By Laurence Boone, Research & Investment Strategy

14 November 2016

US elections: A game changer?

Significant change ahead, but uncertainty prevails for now

The result of the US elections will almost certainly prove a game changer, not only for economics, but for broader global relations and domestic social issues. On the economic front, these elections could mark the end of speculation regarding US "secular stagnation" and the downsizing of global governance (trade, finance and foreign affairs). We could expect that a large part of Trump's proposals will be implemented in line with traditional Republican policies, although there is still scope for divergence on the trade side. Overall, Trump looks set to kick start the "traditional" economic cycle by boosting demand from the public and private sectors, while encouraging a more conservative Fed that will raise rates more quickly if and when overheating starts to appear. **In a nutshell, a boom-bust cycle could well be on its way over the next few years**. In addition, Trump is likely to withdraw from global governance (trade, finance and even foreign affairs) and thereby radically redefine globalisation as we have known it for the past thirty years.

Policy implications

First, there is some agreement between Trump and the Republicans on tax cut proposals and some infrastructure spending, **as well as a desire to free up banking credit** (through repealing some features of the Dodd-Frank Act). We should therefore expect an increase in public and private demand, although question marks remain regarding the magnitude (maybe half Trump's initial proposal) and the timing (the most significant effect should be rapid credit growth, tax changes in H2 2017, and much later for infrastructure). So, as political uncertainty fades through a depressed Q4 2016/Q1 2017, we should expect quite a sharp rebound in Q2/H2 2017.

Second, his transition administration includes trade experts who have demonstrated their mistrust of current trade programmes. As the President has a lot of freedom for dealing with such issues (even being able to free himself from Congress' influence), we should expect tensions, primarily with China. There will also be some uncertainty for Mexico, where a lot of US firms have their manufacturing base. Trade protectionism, in one form or another, would put a brake on both domestic and international growth, although this slowdown would take some time to materialise. Even if Trump were to repeal existing trade agreements on his first day, it would take another six months before it became effective. **Assuming Trump prefers to negotiate some features of the existing trade agreement, rather than withdrawing altogether, we can assume that there will be little impact before 2018.** A risk to that view would be retaliation from China, which could dent trade and sell holdings of US treasuries, detrimentally impacting financial markets.

Thirdly, he has demonstrated an appetite for financial sector deregulation, which could lead to a rapid increase in credit. Share price action in the financial and insurance sectors indicates that these proposals have been taken seriously by markets. It seems that Trump would reduce the power of the public administration in matters of resolution. He has also reaffirmed that he would enable increased lending to cash-restrained people. If enacted fairly quickly, which is possible given the convergence of Republican and Trump's ideas, and if confirmed when the Treasury Secretary is appointed, this initiative could lead to a rapid renewal of mortgage credit and SME loans (student and auto loans already being at a high level).

Fourth, the "traditional" energy sector could also be revamped, with an unclear impact on oil prices if more drilling is allowed. At the moment, oil prices remain too low for oil corporates to venture into new drilling projects. Trump's proposals therefore favour more traditional types of energy.

Finally, the reality of repealing Obamacare now appears a little more complicated than Trump had initially hoped, as he acknowledged after his first transition meeting with Barack Obama. Trump has already put a specialist in charge of health in his transition team, but hinted that he will likelier look at reducing the cost of Obamacare rather than dismantling it fully.

Overall, and acknowledging the significant uncertainty of policy implementation, it seems that **the arrival of Trump in the White House will be a significant change for the US and the global economy. With fiscal stimulus, rising rates and possible inflation spurs, we could be leaving the 'lower for longer' paradigm for a more traditional boom to bust cycle. This could start with the boost to private/public demand overheating, triggering a more rapid pace for Fed tightening, and the eventual collapse in certain asset bubbles.** Indeed, if demand is fuelled quickly, wages will increase before the disenfranchised unemployed re-enter progressively the marketplace, capping some of the upward pressure on wages longer-term. Initially, we will witness rapid wage increases and higher inflation, rather than rising labour market participation. This in turn, and likely coinciding with changes on the Fed Board, would trigger a faster pace of monetary policy tightening and rising rates. This would have negative implications for all dollar-denominated sovereign and corporate debt.

