# The Weekly Letter

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GWIM Chief Investment Office

GWIM Investment Strategy Committee

→ **Will the BAT fly?:** A Republican proposal to tax imports and subsidize exports as part of a broader overhaul of U.S. corporate income taxes has left corporate America intensely divided. The measure is seen as potentially hurting companies and consumers that buy a lot of imports while benefiting export-oriented companies and their workers. Its fate is unclear as it could be dropped from the tax reform proposal.

→ **Markets in Review:** Equities rose last week, with the S&P 500 adding 0.8% and international equities, as represented by the MSCI EAFE Index, remaining flat. Bond prices gained, with the 10-year Treasury yield at 2.39%, down from 2.41% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, added 1.0% as WTI crude rose 5.5% to $50.60, while gold appreciated by 0.5% to $1,249.40 per ounce.

→ **Looking Ahead:** Investors look forward to minutes of a Federal Open Market Committee meeting for further insight regarding monetary accommodation. Markets have interpreted the March rate hike as a "dovish hike." In addition, employment data is expected to remain strong. In the Eurozone, Markit is set to report its final March Composite Purchasing Managers Index (PMI). (See page 3.).

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# Will the BAT fly?

In the wake of their failure to overhaul Obamacare, Republicans have turned their attention to tax reform, including at least one component that's left corporate America intensely divided, the "border-adjustment tax" (BAT). We're addressing this controversial component of the leading tax reform proposal since we believe that in whatever form it may crystallize, if it does at all, it has the potential to impact many aspects of the U.S. economy. They include its competitiveness, productivity and consumer purchasing power, as well as corporate earnings and equity valuations. It could also redefine relationships between the U.S. and its global trading partners and lead to new configurations of global supply chains.

The BAT exempts exports from corporate taxes while taxing imports. It puts an end to corporations deducting the cost of imports for tax purposes, while allowing them to exclude export revenues.

The Republicans' broader tax reform blueprint also calls for a reduction in the U.S. marginal corporate tax rate from 35%, the highest among countries in the Organization for Economic Co-operation and Development (OECD), to 20%. At that rate, the border-adjustment provision would impose a 20% duty on imports and create a 20% tax subsidy for exports.

## Selling points

Supporters of the BAT say it would create a favorable and competitive tax framework for American companies. It would introduce reciprocity to the U.S. tax system. Among the 34 OECD member countries, the U.S. is one of only seven without a border adjustment tax, and the only one with no value-added tax (VAT).

Another incentive for implementing border tax adjustments is the expectation that increased tax receipts would help pay for the cost of a corporate tax cut. The lower corporate tax rate would not only encourage U.S. firms to favor domestic operations, but also attract foreign investment. That new foreign capital could lead to increased productivity, wages and standards of living in America.

## The dollar effect

In theory, the U.S. dollar exchange rate should adjust immediately to offset the full extent of the BAT. A tax on imports would lead to fewer U.S. purchases from abroad, reducing the supply of dollars to foreigners. Meanwhile, an export subsidy would raise demand for U.S. dollars as foreigners would need the American currency to purchase more U.S. goods. By some estimates, a 20% tax on imports and a 20% export subsidy could cause the dollar to appreciate by as much as 25%, making imports cheaper and exports more expensive, offsetting any impact of the tax on the overall trade balance.[1]

A much stronger U.S. dollar would have several unintended adverse consequences. It would make U.S. households poorer by lowering the value of the $20 trillion in foreign assets they hold. It would reduce the value of U.S. corporations' profits earned abroad, currently $400 billion. It would threaten stability in emerging markets countries that hold a large amount of dollar-denominated debt. Also, given the import-dependent U.S. oil market, the price of crude would surge, leaving consumers to pick up the tab.[2]

The practical implications of a border tax, however, remain unseen, and many analysts question the premise of a full adjustment to the exchange rate. For example, BofA Merrill Lynch (BofAML) Global Research does not expect the dollar to appreciate as much as politicians and academics predict, due to the reasons cited above and because trading in currency markets dwarfs real economic activity.[3] But if the amount of dollar appreciation does not come as expected or if it is not immediate, companies could pass the costs of higher import prices on to consumers, causing a disproportionate strain on the lower class.

