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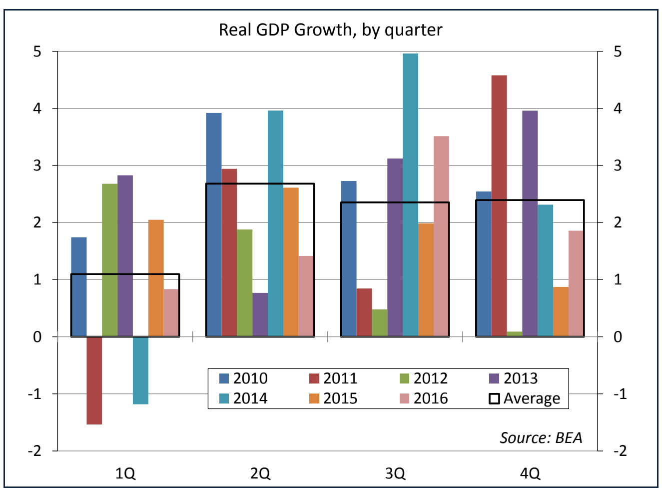
Economic Trends

Reassessing the Trump Trade

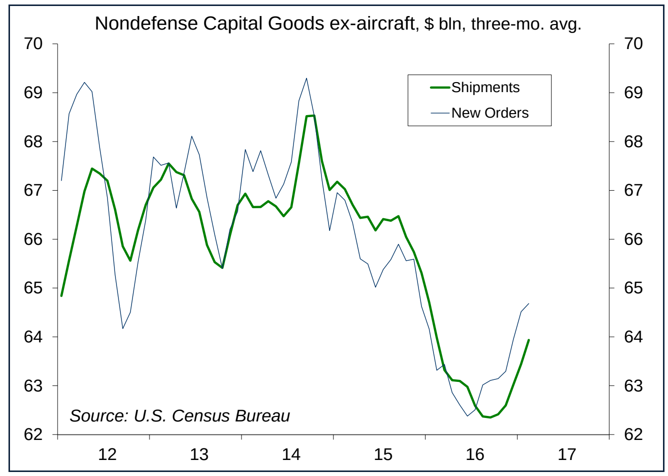
- *Recent economic data have been mixed, consistent with moderate growth over the near term.*
- *The failure of the House to pass legislation to repeal and replace the Affordable Care Act has cast some doubt about the ability to achieve the rest of the "Trump agenda." However, while comprehensive tax reform appears to be unlikely, there's a good chance that Congress will be able to lower tax rates.*
- *The Fed followed up its December move with another rate increase in March. While tightening is more aggressive than in the last two years, there's considerable uncertainty ahead.*

As the first quarter nears an end, the available data suggest real GDP growth of 1-2% (annual rate). While this may be viewed as subpar, first quarter GDP figures have tended to be below the pace of other quarters, which may reflect problems in the seasonal adjustment (the Bureau of Economic Analysis is working to address residual seasonality).



Consumer spending growth is expected to have moderated following the strong pace of the fourth quarter (+3.5% in the 3rd estimate, following +3.0% in 3Q16). Job gains and wage growth have been supportive, but the year-over-year increase in gasoline prices has reduced purchasing power. That is a short-term restraint as gasoline prices are expected to trend flat over the next several months. Measures of consumer confidence have been mixed, but there's little evidence that such attitude measures drive spending (the key factors are income, wealth, and the ability to borrow).

Business fixed investment is a different story. Confidence is an important factor in the decision to expand. Capital goods orders began to turn up last June, partly reflecting a bottoming in energy exploration (which is capital intensive) and an improved global economy. Orders and shipments took a further leg up following the election, apparently driven by the expectation that reduced regulation, large-scale infrastructure spending, and major tax reform would boost earnings in the quarters ahead. However, the magnitude of the improvement in business fixed investment does not appear to be especially large and demand for the goods and services produced will have to increase to justify further capital spending.



During the Obama years, House Republicans passed legislation to repeal the ACA more than 60 times, which makes the recent failure perplexing. That's because it's not enough to repeal the ACA. There has to be some sort of replacement (moderates feared that there would be reprisals at the polls if coverage was scaled back too far, while Freedom Caucus members felt that the proposed bill didn't go far enough).