The US change of government and economic policy also has implications for Europe: on the demand side (where a small spill-over from US fiscal stimulus can be expected) and more visibly, on financing conditions (notwithstanding political implications). Very likely, and as alluded to by the ECB's Benoît Cœuré in a recent interview, **the ECB will have to review economic and financial conditions in the coming weeks and possibly reassess its stance**. Yet we do not expect a massive change ahead of the ECB's meeting on 8 December: growth will be barely affected, and inflationary pressure from the US will likely be offset by the dollar's appreciation. Rather, this will have implications further into 2018-19. On one hand, the demand boost and inflationary pressures created by the US could start feeding through to the rest of the world, albeit softened by the dollar's likely appreciation, resulting in higher growth and rates before a downturn in the US. In this scenario, Europe will likely mimic the US, albeit to a more modest extent. On the other hand, European growth may not have had time to revive before Fed tightening depresses the global outlook. It is difficult to say which of these scenarios will prevail.

Implications for Europe are also important for the forthcoming political cycle: Italy's referendum, and elections in Austria, the Netherlands, France and Germany. **The US results will likely trigger unconventional political talks, promote unconventional candidates, and should (but by no means can we be certain) lead Europe to re-think the balance between demand and supply side policies.** This could materialise with the German coalition in Autumn 2017 should it include the Green Party.

In more detail:

1. **Uncertainty will prevail until Trump is inaugurated. In the meantime, the best indicators we'll get will be through ongoing transition team nominations and the appointees' past experience and ideas**

The President-elect has been very careful to deliver a conciliatory, vague and reasonable first speech. The only hints about his programme have been: infrastructure spending, veterans and foreign policy. He has repeated his commitment to the first two and asserted his openness to others. The speech succeeded in calming markets, and reversing initial reaction. This suggests that markets are hoping for a significant fiscal stimulus to raise demand, inflation and rates. Larry Summers and the like are calling for policy to move away from monetary stimulus to fiscal stimulus. On the downside, the Mexican peso and renminbi depreciated against the dollar, reflecting concerns about trade and relations with China.

Part of his transition team comes from the Heritage Foundation, a conservative think tank, which has promoted similar policies to Trump's (reduction of taxes and regulatory burden, repealing Obamacare and Dodd-Frank, defence spending), but argued for a balanced budget which is far from Trump's proposals. This suggests lower-than-expected tax cuts, especially on health and welfare spending. Indeed, although repealing Obamacare in its entirety looks unlikely, the Trump administration in transition has already sent signals that it would seek to reduce its costs.

2. **Main policy points: Trump vs Republicans**

There are significant similarities between Trump's plans and the Republican views, excluding the former's more outrageous proposals. In addition, the Heritage Foundation Blueprint also suggests some convergence points.

- *Budget:* Trump and the Republicans agree on across the board tax cuts (although the Republicans propose levels half that of Trump), less so on infrastructure, and also defence/homeland security spending. There is convergence on principles, but exact amounts remain contentious given

Republicans have been traditionally more concerned about the size of the debt and the deficit. So we should expect smaller than expected, but nevertheless substantial, tax cuts.

