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John Dessauer's market review and update as of Wednesday January 18, 2017

Thomas Sowell, a brilliant 86 year old economist, unfortunately recently retired, characterized Trump, before the election, as a Russian roulette game when it comes to the U.S. economy. He also wrote that electing Hillary Clinton would be putting a shotgun in your mouth and pulling the trigger. Luckily the voters did not elect Hillary. But there still are risks. If Trump policies act like a bullet in the chamber, the economy will be hurt. There are at least two scary possibilities for that bullet. One is trade and the other is corporate tax reform. Both are connected.

President-elect Trump apparently does not understand the economics of international trade. For example, he sees our trade deficit as a problem that needs fixing. He is not alone. Probably most Americans would agree with that conclusion. The word deficit has negative connotations and is often connected to the word debt. However, when it comes to trade we use double entry accounting. There is our national current account on one side of the ledger and the capital account on the other. For every entry on one side there is an equal and offsetting entry on the other. The trade deficit is on the current account side. It is equaled by a capital account surplus on the other. This is not accounting gimmickry; this is accounting based on reality. If the trade deficit were to shrink, the capital account would also shrink. In that case, there would be a reduction in foreign investment in the U.S. Unless that was matched by an increase in domestic business investment, the economy would suffer. Another way to look at international trade is to understand that exports and imports are two sides of one coin. When President

Obama said he wanted to see U.S. exports double, he did not mention that if that happened U.S. imports would also increase. Trade and accounting, as you can see, are complicated. However, one thing is clear: demonizing our trade deficit is wrong and risks doing real damage to the U.S. economy.

When state and local taxes are included, the U.S. has the highest corporate tax rate in the rich world - 39.6%. It makes sense to reduce that to make the U.S. more competitive. President-elect Trump wants to cut the federal corporate tax rate from 35% to 15%. House speaker Ryan wants to cut the rate to 20%. That may seem simple, but it is not, because the U.S. has a complex warren of corporate deductions, such as special treatment for NASCAR racetracks.

Speaker Ryan proposes paying for his corporate tax cuts by eliminating deductions, including the deduction for interest paid on corporate debt. Over the past couple of years there has been a surge in U.S. corporate borrowing. Companies have been taking advantage of low interest rates while they can. Eliminating the interest deduction would raise taxes on companies with debt. It is far from clear if the cut in the tax rate would offset the loss of the interest deduction. However, it is clear that eliminating the interest deduction would discourage borrowing for business investment. The economy needs an increase in business investment. One major reason the recovery from the 2008 financial crisis has been so slow is the low level of business investment.

The stock market has been celebrating the idea of corporate tax cuts. However, as usual, the devil is in the details. What we know so far about the plans for cutting corporate tax rates raises more questions than answers. It is not clear that corporate profits would benefit from the current plans.

U.S. businesses have $2.6 trillion in cash held offshore. The reason is that the U.S. imposes taxes on global profits, but that applies on foreign profits only when the cash is brought back to the U.S. President-elect Trump wants to offer a one-time tax of 10% for firms that bring the cash home. Speaker Ryan wants to stop taxing foreign profits altogether. His plan would stop taxing profits on American exports. It also would eliminate the deduction for the cost of imports. This combination is called "border adjustment" because it penalizes imports and subsidizes exports. Economists are critical of this plan because the combination would push up the dollar. The currency markets would adjust to the new tax scheme. An effective 20% border adjustment tax would mean a 25% increase in the dollar. But since 2014, the dollar is up 24%. Goldman Sachs warns that such a staggering additional increase in the dollar would hammer dollar debt ridden emerging markets and threaten the health of the world economy.

Political leaders, CEOs, and top bankers are making their annual trek up the Swiss Alps to the World Economic Forum in Davos, and the mood is anything but celebratory. They are suffering acute anxiety about an increasingly toxic political climate in Europe and a deep sense of uncertainty surrounding the U.S. presidency of Donald Trump, who will be inaugurated on the final day of the forum. President-elect Trump is not the only political leader who is skipping Davos. Germany's Angela Merkel has also opted out.

The Brexit vote in Britain plus the Trump election victory are not the only sources of the acute anxiety over global politics. There appears to be a lurch to the right developing in Germany, France and possibly Italy. The American middle class is not the only one to be suffering from low wage gains, part time jobs, and shaky retirement prospects. Left-leaning governments have made economic promises for decades, and failed to deliver. The financial crisis of 2008 has exposed the weaknesses in their policies. Now a wave of immigrants from the Middle East is straining resources further. Voters are searching for a way to return to feeling safe at home and regaining the means to prosperity. Will the Trump presidency accomplish that for Americans? Will Theresa May and Brexit be successful for Britain? Not only is there no way of answering those questions now; there is a high degree of uncertainty about the consequences of the plans here at home and abroad.

I am happy that the U.S. stock market has stalled at Dow 20,000. My hope is that investors will now patiently wait for the Trump team to take office and get to work. If they are successful, stocks can rise based on improving fundamentals. We could be at the beginning of a new cycle of growth in corporate sales and profits. It is just too soon to be sure.

I will have the next market review and update for you one week from today on Wednesday January 25, 2017.

All the best,

John Dessauer