There are a number of tax issues embedded in the ACA and the failure to repeal it makes fundamental tax reform much more difficult (not that it would have been easy). Reform means lowering tax rates and eliminating deductions. The CBO estimates that "tax expenditures" (deductions) will total 8% of GDP in 2017, nearly half of federal tax receipts.

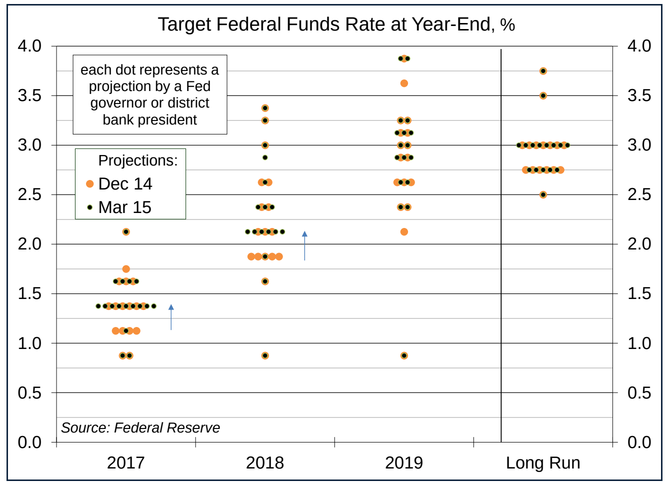
While the prospects for broad tax reform have faded, it's still likely that Republicans will pursue lower tax rates, especially for businesses. The U.S. has one of the highest business tax rates in the world, but the effective rate is lower due to deductions (and no one wants to give up their specific tax breaks). Lowering the corporate tax rate will reduce tax revenues. Republicans have proposed a Border Tax Adjustment (a tax on imports) to recoup some of that lost revenue. However, U.S. firms do not want to pay more for imported supplies and materials, and at least three Republican senators have come out in opposition to the BAT.

As a percentage of GDP, nondefense discretionary spending has never been lower – and (based on current law) is expected to fall further (again, as a percentage of GDP) in the years ahead. Even if nondefense discretionary spending were zeroed out, the U.S. would still have a budget deficit. As the baby-boom generation moves into retirement, Social Security and Medicare will account for an increasing share of the government's budget. Interest payments are a function of interest rates, which will move higher as the Fed continues to normalize monetary policy. President Trump wants to increase defense spending, and has proposed sharp cuts to several government departments. However, the Senate is not going to go along with that. Note that federal government employment is about where it was in the late 1960s.

Following the November election, stock market investors expected that a rollback in regulations, added infrastructure spending, and tax reform would boost economic growth and, in turn, corporate earnings. However, economists generally expect that the underlying pace of growth will be limited by labor market constraints (a tight job market). Moreover, even with one-party rule in Washington, the Trump agenda was going to face resistance. Some market reassessment of the Trump trade is warranted. Bond yields rose following the election, fearful of higher budget deficits and a resurgence of inflation, but have since backed down. Importantly, the economy remains in relatively good shape, with few signs of the type of imbalances that might lead to recession.

The federal debt ceiling went back into effect on March 16 (the limit was set to the level of the national debt on March 15). Treasury is employing "extraordinary measures" to fund the government. With April tax receipts due, this can go on well into autumn. However, the debt ceiling will have to be raised at some point and, while this should not be a problem, there is some possibility of a budget/debt ceiling showdown.

Some Federal Reserve officials apparently factored fiscal stimulus into their economic projections in December. However, there was little change in the outlook at the March Federal Open Market Committee meeting. In fact, the decision to raise short-term interest rates another 25 basis points was not driven by any change in the Fed's thinking, according to Chair Yellen. The more modest pace of tightening in 2015 and 2016 was due to a couple of factors (slower improvement in the job market and subdued inflation pressures). The Fed is expected to raise rates more aggressively in 2017 (though still gradually), but future moves will remain data dependent. The Fed expects that the job market will tighten further and inflation will pick up (still moderate). However, there is considerable uncertainty in the economic outlook and the pace of growth is rarely even across months and quarters.