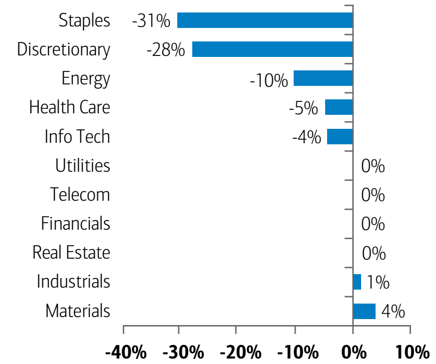
## Winners and losers

If dollar appreciation does not fully offset the subsidy on exports or tax on imports, many companies may have to reconsider their global supply chains and business strategies.

BofAML Global Research believes that the border adjustment tax would hurt companies and consumers that buy a lot of imports and benefit export-oriented companies and their workers.[4] Think U.S. auto manufacturers that rely heavily on vehicles imported from Mexico or parts procured from China for U.S. assembly. Retailers, from department stores to apparel companies, also would be severely affected; in an industry where disruptive players have already driven down prices, further margin compression or higher prices for consumers may be in store.

On the other hand, a border-adjustable tax system would be a boon to U.S.-based global exporters whose manufacturing operations have a large value-add component. These global exporters have arguably the most to gain from a border-adjusted tax. Multinationals with intellectual property (IP)-intensive business models stand to benefit the most, specifically those in software, media, pharmaceuticals and biotech along with IP-intensive industrial firms. Net exporters in agriculture, energy, chemicals and materials are also potential winners.

**Exhibit 1: Sector EPS impact from border adjustment tax (20% rate)**




Source: BofAML Global Research, "Death and tax reform," January 29, 2017.

There are some intra-industry divisions on the tax reform measure. While some U.S. oil producers stand to benefit from the border tax and a higher U.S. dollar, just the opposite could be true for refiners that rely heavily on imported crude. Retail gasoline sellers have come out against the proposal.

## Momentum is waning

Although tax reform is one of the top agenda items for the new administration, support for the border-adjustment tax has recently lost momentum. Senate Republicans and some of President Donald Trump's advisory team have voiced concerns over the concept. Deficit hawks may have trouble getting behind the overall business tax plan, which is projected to reduce federal revenue by more than $1.2 trillion in the first 10 years.[5] Other opponents of the levy claim it is essentially a tax on consumers being used to fund tax breaks for corporations.

What's more, the border adjustments may be incompatible with World Trade Organization (WTO) rules. While the WTO allows border adjustments for value-added-tax regimes, the Republican blueprint may be viewed as an income-based tax system.

BofAML Global Research believes that a 5% VAT would be WTO-compliant, revenue-neutral, and less disruptive than a BAT, providing all the benefits of a BAT and none of its drawbacks[6].

Whether Trump sticks with a tariff-based approach or adopts the border-adjusted tax is up for debate. BofAML Global Research believes that after the stalled healthcare reform, tax reform has become the government's policy priority with a higher probability of being accomplished this year, but a lot of uncertainty remaining over the final form. What's certain is that tax reform and "fair" trade proposals will continue to prompt debate in the investment community. Stay tuned.

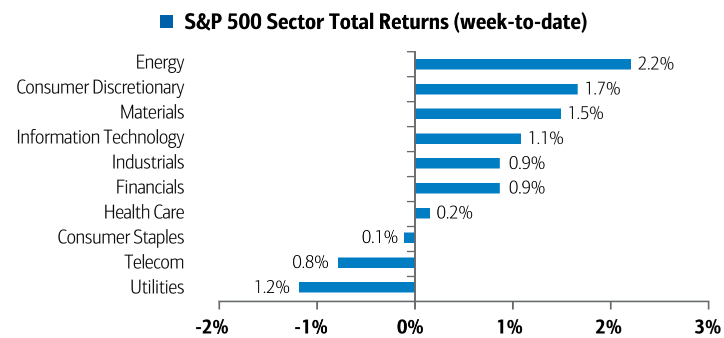
[1] Martin Feldstein for Project Syndicate, "The Shape of U.S. Tax Reform," January 30, 2017.
[2] *Financial Times*, "Why a U.S. border adjustment tax would matter for the oil price," January 31, 2017.
[3] BofAML Global Research, "Cause and Effect: New lease on life for Trump trades," March 28, 2017.
[4] BofAML Global Research, "Ethanomics: Legislative logjam," March 14, 2017.
[5] Peterson Institute for International Economics, "Lessons for U.S. Business Tax Reform from International Tax Rates," January 2017.
[6] BofAML Global Research, "Cause and Effect: New lease on life for Trump trades," March 28, 2017.

