters of above-trend growth.

Interestingly, it appears that a shifting trade balance in the second quarter did have an outsized effect on the U.S. economy **(Exhibit 2)**, contributing 1.1% to growth (compared to an average -0.3% detraction during this expansion). Moreover, ignoring the trade sector entirely, growth would have been a more modest 2.7% annualized. GDP data suggest that real exports grew with no corresponding increase in imports; this was more than accounted for by trade on the goods side, where exports were up 17.0% annualized while imports were flat **(Exhibit 3)**.[3]

The 2017 corporate tax cut put the U.S. rate in line with average

EXHIBIT 1: 2018 CORPORATE INCOME TAX RATE BY OECD COUNTRY



Source: OECD, J.P. Morgan Asset Management. Data are as of July 27, 2018.

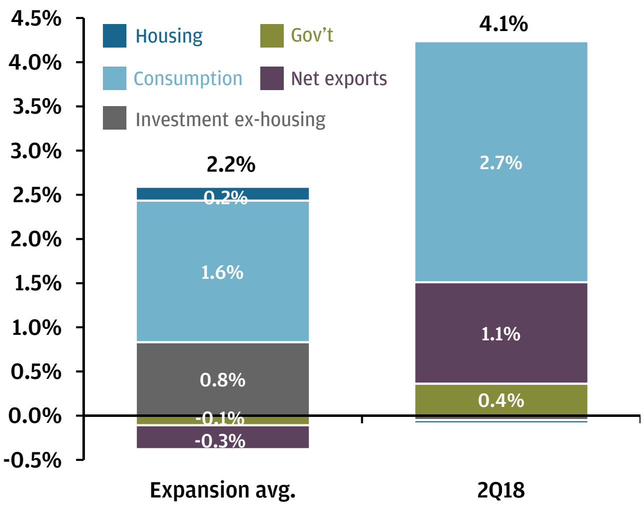
[1] The 2017 corporate income tax rate for the U.S. was 35%, compared to the OECD average of 22%.
[2] Guvenen, F., Mataloni Jr., R, Rassier, D. and Ruhl, K. (2017) *Offshore Profit Shifting and Domestic Productivity Measurement*. Bureau of Economic Analysis.
[3] Some of this shift may be in response to rising tariff uncertainty, with exporters seeking to front-load shipments to avoid future tariffs. Nonetheless, the accounting component should not be overlooked

A reduction in profit shifting does have its downsides, however. For every extra dollar of GDP from an improving trade balance, there is a commensurate decrease in foreign investment income. As a result, while the U.S. trade position might improve, the current account balance likely will not be affected.

A shifting trade balance had an outsized effect on 2Q18 growth

EXHIBIT 2: CONTRIBUTION TO REAL GDP BY SUBCOMPONENT

%, q/q, saar

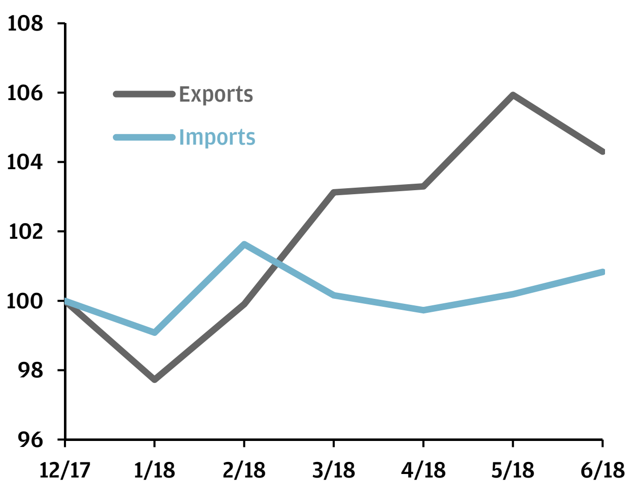


Source: Bureau of Economic Analysis, J.P. Morgan Asset Management. Expansion average begins in 2Q 2009. Data are as of July 27, 2018.

Second quarter goods exports grew while imports stayed flat

EXHIBIT 3: MONTHLY GOODS TRADE DATA

Index, December 2017 = 100



Source: FactSet, U.S. Census Bureau, J.P. Morgan Asset Management. Data are as of July 27, 2018.

A historical case study

The U.S. is not alone in experiencing the distorted effects of taxes and trade accounting on GDP growth. Following an outflow of business activity from the country, the UK government launched a series of tax reforms in 1980. Under the Thatcher administration, the corporate tax rate fell from 52% (at the time, among the highest in the world) to 35% in 1986; gradual adjustments from there culminated in a final round of reforms in 2009 and a 20% corporate tax rate by April 2011.

The results suggest that incremental adjustments to the corporate tax rate can have a meaningful impact on growth and trade. UK GDP spiked in 2Q 2010 and again in 1Q 2011, roughly contemporaneous with the tax cuts. Moreover, throughout the course of 2011, UK exports grew nearly twice as fast as UK imports, cutting the annual trade deficit in half relative to the prior year. If history is a reliable guide, it seems that a reduction in the corporate tax rate could translate into measured economic growth relatively quickly.

Growth moving forward

Despite its unusual impact on second quarter growth, trade remains a relatively small piece of the economic pie. In assessing the prospects of future growth, it is worth keeping the following in mind:

- Consumer spending grew 3.9% in the second quarter, thanks both to the stimulative effects of tax reform and the easy comparison relative to a weak first quarter. With most pent-up demand exhausted, however, consumption will not likely contribute meaningfully to growth through the rest of the expansion.
- The housing sector weakened in the most recent quarter, as rising home prices and mortgage rates put pressure on potential buyers. As with consumer spending, there seems to be little pent-up demand left for meaningful growth.

- Business fixed investment, particularly in the wake of tax reform, could show an outsized contribution to growth in the future. With strong corporate profits and a tax code that encourages capital spending, investment should accelerate so long as major sources of uncertainty, like the current trade disputes, are resolved or clarified.

Beyond these, there are other considerations. Inventories fell unexpectedly for the quarter but should normalize, providing a boost to 3Q growth; advancements in inventory management systems, however, should limit inventory impact on longer-term growth prospects. Government spending improved marginally, but not as significantly as the recent relaxation on spending caps might suggest. More broadly speaking, the effects of tax reform should begin to wear off in the second half of 2019, easing the U.S. economy off of its sugar high. And finally, year-over-year growth remains sub-3% thanks to revisions to historical data.

All-in-all, it would be wise to not assume that this quarter's strong growth is a sign of things to come. As the U.S. expansion continues to age, structural limitations should outweigh the benefits of tax reform, trade-related or otherwise.

MI-MB_TradeTaxesGDP_July2018
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