HOT TOPIC – Mature economies

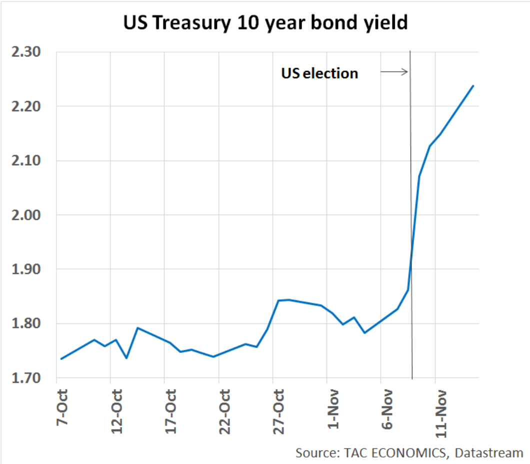
November 15, 2016

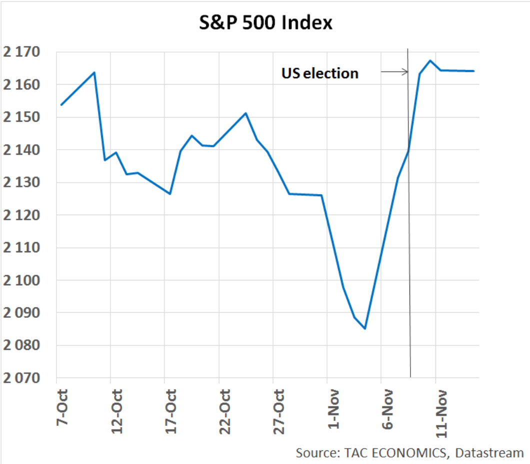
From "*What If ?*" to "*Then What ?*"

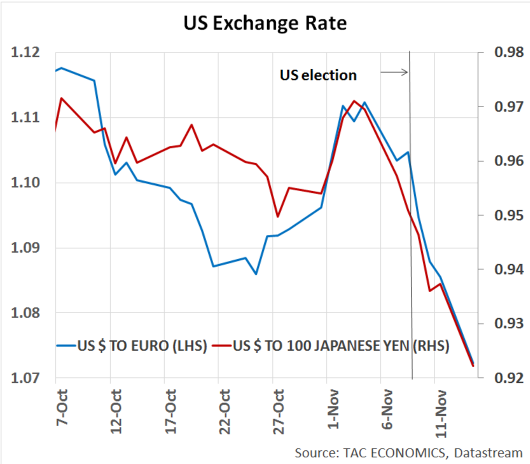
First insight into the Trump's presidency

Once again after the case of Brexit, our models signaled a plausible "unexpected" outcome of a major electoral consultation. In our previous Hot Topic[1] (published on November 4), we highlighted the likelihood of the event, the quasi-certainty of major compromises between promises and policies under a Trump's presidency, and a bottom-line on "reasonable" economic outcome accompanied by a strong re-appreciation of inflation risks.

Now that we shift from an analysis of "*what if*" to one on "*then what*", such initial findings remain fully valid, and, at least for inflation, quite in line with the very substantial deterioration in US bond markets since the election, while both the USD and equity markets performed much better.







1 Available at http://www.taceconomics.com/publ/uselections.pdf

Expected shift in policy mix with further risks on bond markets

When reviewing the US economic outlook even before the election, we insisted on the likely upward pressures on wages resulting from increasingly tight labor market conditions. We also indicated that both candidates were supporting increases in minimum wages (by the way, 5 different state ballots were conducted on changes in state-level minimum wage, and all were in favor of increase). Even before any policy shift, price pressures were expected to build-up, with a transmission to both monetary policy and bond yields.

The election of Donald Trump is going to push this movement forward more forcefully, with larger fiscal deficits, further upward pressures on wages as a result of the expected anti-migration policy, and higher tariffs on imported goods. Even a more realistic "compromise" scenario including massive adjustments to Trump's electoral promises[2], and closer to what he described as his first 100 days in office[3], clearly go in these four different directions, all paving the way for faster price increases in the US. In parallel, his critics against a presumed Fed's inactivity and lag in terms of monetary policy, and even more importantly the message from the bond markets, are going to push for higher or more frequent rise in Fed Fund rates over the near future.

The post-election reading of the next cyclical steps for the US should therefore focus on the short-term relationship between inflationary pressures and interest rate movements, growth acceleration from increasing income, infrastructure spending and tax cuts, and the overall result on broad financial markets as well as domestic confidence.