# Markets in Review

## Trailing Economic Releases

- The Bureau of Economic Analysis revised growth in U.S. gross domestic product for the fourth quarter of 2016 to 2.1% quarter-over-quarter, surprising to the upside and exceeding BofAML Global Research's expectation of 2.0%. The growth was 0.2% above the third-quarter's, driven largely by stronger consumption growth concentrated within services.
- The University of Michigan reported consumer sentiment for March at a level of 96.9, just trailing the BofAML Global Research projection of 97.0 and down from a February level of 97.6. Consumer confidence remains very high, bolstered by improving wage growth.
- Eurostat reported a rise in its advance Core Consumer Price Index (CPI) for March of 0.7% year-over-year, in line with BofAML Global Research expectations. This represents a slight downtick from February's gain of 0.9%.

## S&P 500 Sector Returns (as of last Friday's market close)




## Equities

| | | Total Return in USD (%) | | |
|---|---|---|---|---|
| | Level | WTD | MTD | YTD |
| DJIA | 20,663.2 | 0.3 | -0.6 | 5.2 |
| NASDAQ | 5,911.7 | 1.4 | 1.6 | 10.1 |
| S&P 500 | 2,362.7 | 0.8 | 0.1 | 6.1 |
| S&P 400 Mid Cap | 1,719.7 | 1.5 | -0.4 | 3.9 |
| Russell 2000 | 1,385.9 | 2.4 | 0.1 | 2.5 |
| MSCI World | 1,853.7 | 0.5 | 1.1 | 6.4 |
| MSCI EAFE | 1,793.0 | 0.0 | 2.8 | 7.2 |
| MSCI Emerging Mkts | 958.4 | -1.1 | 2.5 | 11.4 |

## Fixed Income

| | | Total Return in USD (%) | | |
|---|---|---|---|---|
| | Yield (%) | WTD | MTD | YTD |
| ML US Broad Market | 2.57 | 0.1 | 0.0 | 0.9 |
| ML 10-Year US Treasury | 2.39 | 0.1 | 0.0 | 0.9 |
| ML US Muni Master | 2.48 | 0.2 | 0.2 | 1.4 |
| ML US IG Corp Master | 3.35 | 0.1 | -0.1 | 1.4 |
| ML US HY Corp Master | 5.90 | 0.9 | -0.2 | 2.7 |

## Commodities & Currencies

| | | Total Return in USD (%) | | |
|---|---|---|---|---|
| | Level | WTD | MTD | YTD |
| Bloomberg Commodity | 172.8 | 1.0 | -2.7 | -2.3 |
| WTI Crude $/Barrel[1] | 50.6 | 5.5 | -6.3 | -5.8 |
| Gold Spot $/Ounce[1] | 1,249.4 | 0.5 | 0.1 | 8.4 |

| Level | Current | Prior Week End | Prior Month End | 2016 Year End |
|---|---|---|---|---|
| EUR/USD | 1.07 | 1.08 | 1.05 | 1.05 |
| USD/JPY | 111.39 | 111.34 | 116.96 | 116.96 |

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
**Past performance is no guarantee of future results.**

# Looking Ahead

## Upcoming Economic Releases

- On Wednesday the Federal Reserve releases its Open Market Committee minutes. The market will be looking for signs that Fed members may skew more hawkish or dovish than believed after their March rate hike. Since the hike, Treasury yields have moved lower along with the dollar as expectations for a quicker pace of tightening have been reduced.
- On Friday, the Bureau of Labor Statistics will report the seasonally adjusted March change in U.S. nonfarm payrolls. BofAML Global Research expects job growth of 200,000, while the consensus is a bit lower at 174,000. Both estimates are below February's gain of 235,000. Job growth has remained strong and incoming March data indicates another solid month for the labor market.
- On Friday in the Eurozone, Markit will release its final Eurozone Composite Purchasing Manager's Index (PMI) for March. BofAML Global Research projects a reading of 56.7, a multi-year high, as manufacturing has recently picked up within the region.

## BofA Merrill Lynch Global Research Key Year-End Forecasts

| S&P 500 Outlook | 2017 E |
|---|---|
| Target | 2,450 |
| EPS | $129.00 |
| **Real Gross Domestic Product** | **2017 E** |
| Global | 3.5% |
| U.S. | 2.1% |
| Euro Area | 1.5% |
| Emerging Markets | 4.6% |
| **U.S. Interest Rates** | **2017 E** |
| Fed Funds (eop) | 1.38% |
| 10-Year T-Note (eop) | 2.85% |
| **Commodities** | **2017 E** |
| Gold ($/oz-period average) | $1,286 |
| WTI Crude Oil ($/bbl-eop) | $59.00 |

All data as of last Friday's close.

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