By David Page, Research & Investment Strategy

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US outlook 2017

All the precedents mean

Key points

- A more conciliatory president-elect has fuelled market hopes for a pro-growth stimulus with limited protectionism. We tentatively concur.
- Fiscal stimulus should offset expected headwinds to consumer activity and pro-long the economic cycle. We do not expect this to materially impact longer-term growth.
- While Trump's fiscal plans echo Reagan's, we do not expect GDP growth to return to 1980s rates.
- We have increased our GDP forecast to 2.1% in 2017 and 1.9% in 2018 from an estimated 1.6% in 2016.
- Trump has also alluded to financial de-regulation, particularly to boost lending, which adds upside risk to our outlook.
- This above-trend outlook comes in an economy that we estimate to be operating around full capacity. We expect inflation to rise to 1.8% and 2.5% in 2017 and 2018, from 1.3% in 2016.
- Continued growth and faster inflation should prompt the Fed to tighten policy further. Tighter financial conditions should see the Fed proceed cautiously in 2017. But we have increased our Fed funds rate outlook sharply to now see FFR at 1.75-2.00% by end-2018.
- We are mindful that changes to the composition of the FOMC might change the Fed's reaction function and balance sheet management.

Exhibit 1
President-elect Trump's campaign proposals

Detailed estimated 10-year fiscal impact of Trump's proposals	in US$tn
Material commitments	
Health policies (net)	-0.05
Tax policies	
Reform business taxes	-2.85
Reform individual income taxes	-0.90
(Childcare & caretaking)	-0.55
Estate tax	-0.20
Spending	
Infrastructure spending	-1.00
Defence spending	-0.45
Veterans spending	-0.50
"Penny plan" to reduce non-defence spending	0.75
Other non-defence spending	0.25
Total (US$ tn)	**-5.45**
Equivalent (% of annual GDP)	**2.60**

Source: Committee for a Responsible Federal Budget, September 2016

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Introduction

Donald Trump's victory in the US presidential election proved a significant catalyst for change in financial markets. Since the eve of the vote, the S&P 500 is nearly 8.5% higher, the dollar is 3.25% higher in trade-weighted terms, while US Treasury yields have risen 73bps higher, to reach 2.58% – their highest level since mid-2015.

In this note we provide our outlook for the US economy under President Trump. We do this cognisant that significant uncertainty surrounds the policy outlook. Little detail exists on policy priorities. Nevertheless, our forecast is shaped by Trump's more conciliatory language with regards to protectionism and key appointments that suggest a Republican, corporate-focused fiscal boost. Such a policy would have echoes of two previous Republican presidents: Reagan and Bush.

Overall, we expect US GDP to grow by 2.1% in 2017 (from 1.6% in 2016) and 1.9% in 2018. We see looser fiscal policy pro-longing US expansion against a likely headwind to consumer growth into 2018. In an economy that we estimate to be already operating around full capacity, this is likely to drive inflation higher. We forecast a near doubling of the inflation rate over the coming two years from 1.3% in 2016 to 1.8% in 2017 and 2.5% in 2018.

This combination of continued economic growth and a rise in inflation is likely to spur the US Federal Reserve (Fed) to raise the Fed Funds Target Rate (FFR) and we have increased our expected outlook for the policy rate over the coming years. Following December's hike, we forecast a cautious two hikes in 2017, constrained by an expectation of tighter financial conditions. We then forecast three hikes in 2018, taking interest rates to 1.75-2.00% by end-2018.With continued Republican antipathy towards the scale of the Fed's monetary intervention and the possibility of up to five new Board appointments over the coming 18 months, we will also discuss the risk of a shift in the Fed's reaction function, particularly with regards to the Fed's balance sheet management, and consider what this could mean for longer term market rates.

No policy clarity yet

Despite markets emphatic reaction to the election of Donald Trump as the 45th President of the US, a great deal of uncertainty continues to surround the US economic outlook.

Trump campaigned to make the US "Great Again" and raise economic growth to 3-4%. He has proposed tax reform/fiscal stimulus and protectionism (both in terms of trade policy and immigration) to achieve this aim.

Since election, the president-elect has been more conciliatory. His acceptance speech described working with countries that work with the US. This suggested a more cautious stance over the implementation of penal tariffs on Mexican and Chinese imports and a more evolutionary than revolutionary approach to reviewing trade arrangements, including NAFTA[1]. The appointment of Reince Priebus as Trump's Chief of Staff also suggests greater alignment with Republican core values, including free-trade, than during the campaign trail. Our assumption is that most of the more aggressive anti-trade proposals will not be enacted. However, Trump has made it clear that he does not intend to enact the Trans Pacific Partnership (TPP) trade deal.

A similar softening has materialised over Trump's stance on immigration. While campaigning, Trump discussed deporting all unauthorised immigrants. In an interview immediately after the election, the President-elect discussed deporting those with criminal records, which he said was around 2-3 millions. Targeting this level would be more akin to following President Obama's policies of the past eight years. Trump's rhetoric has increasingly focused on controlling borders – managing the flow, not stock, of migration.

