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John Dessauer's market review and update as of Wednesday April 26, 2017

President Trump says he will provide details on his plan to simplify and cut taxes this week. There are lots of opinions swirling around about what his plans will be. The hope is that he will be like President Reagan - cut taxes, and then allow economic growth to increase revenues. But there is one troubling opinion, and that is that he may want to impose a "border tax" to pay for the tax cuts. A border tax is a very bad idea. It would hurt the economy and the stock market. We need to fully understand the stakes. In the 1980s the Federal Reserve under Paul Volker as Chairman raised interest rates to fight nonexistent inflation. The dollar soared, threatening the U.S. economy. Paul Volker was forced to reverse course and bring interest rates back down. A Trump border tax could have the same dismal result, threatening the U.S. economy and forcing Congress to reverse course and eliminate the border tax.

The idea behind a border tax is to impose a tax - 20% has been mentioned - on imports. The revenue collected would offset tax revenue lost by cutting corporate and individual income tax rates. However, it would also make imports more expensive for American consumers. Think of the consequences for retailers such as Wal-Mart and Best Buy. Their cost of goods would rise significantly and they would have no choice but to pass the additional costs on to consumers in the form of higher prices. The impact on the economy could be devastating. Lawmakers, including House Speaker Paul Ryan, who propose the border tax understand this and they have an answer. They argue that the dollar will rise as a result of the border tax and that will offset the cost of the tax by making imports cheaper in U.S. dollar terms. Speaker Ryan in February said the dollar's rise after a border tax is "obvious and mathematical." JP Morgan Chase says that is all straight forward in theory, but in the real world, it's anything but. Adopting a border tax could trigger tensions with trading partners, or outright retaliation.

The dollar would have to rise by 25% to fully offset the additional cost from a 20% border tax. On Wall Street, traders who make a living dealing in the $5.1 trillion-a-day currency market say that argument is preposterous. The politicians would be hard pressed to find anyone who deals in the real world of currency markets who believes the dollar would appreciate by 25% after the imposition of a 20% border tax. Speaker Ryan and his border tax supporters do not appreciate how unpredictable the vast, foreign exchange market can be, especially when politicians meddle in trade basics, and trillions of dollars change hands in response.

David Woo, head of global rates at Bank of America said: "The foreign exchange market is the most difficult thing to forecast, and to build an inter-generational tax reform based on the assumption of what the foreign exchange market will do is a laughable notion."

When you move from the broad foreign exchange market to trade with specific countries, the situation becomes even more complex and unpredictable. Consider our trade with China, the world's second largest economy. For years, we have been accusing China of currency manipulation, keeping the yuan low to make Chinese goods cheaper. A border tax of 20% would reverse that thinking. All of a sudden we would be hoping the Chinese currency would fall by 25% so the dollar could appreciate and offset the border tax. That is ridiculous on its face. In addition, what makes any politician think that the Chinese would go along with a major decline in their currency? That certainly would not be in their best interests. The better bet is that the Chinese would take steps to prevent their currency from falling 25%. In fact, in recent months the Chinese have been dealing with capital outflows that put downward pressure on the yuan. They have been successful in keeping the yuan stable. The last thing the Chinese want is more downward pressure on their currency.

There are always two sides to a currency transaction. For the dollar to go up 25% means other currencies have to go down by a similar amount. What makes Speaker Ryan and his supporters think that our trading partners would go along with that? More than likely, most would oppose such a dramatic change in world exchange rates. The bottom line is that a U.S. border tax is a really bad idea. It could rattle U.S. and world stock and bond markets. The good news is that a border tax would be relatively easy to repeal. Speaker Ryan, like Chairman Volker in the 1980s, could be forced to run backwards quickly.

Meanwhile there is very good economic news from China, the world's second largest economy.

In the first quarter of 2017 the Chinese economy grew at a 6.9% annual rate, better than the government's 6.5% target rate and better than what most economists were expecting. Critics warn that there still are risks, especially in the overheated real estate sector. Real estate investment grew at a 9.1% rate in the opening quarter. Chinese home buyers are well known for paying cash and otherwise making large deposits and taking small mortgages. This is very different from the no money down housing boom in the

U.S. that preceded the 2008-2009 financial crisis. In addition, more than two dozen Chinese cities have imposed property cooling measures in recent weeks. Most analysts agree that the cumulative weight of property curbs will eventually slow down activity and not result in an outright real estate crash.

Chinese consumers were quite active in the first quarter. Retail sales rose 10.9% and disposable income was up 7.0%. Domestic consumption is a fast-growing part of the Chinese economy. That is very good news both for the long term in China and for China's trading partners.

I will have the next market review and update for you one week from today on Wednesday, May 3, 2017.

All the best,

John Dessauer