With a two-year window, Brexit negotiations, set to begin soon, are expected to be most intense about a year from now (in order to allow time, within the two-year window, for EU countries to vote on the agreement). China's economic transition is expected to remain bumpy. However, the outlook for the rest of the world is brighter, despite fears of a possible U.S. misstep on trade policy.

	1Q16	2Q16	3Q16	4Q16	***1Q17***	***2Q17***	***3Q17***	***4Q17***	***1Q18***	***2Q18***	2016	**2017**	**2018**
GDP (↓ *contributions*)	0.8	1.4	3.5	2.1	***1.3***	***2.5***	***1.9***	***1.9***	***1.9***	***1.9***	1.6	***2.1***	***1.9***
consumer durables	-0.1	0.7	0.8	0.8	***0.1***	***0.3***	***0.2***	***0.2***	***0.2***	***0.2***	0.4	***0.4***	***0.2***
nondurables & services	1.2	2.2	1.2	1.6	***0.8***	***1.5***	***1.2***	***1.2***	***1.2***	***1.2***	1.6	***1.3***	***1.2***
bus. fixed investment	-0.4	0.1	0.2	0.1	***0.5***	***0.4***	***0.3***	***0.3***	***0.3***	***0.3***	-0.1	***0.3***	***0.3***
residential investment	0.3	-0.3	-0.2	0.4	***0.4***	***0.2***	***0.1***	***0.1***	***0.1***	***0.1***	0.2	***0.2***	***0.1***
Priv Dom Final Purchases	1.1	3.2	2.4	3.4	***2.1***	***2.8***	***2.2***	***2.1***	***2.1***	***2.0***	2.3	***2.6***	***2.1***
government	0.3	-0.3	0.1	0.0	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	0.1	***0.1***	***0.1***
exports	-0.1	0.2	1.2	-0.6	***0.6***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.0	***0.3***	***0.2***
imports	0.1	0.0	-0.3	-1.3	***-0.9***	***-0.3***	***-0.3***	***-0.2***	***-0.2***	***-0.2***	-0.2	***-0.6***	***-0.2***
Final Sales	1.2	2.6	3.0	1.1	***1.7***	***2.5***	***1.9***	***1.9***	***1.9***	***1.9***	2.0	***2.0***	***1.9***
ch. in bus. inventories	-0.4	-1.2	0.5	0.0	***-0.4***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	-0.4	***0.1***	***0.0***
Unemployment, %	5.0	4.9	4.9	4.7	***4.7***	***4.6***	***4.6***	***4.6***	***4.5***	***4.5***	4.9	***4.6***	***4.5***
NF Payrolls, monthly, th.	196	164	239	148	***155***	***150***	***145***	***140***	***135***	***130***	187	***148***	***128***
Cons. Price Index (q/q)	-0.3	2.5	1.6	3.4	***2.5***	***2.2***	***2.2***	***2.2***	***2.2***	***2.2***	1.3	***2.4***	***2.2***
excl. food & energy	2.7	2.1	1.9	2.0	***2.1***	***1.9***	***2.0***	***2.0***	***2.1***	***2.1***	2.2	***2.0***	***2.0***
PCE Price Index (q/q)	0.3	2.0	1.5	2.2	***1.9***	***2.0***	***2.0***	***2.1***	***2.1***	***2.1***	1.1	***1.9***	***2.1***
excl. food & energy	2.1	1.8	1.7	1.3	***1.5***	***1.8***	***1.9***	***2.0***	***2.0***	***2.0***	1.7	***1.6***	***2.0***
Fed Funds Rate, %	0.36	0.37	0.40	0.45	***0.66***	***0.68***	***0.91***	***0.96***	***1.16***	***1.19***	0.39	***0.80***	***1.30***
3-month T-Bill, (bond-eq.)	0.2	0.3	0.3	0.4	***0.6***	***0.6***	***0.9***	***0.9***	***1.1***	***1.2***	0.3	***0.8***	***1.3***
2-year Treasury Note	0.8	0.8	0.7	1.0	***1.2***	***1.4***	***1.5***	***1.6***	***1.7***	***1.9***	0.8	***1.4***	***1.9***
10-year Treasury Note	1.9	1.8	1.6	2.1	***2.5***	***2.7***	***2.9***	***3.2***	***3.3***	***3.4***	1.8	***2.8***	***3.5***