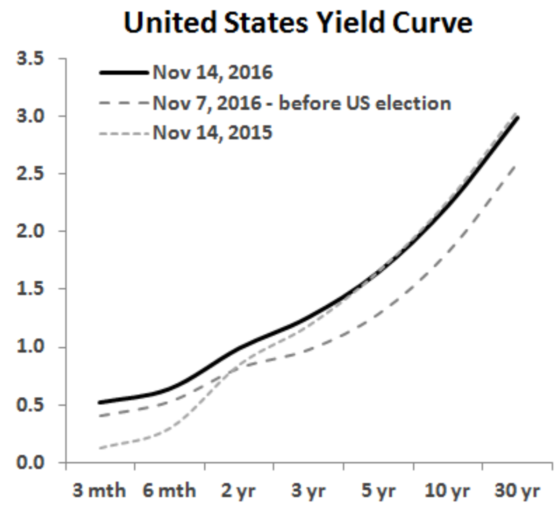
- In the short-term, households' consumption and corporate profits are likely to benefit from the fiscal boost and the positive development in equity markets, thus building up on the current wage acceleration and supporting a short-term growth acceleration. It is difficult to use "traditional" models when getting into a highly uncertain policy / perception environment, but initial estimates suggest that US GDP growth could be around or above 2.5% on average in 2017 against an initial projection closer to 2%.

- This positive outlook, itself supporting the strength of equity markets in the US despite high valuation metrics, will increase tensions on the labor market and raise therefore the question of the transmission of higher costs to inflation and to a compression in corporate margins. For the latter, the expected tax cuts and a likely improvement in productivity gains may provide critical cushions. Accelerating inflation and the expectations about such a "trend reversal" for prices is going to force a tighter monetary policy than previously expected. As we repeated over the past months, the US Federal Reserve is now caught between a rock (accelerating inflation) and a hard place (vulnerabilities in financial markets), and will need to respond as closely as possible to what market expectations and prices are telling: the mini-crash on bond markets since Trump's election clearly increase the pressure to raise rates, in December as previously

[2] As already presented in our previous Hot Topics, Moody's assessed the macroeconomic consequences of Trump's proposed economic policies under different assumptions regarding the degree of compromise with Congress: the "more likely" outcome is a compromise scenario with USD1Tr tax cut (instead of USD9.5Tr) concentrated on lower / middle income, deficit neutrality, higher trade tariffs (only for 1 year), 1/3 of undocumented workers' deportations. A table at the end of this Hot Topic provides a reminder of key results.

3 For more details on its 100-day action plan: https://assets.donaldjtrump.com/_landings/contract/O-TRU-102316-Contractv02.pdf

expected (but possibly with a 50 bp increase and not just 25 bp), and probably more frequently next year (our models suggest at least 4 hikes in 2017). We would therefore expect the whole yield curve to translate higher, with a modest flattening from current levels if the Fed acts "strongly" in December.



- Such an increase in overall interest rates will have a substantial though possibly deferred effect on spending, as US households and corporates are highly leveraged with most debt at variable rates. Remember that households' debt amount to almost 80% of GDP, meaning that a 100 bp increase in average cost of debt translates into a roughly 1% decline in income available after interest payments. This would add to the inflationary impact on disposable income. Here again, the short-term risk of such reduction in household spending capabilities is mitigated by the expected tax cuts on households. After the initial positive effect, i.e. in 2018, the increase in inflation and rates will exert a much more constraining effect on both consumption and investment. This could be precipitated if the bond market were to crash further, e.g. if a conflict between the incoming administration and the Fed became more pronounced.

- According to different quantitative models developed by TAC ECONOMICS on bond market performances and outlook, the recent bond sell-off (+38 bp from November 8 to November 14) is likely to continue (albeit with potential volatility) in 2017. This would progressively drive yields towards their fair-values, with limited transmission to equity markets (according to our latest Quantitative Monthly Market Alert[4]) over the short-term.

  Our long-term econometric valuations that US 10y-Treasury yields would increase from the current 2.24% (November 14) to:

  - Around 2.6% at mid-2017 and between 3.1% at end-2017 under a "base compromise scenario" (+25bp/quarter Fed tightening).

[4] Our Quantitative Market Alert provides the outputs of highly complex and extraordinarily powerful data-mining and artificial intelligence tools applied to macroeconomic, financial and market variables. It delivers Early Warning Signals (EWS) on large reversal in market prices (upwards as well as downwards) over a short-term horizon (1, 2 and 3 to 6 months ahead) and the tools include an estimation of cyclically-influenced Fair Values (i.e. market prices that would be fully consistent with the traditional set of economic and cyclical determinants of fair values).

- Around 3.0% at mid-2017 and between 3.6%at end-2017 under a "stronger tightening scenario" (+50 bp/quarter Fed tightening), related to a sharper acceleration in inflation or / and major difficulties in creating a clear policy direction.

Interestingly, our models relating financial markets' performances to final demand (through confidence and spending) clearly show that a decline in bond market prices associated with rising yields has a much lower impact on confidence than a similar move in equity markets (the latter having an impact at least four times as large as changes in bond markets). This shows that a tax cut + higher growth + larger productivity gains could compensate the negative impact of higher wages and higher financial costs and therefore avoid a compression in corporate margins that would create the conditions for a large decline in equity prices.

