# John Dessauer Investments, Inc.

**John Dessauer's market review and update as of Wednesday July 12, 2017**

There has been some very good news. Most U.S. banks passed their recent stress tests with flying colors. It has taken a long time - more than eight years - but U.S, banks have repaired their balance sheets and survived new and difficult regulations. As a result, banks can now increase dividend payments and buy back shares. Warren Buffet's Berkshire Hathaway is increasing its holdings of common stock in Bank of America. This is good news not only for bank shareholders but for the economy as a whole.

Higher short term interest rates make lending more profitable for banks. They can charge more on loans. But until recently, banks have been reluctant lenders for several reasons, including apprehension over new regulations and their ability to pass the ongoing stress tests. Regulatory pressure should subside now that regulators, especially the Federal Reserve, have judged the banks strong enough to buy back shares and increase dividends. Businesses will likely find more banks willing to lend in the coming months.

Argus Research headlined its recent issue of *Argus Update* this way: "Momentum Shifting from Consumer Economy to Industrial Economy."

Last week I explained why raising interest rates has slowed consumer spending. Consumers are simply reacting sensibly to improved income from savings, and higher cost loans to buy cars and other durable goods. Consumers have been the primary driver of economic growth for the last five or more years. Near zero interest rates were an incentive to spend rather than save. Now that interest rates are rising, saving becomes

more attractive and spending becomes less attractive. We are in a period of adjustment. Fortunately, businesses now have the means to fill the gap and keep economic growth alive. The number one complaint among businesses, especially small businesses, has been banks' reluctance to lend. Without financing, businesses were not able to expand even when the opportunities were clear. I don't want to be overly optimistic, but it seems likely that more businesses will now be able to find banks willing to lend to finance expansion plans. That won't boost growth to 3%-5%, but will sustain growth at current rates of 1.5%-2%.

What the economy desperately needs is tax reform and infrastructure spending. The latter is a work in progress, but still months away from a solid spending plan. And tax reform is getting bogged down in the political swamp. I have heard Republicans say that they can't repeal the Obama tax on dividends, interest and capital gains and at the same time cut health care subsidies for the poor. The Obama tax is a bad tax. Teddy Kennedy did something similar in the 1970s when he championed a tax on "unearned" income. During the process of adding the 3.8% tax on dividends, interest and capital gains, then-President Obama used Teddy Kennedy's "unearned" income phrase. The 1970s tax was a total failure. It did not increase tax collection. But it did discourage capital gains, savings and investment. Instead of linking the Obama tax to health care subsidies, Republicans should take a close look at tax collections. I am sure they would find that the Obama tax, like the 1970s tax, did not increase revenue. In other words, the tax did not pay for health insurance subsidies for the poor. This is just one example of the mistakes being made by Republicans in the House and Senate.

There is another even more difficult issue facing the House and Senate, namely the enormous national debt. The national debt doubled during President Obama's two terms. As a result, there is tremendous pressure to make every new piece of legislation, especially tax reform, revenue neutral. Republicans do not want to do anything that might look like an addition to the federal deficit. President Reagan and President Bush (#2) cut tax rates and revenues collected increased because the economy strengthened and growth improved. However, that does not mean that every tax cut would have the same positive result. Cutting taxes is a risk. Get it right and tax collections increase. Get it wrong and you would be accused of adding to the federal deficit.

Rising short term interest rates makes the situation more difficult for tax cutters. It is going to cost more to finance the national debt than it did before the Federal Reserve started raising interest rates. Without an offset, the federal deficit will get worse. The Congressional Budget Office - or CBO - calculates the expected consequences of legislation including tax cuts. The trouble is that the CBO has no way of including likely changes in consumer and business behavior. That is why every tax cut is scored as reducing future tax collections. The CBO's calculations were wrong during President Reagan's terms. Arthur Laffer - an economist and advisor to President Reagan - explained why the CBO got it wrong. However, having been right has not saved him from severe criticism from the tax and spend crowd. They still believe that every tax cut "costs" the government money.

In the Morgan Stanley monthly bulletin *"On the Markets"* there is an article titled: "*10 Reasons to Doubt Legislative Optimism on Tax Reform."* The budget and requirements that any tax cut be revenue neutral dominate their list. While there is

widespread agreement that the economy would benefit from tax reform, the accumulated political baggage from the last eight years is making the task extremely difficult. Tax reform is not likely this year. If passed in 2018 it would be several months before any benefits appeared in the economy.

Therefore, odds are that the economy will keep growing at a slow, 2% or so, annual rate this year and into the early part of 2018.

In this slow growth, low inflation environment, stocks remain attractive.

I will have the next market review and update for you one week from today on Wednesday, July 19, 2017.

All the best,

John Dessauer

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