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The Butterfly Effect

Potentially disruptive border taxes on the table; Be careful of the non-linear feedback loop

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President Trump's inaugural speech has set the tone for a new era. His "America First" doctrine, indictment of the establishment, protectionist rhetoric, and the promise to stop the "American carnage" were music to his ardent supporters' ears. They had voted for a disruptive figure to "drain the swamp," and the new President was anything but conciliatory. To the so-called elites and much of the rest of the world, it was a warning shot of my way or the highway. Yet a new sense of optimism seemed to be taking hold in the U.S., as the University of Michigan Consumer Sentiment Index hit a 13-year high. While that optimism drove equities and base metal prices higher, the currency market showed some hesitation. The U.S. Dollar Index has given up 70% of the post-election gains, which led to a bounce in precious metals. Crude oil prices traded in a narrow range, but their significant year-on-year increases have raised inflation expectation. As a result, bond yields across much of the world moved up, with German long bunds being hit especially hard. China raised its medium-term lending facility rates; it was the first time in six years that the country hiked one if its benchmark lending rates. Chinese President Xi Jinping also attended the World Economic Forum in Davos for the first time and gave a keynote speech in defense of globalization, free trade, and urged all signatories to the Paris Agreement on climate change not to renege on the pledge. Isn't there an irony with the U.S. potentially ceding the high ground on these issues? To quote the newly minted Nobel laureate in Literature, "the times they are a changin'."

Equity Markets Indices[1]	12/31/2016 Price	1/31/2017 Price	MTD Change	YTD Change
MSCI All Country World	422	433	2.7%	2.7%
S&P 500	2239	2279	1.8%	1.8%
MSCI EAFE	1684	1732	2.9%	2.9%
Russell 2000®[2]	1357	1362	0.3%	0.3%
NASDAQ	5383	5615	4.3%	4.3%
TOPIX	1519	1522	0.2%	0.2%
KOSPI	2026	2068	2.0%	2.0%
Emerging Markets	862	909	5.4%	5.4%
Fixed Income				
2-Year US Treasury Note	1.19%	1.21%	2	2
10-Year US Treasury Note	2.45%	2.45%	1	1
BarCap US Agg Corp Sprd	1.23%	1.21%	-2	-2
BarCap US Corp HY Sprd	4.09%	3.88%	-21	-21
Currencies				
Australian (AUD/$)	1.39	1.32	5.2%	5.2%
Brazil Real (Real/$)	3.26	3.15	3.3%	3.3%
British Pound ($/GBP)	1.23	1.26	1.9%	1.9%
Euro ($/Euro)	1.05	1.08	2.7%	2.7%
Japanese Yen (Yen/$)	117	113	3.7%	3.7%
Korean Won (KRW/$)	1206	1161	4.9%	4.9%
US Dollar Index (DXY)	102.21	99.51	-2.6%	-2.6%
Commodities				
Gold	1152	1211	5.1%	5.1%
Oil	53.7	52.8	-1.7%	-1.7%
Natural Gas, Henry Hub	3.68	3.00	-18.4%	-18.4%
Copper (cents/lb)	251	273	8.9%	8.9%
CRB Index	193	192	-0.2%	-0.2%
Baltic Dry Index	961	800	-16.8%	-16.8%

SOURCE: BLOOMBERG

Chaos Rules

One winter day in 1961, Professor Edward Norton Lorenz was at his MIT lab running a program simulating weather patterns on a vacuum tube computer. The mathematical model was based on twelve variables such as temperature and wind speed. Dr. Lorenz decided to re-run an earlier simulation, but he rounded off one variable from the original entry of 0.506127 to 0.506. To his surprise, the tiny 0.025% difference in one input resulted in a vastly different outcome. This observation led to the realization that a small change in nature can have large consequences. The theoretical study was later published in his 1963 paper *Determinsitic Non-periodic Flow*. The paper was initially buried in obscurity, but over time it was recognized as the seminal work that gave birth to the chaos theory.

> The swishing of the President's pen on paper to sign protectionist measures into law or executive orders could unwittingly cause a financial storm.

In explaining this concept to laymen, Dr. Lorenz initially used the analogy that one flap of a seagull's wings could alter the course of weather forever. He later used the butterfly as a more poetic analogy. In 1972, a colleague suggested the title "Does the flap of a butterfly's wings in Brazil set off a tornado in Texas?" for Dr. Lorenz's speech at a conference. Over time, the *Butterfly Effect* became widely used in popular culture.

The chaos theory in essence states that, as the measurement period lengthens, what appears to be deterministic non-linear systems would evolve into unpredictable outcomes. Complex systems in the real world with inherent imprecision -- the weather, traffic, the economy, and elections -- are destined to be unpredictable rather than deterministic.

Border Adjusted Tax

The high hope for tax reform was probably one of the biggest drivers of the post-U.S. election rally. The U.S. has one of the highest statutory corporate tax rates at 35%. President Trump campaigned on the promise of a 15% corporate tax rate, and House Speaker Paul Ryan has proposed a 20% corporate tax rate. For a company taxed at 35%, a reduction in tax rate to 20%, *ceteris paribus*, would mean a 23% increase in net profits. It's no wonder U.S. small cap stocks have rallied the most since the election, as many of them are domestically focused and have been paying fairly high effective tax rates. However, the key phrase in this simple analysis is *ceteris paribus*, and that is an unrealistic assumption with the Congress trying to make the tax reform revenue neutral. A revenue-neutral scheme means that, while some companies would be paying less tax, the difference would be made up by others with various deductions and loopholes eliminated.