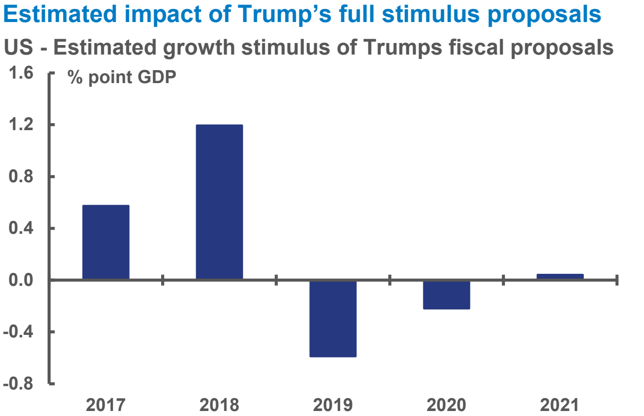
A scaling back of Trump's protectionist agenda would significantly reduce the downside risks of the President-elect's economic programme.

The alignment of Trump's and House Republican's tax reform plans has led many to assume a significant fiscal loosening will pass through Congress. In August, Trump adjusted his proposals to align them with House Republican proposals. He scaled back proposed household tax rate reductions. Corporate tax plans were also similar in terms of reduced corporate tax rates (Trump15%, House 20%) from 35%; introducing a repatriation of overseas profits tax rate (Trump 10%, Republicans 8.75% cash and 3.5% other); full and immediate cost of capital deductibility (Trump only for manufacturers).

Hopes that the administration will prioritise a corporate tax focused easing were further bolstered by the appointment of Steven Mnuchin as Treasury Secretary. Mnuchin said his "number one" priority would be to cut taxes and boost the economy. *Exhibit 2* illustrates our estimates of the boost to US GDP if Trump enacted all of his fiscal boost campaign proposals (*Exhibit 1*).

Exhibit 2

Estimated impact of Trump's full stimulus proposals



Source: Committee for a Responsible Federal Budget and AXA IM Research

[1] North American Free Trade Agreement

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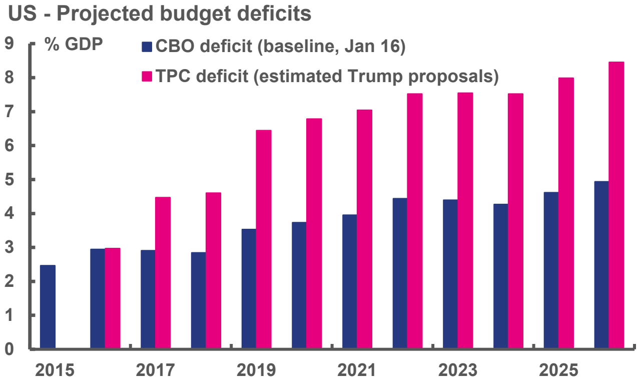
Republican majorities in Congress should make passing Republican policy easier. Republicans hold a solid majority in the House, but the Senate majority is slim. However, using the budget "reconciliation" process, Republicans could pass budget proposals through the Senate without a super-majority.

Disquiet among Freedom Party Republicans (former Tea Party Republicans in the House) over the proposed scale of deficits (*Exhibit 3*) could still hinder any stimulus. The "dynamic scoring" process used to cost potential tax changes will be critical to this process[2]. The scale of forecast deficits and their acceptability to Congress will in part be determined by how stimulative the changes are assumed to be.

Exhibit 3

Projected tax cut boost to corporate profitability



Source: Tax Policy Center, Congressional Budget Office and AXA IM Research

Trump also proposed a US$1tn infrastructure programme. This was designed to be enacted via a number of tax incentive deals structured to provide private funding. However, there are few international examples of the private sector materially investing in public infrastructure projects (and several high profile cases of disappointment, including the euro area's Juncker plan). Beyond difficulties in achieving the right balance of tax incentives, challenges also exist over a viable returns model, risk-return profiles and under-appreciated credit risks, which can help dissuade private sector investment. Moreover, given borrowing concerns, we see little prospect of deficit-financed infrastructure spending. Indeed, even Clinton's more modest US$275bn proposal was going to be funded by increases in corporate taxation. Hence we suggest that Trump's final infrastructure spend may fall significantly short of US$1tn.

Our central forecast is that tax reform and an associated fiscal boost will deliver some stimulus to the economy over the coming couple of years, delivered primarily via reductions in corporate tax rates. Our more cautious assessment limits the impact to around 0.2% of GDP in 2017 and 0.6% in 2018.

That said, we are mindful that the budget process contains many risks and could still restrain hopes for significant fiscal loosening. More broadly, ongoing risks of the new administration implementing the more protectionist agenda that Trump campaigned on remains. Both suggest downside risks to our growth outlook from here.

