THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

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TPWC Market and Economic Update

The Markets

The S&P 500 Index ended the week at 2.351.16, up 1.51% from last week and 5.02% year-to-date. That puts the Index up a whopping 29% from its low last February, and up over 22% from this date last year. It has even managed to cross the 10% gain point from May of 2015! Gold and Treasury bonds were little changed, with both down significantly from last summer's high.

Since relatively few of our readers (if any) are trading gold futures or, for that matter, buying and selling Treasury bonds, a valid question would be, "Why do you include gold and Treasuries in your markets report?" The answer is that equities, or as they are also known, stocks, are a measure of what investors collectively believe the future will hold. If the stock market is generally rising, then people with money to invest are seeing a better economic future. If, on the other hand, Treasuries and gold are rising, then that is a measure of investors believing that the future may not be so good.

We don't go for trying to forecast where the stock market, bonds, or gold will be in the near future. That is because we have seen so many try and so many fail. To the best of our knowledge no one has been able to make accurate short-term forecasts of such things. That does not stop people from proclaiming loudly that some investment category is about to either soar to the heavens or crash to unimaginable lows. The only consistent thing we have been able to glean from all those forecasts is that if one forecasts a large move in the price of some market long enough, it will happen. Rather like a stopped clock, they are not always wrong, just most of the time.

The Economy

<u>Leading Economic Indicators</u>

Armageddon appears to have been once again pushed down the road a bit. One of the most reliable sources of data about the future, the Conference Board's Index of Leading Economic Indicators (LEI) released today was up 0.6% in January to 125. That followed a rise of 0.5% in December and 0.2% in November. Over the last century, three months of rising LEI has forecast good economic times ahead for at least the next six months.

<u>Taxes</u>

The Trump administration has been promising a large-scale change in the tax code, and a lot of discussion has been circulating in Congress on that subject. At least a part of the impressive rise in stock values since the election may have been from the promise of a corporate maximum tax rate cut from the current effective maximum rate of nearly 40% to a new 20% maximum.

The Treasury Department just published its <u>General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals</u>. The <u>Explanations</u> list the changes that the current presidential administration proposes to the tax code each year. The document is 272 pages long, but nowhere in it could we find a reduction in corporate income taxes mentioned. It does call for a much higher "death tax" and a lower estate tax exclusion, an increase in capital gains taxes from the current nominal 20% to 28%, a new tax on health premiums, and a host of other tax increases. It calls for a 19% minimum tax on all corporate overseas earnings and imposes a 14% tax on returning profits to the United States that have been held elsewhere, but says nothing about reducing the U.S. corporate income tax rate. It does, by the way, call for a $19 per barrel federal tax on all domestic and imported oil and higher gasoline taxes to pay for proposed infrastructure improvements. In other words, the promised trillion-dollar infrastructure plan is proposed to be at least partially paid for by about a 25% additional tax on petroleum products.

First, it is a good idea to understand that when a presidential administration submits tax proposals they rarely, if ever, become law, so there is no need to panic about an increase in the capital gains rate or a heavy-handed death tax. The point we want to make here is that we keep reading reports that business leaders are optimistic because of promised reductions in regulatory burdens and a reduced corporate tax rate. The reduced regulatory burden has yet to appear, but the <u>General Explanations</u> document suggests that the tax-reduction may be in trouble. We must admit that we are trying to find the connection between a campaign promise to abolish the "death tax" and a request to Congress to raise said tax, but that is the nature of politics.

Yes, the idea of reducing the corporate maximum income tax rate to something between 20% and 24% is a good idea. Why? Because that is about the average rate in other developed economies. Our federal corporate income tax rate is one of the three highest in the world. That high rate creates a huge incentive to relocate business, and jobs, elsewhere. Think about what you would do if you owned a business making widgets and could manufacture those widgets in one place where you would be charged 40% of any profit you made in taxes, versus another place where the tax rate would only be 15%. All other things being equal, I strongly suspect the 15% locale would be very appealing.

There is a problem with lowering our corporate tax rate to a level that would not drive businesses away from the U.S. It is that it would amount to a reduction in estimated federal tax revenue in 2017 alone, of about *180 billion dollars!* In order to clear the requirements of the *Balanced Budget Act* a proposal has to be at least revenue neutral after ten years. Unfortunately, the ten year projection for the reduction calls for a federal revenue loss of about *two-trillion dollars*. That loss is *after* accounting for the tax revenue on the money corporations are holding overseas because of our higher tax rate.

The Better Way plan circulating in the House of Representatives has a solution to that problem. The House plan calls for a 20% Border Adjustment Tax (BAT). In that plan, corporations importing goods from outside the U.S. would not be able to deduct the cost of those imports from their profits, while export profits would be tax exempt. The BAT then becomes an effective 20% tax on imports. As our annual imports are running about $500 billion more than exports, a 20% BAT yields new federal tax revenues of about $200 billion dollars. Simple solution, yes?

Here is the rub. If the price of imported goods goes up 20% to pay for the corporate tax cut, who pays the extra 20%? In the end most of what we buy in America would see a price increase. How much price increase would we have pay to cover the $200 billion border tax? Again, some quick arithmetic suggests that each person in America would need to pay about $275 per year in higher costs. For a family of four that would only amount about $180 per month. Since those purchases are not tax-free, that means that our hypothetical four-person family would need to see their wages go up about $250 per month to stay at the same standard of living. For higher income Americans, that would not be at all significant, but like the 25% increase in fuel tax to pay for highways and bridges, there is no such thing as a free lunch.

To be fair, the proponents of the Better Way plan theorize that the dollar would rise about 25% against all the other currencies of the world, which would then offset the increased tax with cheaper imports. In our opinion, there are some problems with that assumption. First, international currency exchange rates are not that simple. Second, if the dollar went up 25% against, for example, the Euro and the Chinese Yuan, our exports would collapse, and they make up about 12% of our economy.

Why is all this important to you? First, we think this economic expansion is real and corporate earnings will improve this year; barring something horrible coming out of Washington. But, at least some of the run-up in this current market is based on rhetoric and the hope of regulatory and tax relief for corporations. What we are not seeing is a path forward for the tax reduction. At some point if someone does not pull a rabbit out of a hat some of this euphemism may fade when it sees the light of fiscal reality. When the dust settles, the strength of the current economic expansion should survive some disappointment and go on ahead on fundamentals. Meanwhile, patience may be needed.

Again, we are optimistic for the long-term prospects of the market, but in the short-term we may see some serious bumps.

Until next week, we remain your faithful servants,

Jeffrey W. McClure CFP®
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