- *Anti-free-trade policies:* there is less common ground with traditional Republicans here, but 1/ many of the states where Trump outperformed were those with some of the highest share of manufacturing-related employment, and 2/ his transitional team includes advisors who have worked on NAFTA and publicly expressed strong views on China as a currency manipulator. As there is huge intra-trade with Mexico, but given China is currently negotiating a tariff decrease within the framework of its accession to the status of a market economy, we could expect some push towards China. An immediate question is where this would leave Europe, which has already made steps to grant this status to China. In theory, a Peterson Institute Study shows that Trump could pull out of NAFTA six months after he notifies his intention to do so. However, the value chain is so integrated that it is difficult to envisage such an initiative; intense lobbying from US manufacturers would likely put a brake on such decision.
- *Financial regulations:* the Heritage Foundation's 2016 presidential programme proposal is very clear in supporting a repeal of the Dodd-Frank Act, arguing that even without it there is already enough regulation on the financial sector. Since then the Trump transition team has been more precise: less state intervention and financial support on resolution, but also fewer constraints on borrowing for households and small firms. This would have two impacts: boosting credit (especially on SME loans and household mortgages) and possibly leading to a boom/bust credit-driven economic cycle.
- *Monetary policy:* Trump has often suggested he would not reappoint Fed Chair Yellen when her term ends in February 2018. Fed Vice-Chair Fischer's term ends in June 2018 and Trump could select nominees for two vacancies on the Board, potentially leading the Fed to be more hawkish. Additionally, some have increasingly argued for competition of money, a more rule-based policy, lesser role for the Fed as a regulator and its emergency lending authority.
- *Others:* Repeal and replace *Obamacare*. Trump's views here are easily seen in Republican ideas. Yet it is less clear how, at this stage of implementation, it can be repealed. Rather it could be reformed with less public money. *Immigration* is also a widely shared concern of Republicans. However, the emphasis appears to be switching towards control of borders (and the flow of migration, rather than the stock). We can expect a tightening of immigration and expediting deportations. However the pace and scale of change promoted by Trump during his campaign seem far-fetched and the President Elect has more recently scaled back talk to 2-3m law-breaking unauthorised immigrants (compared with the estimated 11m total) – although this would still be a significant number.

Overall, this suggests more risks, higher rates, and the potential for more disruption for financial markets.

3. The range of possible outcomes

Market movements reflect expectations of a sizeable fiscal stimulus, together with a marginal negative effect stemming from difficult relationships with Mexico and possibly China. These do not look very consistent reflecting that, in reality, we know little of what Trump is likely to implement and at what pace. But overall, we expect a demand surge in Q2-H2 2017 from taxes, prolonged by financial deregulation, with trade impact being unlikely before 2018:

- Fiscal stimulus will most likely unfold as following: A budget around March would enable tax cuts for H2 2017. Current spending levels would materialise in H2 2017, while infrastructure plans are unlikely to be implemented before 2018. The Republicans' desire to contain the deficit remains a significant factor in determining the ultimate size of the fiscal stimulus.

- Trade remains one the most uncertain areas. Republicans have traditionally been pro trade and globalisation; Trump's campaign has been violently against trade. Pointing at China as a currency manipulator is difficult when the current account has shrunk to less than 3% of GDP, and the renminbi is now a reserve currency, with a floating peg. The manufacturing value chain is also hugely integrated with Mexico. Yet, Trump arguably needs less Congressional support here than in other areas, meaning he can enact large short-term increases in tariffs, or modest long-term increases. In either case, Trump appears unlikely to develop trade agreements, signalling the end of the Transatlantic Trade and Investment Partnership.

So we could see rising domestic demand, inflation and credit supply, and a more hawkish Fed in 2018, assuming that: the fiscal stimulus is voted in according to the above calendar, bank regulation is partly repealed, NAFTA is repealed for renegotiation by end-2017, and China sees tariffs imposed on exports. Meanwhile rates would have increased beyond our pre-Trump expectations.

In reality, uncertainty and market shock is possible, particularly relating to foreign policy where Trump's influence will prevail.

The Fed

In reaction to this, the Fed is likely to implement a hike of 25bp in December, unless financial market conditions deteriorate materially in the meantime. Then the pace of tightening will depend on the magnitude of the fiscal stimulus, the magnitude and timing of trade measures, and market conditions. Given the level of uncertainty at this stage, it is difficult to be precise, but more certainty can be gleaned over the coming weeks.

When the time comes to appoint or change up to four Fed members, we can expect a more hawkish composition with participants like John Taylor coming to the fore.

4. Europe

Against this new backdrop, the ECB will have to reassess the economic outlook, thus raising uncertainty for the 8 December press conference. Beyond the broadly unchanged economic data, the ECB will look at: 1/ evolution of financial market conditions – which will be tighter across the board with wider spreads; 2/ any information on Trump's economic policy analysis (and it is likely to have some by then); 3/ Italy's referendum result. All these elements argue for an ongoing dovish stance, while making it easier for the ECB to extend QE (mostly in terms of time, little in asset types) until well into the summer. In addition, the December press conference will most likely be dovish, pending Italy's referendum results. The broader sweep of European elections will likely influence the political landscape as it may favour unconventional politicians, but their impact on policy will be muted until the German election.

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