Key uncertainties to monitor in the short term

It is useful to state again that the key uncertainty created by Donald Trump's election is more about his character than about policies: for the latter, check and balances, initial comments from the upcoming administration and the "underlying economic logics" behind US economic performances suggest that a "compromise" is highly likely, as described earlier. But, the more worrying element is the election "for the toughest job in the world, of a man who is completely unprepared for it in terms of knowledge, experience and temperament"[5].

Over the next few weeks, three different aspects need to be very closely monitored to assess more precisely the short-term risk implications of the new presidency:

- *Composition of the new administration and nature of the relationship with Congress*. Mike Pence (US vice president) as well as Reince Priebus, the Republican National Committee chairman just appointed as Trump's Chief of Staff, will be the key protagonists of Trump relations with the Republican Party, with the objective of reassuring about the coming administration's authority and professionalism and ease the construction of policy compromises.

- *International relations ad initial statements on international policies*. This is clearly the area where we feel most ill-at-ease: Trump's campaign (and its "core" ideological support – see Box below on American Populism) point to the plausibility of very "confrontational" and "one-sided" international relations between the US and its political allies as well as its most important trading and economic partners. The declared hostility vis-à-vis free trade agreements (re-negotiation of NAFTA[6], withdrawal from the TPP[7] discussions, abandonment of TAFTA[8] negotiation) but also vis-à-vis the WTO, and a stronger willingness to engage in trade dispute have the potential to trigger a trade war, especially if it boils down to a bilateral stand-off between the US and China. In parallel, the fierce rhetoric against close US allies (including NATO), critical uncertainties on future US

5 From a paper by J. Methews, Carnegie Foundation, November 10, 2016
6 North American Free Trade Agreement
7 Trans-Pacific Partnership
8 Transatlantic Free Trade agreement

international engagement and commitments, and likely geopolitical realignments have all the potential for sharply disruptive surprises. Any conciliatory or "real-politic" speech would reassure the international community and reduce potential market tensions.

- *Nature of the relationship with the Federal Reserve.* Frequent comments by candidate Trump on the too-extended period of accommodative policy and its impact on a stock market bubble, his attack on the Fed Chairwoman Janet Yellen and a clear preference for fiscal stimulus have raised concerns about the Fed's independence and potential pressures from the administration. J. Yellen's term expires in February 2018, and it looks today pretty unlikely to be renewed; in the meantime, two existing vacancies on the seven-member board of governors may be filled by more "hawkish" board members. Here again, the tone and nature of the comments on the Fed need to be monitored in detail over the next few weeks.

Reminder: history of American Populism

Populism is not new in US political history. Here below, we provide an extract from an investigation into the issue and the relationship between Trump's candidacy and the populist tradition in the US:

"Two different, often competing populist traditions have long thrived in the United States. Pundits often speak of "left-wing" and "right-wing" populists. But those labels don't capture the most meaningful distinction. The first type of American populist directs his or her ire exclusively upward: at corporate elites and their enablers in government who have allegedly betrayed the interests of the men and women who do the nation's essential work. These populists embrace a conception of "the people" based on class and avoid identifying themselves as supporters or opponents of any particular ethnic group or religion. They belong to a broadly liberal current in American political life; they advance a version of "civic nationalism," which the historian Gary Gerstle defines as the "belief in the fundamental equality of all human beings, in every individual's inalienable rights to life, liberty, and the pursuit of happiness, and in a democratic government that derives its legitimacy from the people's consent."

Adherents of the second American populist tradition—the one to which Trump belongs—also blame elites in big business and government for under-mining the common folk's economic interests and political liberties. But this tradition's definition of "the people" is narrower and more ethnically restrictive. For most of U.S. history, it meant only citizens of European heritage—"real Americans," whose ethnicity alone afforded them a claim to share in the country's bounty. Typically, this breed of populist alleges that there is a nefarious alliance between evil forces on high and the unworthy, dark-skinned poor below—a cabal that imperils the interests and values of the patriotic (white) majority in the middle. The suspicion of an unwritten pact between top and bottom derives from a belief in what Gerstle calls "racial nationalism," a conception of "America in ethno racial terms, as a people held together by common blood and skin color and by an inherited fitness for self-government."

Both types of American populists have, from time to time, gained political influence. Their outbursts are not random. They arise in response to real grievances: an economic system that favors the rich, fear of losing jobs to new immigrants, and politicians who care more about their own advancement than the well-being of the majority. Ultimately, the only way to blunt their appeal is to take those problems seriously."

From Michael Kazin, Foreign Affair, October 6, 2016

Reminder: Economic impact of a "compromise" program being implemented (Moody's)

Variables	2017	2018	2019	2020	2026
Real GDP (%)	2.8	0.8	1.8	2.2	1.3
Unemployment rate (%)	4.8	5.7	5.9	5.4	6.0
FED Fund rate	2.0	4.0	2.9	1.8	2.7
10-yr Treasury yield (%)	3.6	4.0	4.0	4.0	4.2
Debt to GDP ratio (%)	76.6	78.3	80.0	80.0	90.5
Deficit to GDP ratio (%)	-4.1	-4.6	-4.3	-4.3	-5.3

Source: Moody's