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John Dessauer's market review and update as of Wednesday February 15, 2017

There has been a lot of damage done to the U.S. economy. The figures on trade during 2016 provide more evidence that the damage persists. That is the bad news. The good news is that there is tremendous potential for future growth.

First, the bad news from the trade figures: The media headline "Trade deficit last year hit highest level since 2012" clearly was designed to scare readers. The word "deficit" is loaded with negative implications. The headline could have been "Capital account surplus last year hit highest level since 2012." That would also be correct, but not scary. The trade account is one side of our national ledger. The capital account is the other. The misleading reporting by the media did not stop with the scary headline. For example, after correctly reporting "U.S. exporters have struggled for the past two years with a rising value of the dollar, which has made U.S. goods less competitive in global markets….." The Associated Press reporter went on to say "Imports were down 1.8 percent last year, reflecting in part the drop in global oil prices." When I read that, I wanted to find that reporter, shake her or him and say "Wait a minute! You are missing the biggest part of the story. When the dollar is strong, making imports cheaper for U.S. consumers, imports should be going through the roof. The fact that imports in 2016 went down is a very big deal. At the very least, imports should have been up in 2016, driven by demand from U.S. consumers. That didn't happen. A label saying "Made in China" can be found on tens of thousands of U.S. goods. Last year, U.S. imports from China went down about 5%. Why did U.S. consumers cut back on cheaper imports from China and

elsewhere? Ever since the recovery from the 2008 financial crisis began, we have heard that the recovery is weak because of a lack of final demand. And last year the economy grew at a very weak 1.6% rate. The logical conclusion is that American consumers are still struggling financially. We have created lots of jobs, but not lots of pay. The trade data are the latest in a series of data confirming that this has been a low wage recovery and that low wage conditions persist.

While no single regulation or legislation can be blamed for the whole of the anemic recovery, there is one that stands out as having been a major force in inhibiting economic growth and contributing to the low wage recovery, and that is the Dodd-Frank bill. It is a monster of a law, 848 pages, programmed to spawn more regulations. It imposed more than five times as many restrictions as any other law passed by the Obama administration. More constraints were added to the federal banking code between 2010 and 2014 than existed in 1980. As new rule piled on new rule, the compliance costs escalated. It is estimated that between 2010 and 2016, 73 million hours were spent by banks doing Dodd-Frank paperwork, at a cost of $36 billion. That ate into profits of the big banks, and threatened the smaller banks. A study by the Minneapolis Federal Reserve found that adding two extra members to their compliance departments pushed a third of small banks into the red.

Barney Frank, a liberal politician and co-sponsor of the bill, has from time to time objected to the expansion of rules and regulations as going further than the sponsors intended. Many banks, especially smaller ones, loathe the Dodd-Frank monster. And for good reasons - the bill can catch banks no matter how careful they are with depositors' money. Wayne Abernathy of the American Bankers Association, points out that

community banks shun loans to new or marginal customers because they can't afford the time and expense of justifying the loans to several regulators. Abernathy says: "Lending is being narrowed down to mortgages, familiar customers and agriculture." While this does limit risks, it also opens the banks up to another Dodd-Frank attack because their lending is too concentrated. According to Davis Polk, a law firm, of the 390 Dodd-Frank rule making requirements enacted in 2010, 111 have not yet been finalized.

We know that the trillions of dollars added to the financial system by the Federal Reserve have not flooded the economy; instead they have remained bottled up, mainly as bank deposits at the Federal Reserve. Dodd-Frank is a major reason banks have preferred the safety of Federal Reserve interest bearing deposits over ordinary lending. You could say that Dodd-Frank spawned a self-intensifying negative circle where bankers' reluctance to lend led to slow growth in final demand which reinforced bankers' reluctance.

Dodd-Frank is now under attack and there will be major changes. President Trump's eighth executive order did not mention Dodd-Frank, but it lists "core principles" for regulating America's financial system, and they clearly will require a line by line look at Dodd-Frank.

The clearest signal that Dodd-Frank will be changed is the resignation of Federal Reserve board member Daniel Tarullo. He was appointed to the Federal Reserve board by President Obama on January 28, 2009, just days after the inauguration. According to Reuters, he was the most influential architect of post-crisis financial reform, including the bank stress tests. His exit may be one of the biggest determinants of how banks are

overseen. Reuters describes his resignation as a generous parting gift to the banks. I would add that it is also a parting gift to the economy.

Opponents of moves to unwind the smothering Dodd-Frank rules are hysterical. They say Wall Street caused the financial crisis and argue that weakening Dodd-Frank will lead to the next disaster. Wall Street was not alone in causing the financial crisis. High ranking politicians from President Carter to President Clinton attacked banks for "redlining" and refusing to grant home mortgages to minorities. Banks were forced by political pressure and new regulations to expand their mortgage lending into higher risk areas. Politicians are also to blame for creating the financial crisis. By denying their own blame and focusing solely on Wall Street and the banks, the Obama administration went too far, almost crushing the banks' lending authority and thereby doing severe damage to the economy.

The eighth executive order and Daniel Tarullo's resignation go a long way in explaining the recent rally in financial stocks. Financial stocks have led the way to new highs on the Dow Jones Industrial Average. They are also a leading indicator for the economy. Dodd-Frank did good as well as bad. U.S. banks' equity capital ratios are much stronger than they were before the 2008 financial crisis. That is a major positive. Well-capitalized banks and relief from the worst of Dodd-Frank will improve U.S. economic conditions. Tax reform and health insurance reform are getting the headlines. But Dodd-Frank relief is an equal reason to be optimistic about future economic growth and higher stock prices.

I will have the next market review and update for you one week from today on Wednesday February 22, 2017.

All the best,

John Dessauer

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