As mentioned in our recent *Global Foresight* publication, a key piece of the House's "A Better Way" tax plan is the proposed border adjusted tax. This provision would make import costs non-tax-deductible and export revenues tax-exempt. It is expected to raise more than $1 trillion of revenue over the 10-year projection horizon to help fund the reduction in corporate tax rate from 35% to 20%. The proposed border adjusted tax would disproportionally penalize U.S. retailers and oil refiners as imports account for a large part of their costs of goods sold. On the other hand, American exporters of industrial and agricultural products would receive significant tax benefits.

With 98% of clothes sold in the U.S. being imported, the National Retail Federation has warned that the border adjusted tax provision will push some retailers into bankruptcy as their tax bills would be three to five times their current pre-tax profits. Koch Industries, a conglomerate run by big-league Republican donors, cautioned that the tax plan would distort the market and create "devastating" consequences for the economy and American consumers. The move could also turn out to be highly inflationary as importers will likely raise prices to offset the potential hit to their earnings. Over time, they may move some production back home, as intended by the policymakers, but that would also result in higher prices due to higher domestic production costs. Lastly, to free market purists, this could be viewed as yet another instance of the government picking winners and losers.

Defenders of the border adjusted tax argued that these criticisms are based on static thinking. They believe that the tax provision, once enacted, would cause the U.S. dollar to appreciate sharply, as foreign exchange markets would start to anticipate smaller U.S. trade deficits and a stronger U.S. economy. A stronger U.S. dollar would make foreign goods cheaper in U.S. dollar terms, ceteris paribus, thereby offsetting the potential impact of the border adjusted tax. For instance, at a 20% corporate tax rate, the tax penalty on imports would be neutralized with a 25% appreciation in the U.S. dollar.

Such an argument may sound good in theory, but the foreign exchange market is likely too volatile to be a reliable offset against the border adjusted tax. Empirical data has not shown trade balances as a consistent driver of exchange rates, not to mention the issue with pegged or semi-pegged currency regimes. Furthermore, if the expected U.S. dollar appreciation would indeed neutralize the impact of the border adjusted tax, why bother with this controversial and potentially disruptive provision in the first place?

Seed of the Next Financial Crisis?

President Trump has criticized the border adjusted tax provision as “too complicated,” and complained that the U.S. dollar was already “too strong” and “killing us.” The President prefers a 15% corporate tax rate and border taxes on imports (e.g., 35% tariffs on cars imported from Mexico; 45% tariffs on imports from China).

While something needs to be done to help American workers displaced by the forces of globalization, protectionism is not costless and may not be the optimal solution. Tariffs are usually passed on to consumers in the form of price hikes. Ironically, the elites that the President railed against are unlikely to be pinched by price hikes in French wines, Russian caviar, and European luxury goods. However, the forgotten families cited by the President, living paycheck-to-paycheck, will likely be hard hit by rising prices in clothing, gasoline, and consumer electronics, as consumption accounts for a larger share of their income. Protectionist policies also tend to force companies to make potentially uneconomic decisions which could hurt their competitiveness. U.S. exports could also face tit-for-tat measures from our trading partners. China has recently upped anti-dumping and anti-subsidy tariffs on U.S. corn products used as animal feed, a move seemingly aimed at strengthening their trade negotiation stance.

The border adjusted tax and tariffs also have the potential to trigger a global financial crisis. As the world’s de facto reserve currency, the liquidity of the U.S. dollar plays a significant role in the global economy. Declining U.S. imports would reduce the supply of U.S. dollars to the rest of the world, which would likely drive up the value of the currency. As a reaction, capital would likely flow out of emerging markets on the concerns of these countries’ weaker growth outlook and impaired ability to service their U.S. dollar denominated debts. An accelerated pace of Fed rate hikes in reaction to higher inflation would further tighten financial conditions. A vicious cycle could then feed on itself to create a financial crisis. In short, the swishing of the President’s pen on paper to sign protectionist measures into law or executive orders could unwittingly create a financial storm in foreign lands. In time, that storm would swirl onto our shores whether there is a wall or not. “America First” policies could change trade dynamics, but they will not be able to shield the U.S. from major global issues in an interconnected world.

So far, investors seemed to have shrugged off the risk of protectionism. President Trump’s persistent threats of tariffs are viewed as a negotiation tactic. Optimists believe that ultimately President Trump, as a savvy dealmaker, will be sensible enough to avoid a trade war with significant trading partners like China. Markets also do not seem to expect the proposed border adjusted tax to get enough support in the Senate. However, policy uncertainties over trade, tax code, Obamacare replacement, and even immigration issues could start to weigh on business sentiment and decision making. Judging by the controversies in just the first ten days of the Trump presidency, one should not underestimate the odds of negative market moving events.●

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