One further area of uncertainty is over financial regulation. On the campaign trail, Trump promised a moratorium on new regulations, a reinstatement of the Glass-Steagall Act[3], has argued that too much regulation is restricting bank lending and said he would "dismantle" Dodd-Frank legislation, enacted after the Financial Crisis.

These campaign proposals cover a broad range of policy initiatives and there is little clarity yet over how these will be pursued. At a high level, this reflects concerns about over-regulation of the financial industry since the financial crisis. The House of Representatives has already approved an alternative "Financial Choice Act", which would revoke the current process of nominating systemically important financial institutions (SIFIs), allow firms to 'opt out' of current regulation (albeit with a marked increase in capital) and revoke the authorities ability to bail out institutions in distress.

There is also less partisan support for reviewing the level at which additional regulations apply, with some concerns that the current level ($50bn assets) is too low. This chimes with comments made by Fed Chair Yellen at the latest FOMC meeting over the impact on community banks and the effect this has had on lending. A full scale repeal of Dodd-Frank legislation would likely require significant legislative time and capital and in our minds come with risks of allowing a build-up of risks to financial stability. However, it equally appears likely that the new administration will have significant scope to amend the *implementation* of Dodd-Frank regulations by the choice of regulators empowered to enact these laws.

The scope and scale of financial deregulation is thus a further risk to the outlook for activity. We have not included a significant shift in financial regulation to our forecasts. However, we would consider this an upside risk to the outlook over the coming years, particularly as it impacts household borrowing (mortgage-based and potentially student loans – see below).

Been here before? Reagan and Bush

President-elect Trump's plans for a tax-cut focused fiscal stimulus echoes previous Republican presidents' economic programmes, namely those of Reagan and George W Bush. Trump's economic proposals are estimated by the Tax Foundation to cost between US$4.4-US$5.9tn over 10-years. The Tax Policy Center estimates a higher US$6.2tn. Assuming the lower end of this range, this is equivalent to US$440bn/per annum. This compares with inflation adjusted estimates of President Reagan's initial tax cuts of just over US$210bn

[2] Dynamic scoring assesses the cost of proposed tax/spending changes, including the second round impact of those changes on broader levels of activity.

[3] This was imposed during the Great Depression to separate retail and investment banks, it was repealed in the 1990s.

per annum and President Bush's US$180bn (combining 2001 and 2003 cuts)[4].

Trump's rhetoric echoes the achievements of the Reagan Presidency. Under Reagan's tenure the US economy rose by 30% in real terms, averaging annual growth of 3.5% (Bush presided over a 15% gain, at an average rate of 2.1%). Considering Reagan's fiscal policy is therefore instructive, but we are cautious of suggesting Trump will be able to replicate this growth.

Reaganomics proposed to reduce the tax burden, curb excessive regulation and contain social spending programs to boost growth. Reagan reduced the top marginal income tax rate to 28% from 70%. He also reduced non-defence and social security spending from 11.9% at inauguration to 10.6% at exit. At the same time, he increased defence expenditure, by 84% over his two terms, seeing this rise by around 1% of GDP over the period. Total government outlays still fell to average 20.3% of GDP in 1988 from 20.7% in 1980. However, this combination (and recession early in his presidency) contributed to a swelling of deficits to average 4.1% of GDP in the Reagan's first term and 3.9% in his second (from 2.6% in 1980). Debt tripled over the period, rising as a proportion of GDP to 39.1% in 1988 from 24.9% in 1980. Accordingly, after initial tax cuts, Reagan was forced to rescind much of the give-away with eleven separate tax hikes over the remainder of his presidency, including payroll, corporate and gasoline taxes.

Reagan's fiscal policy should also be considered in the light of monetary policy. At face value, Reagan appeared to benefit from a material decline in interest rates over his two terms: the FFR fell from 17.5% in Q1 1981 to 8.1% in Q4 1988. However, as this occurred against a backdrop of material declines in inflation (and inflation expectations), even with an estimated firmer neutral rate over this period, monetary policy is estimated to have been the most restrictive over the first term of Reagan's presidency as at any point over the past 45 years. This contributed to the marked appreciation in trade-weighted dollar up to the Plaza Accord in 1985, which also served as a headwind to the economy.

The timing of stimulus within the economic cycle is a key difference this time. Presidents Reagan and Bush were both inaugurated as the economy contracted and provided stimulus into an economy with rising spare capacity. As a proxy for this, unemployment rose from 7.4% in Q1 1981 to 10.7% by end-1982 and rose from 4.2% in Q1 2001 to 5.9% in Q4 2002. By comparison, the president-elect's proposals would boost an economy that we believe is already operating around full capacity, with unemployment currently at 4.6%. Stimulus at this stage of the economic cycle threatens greater resistance to the fiscal impetus in the form of tighter financial conditions, which could limit overall effectiveness.

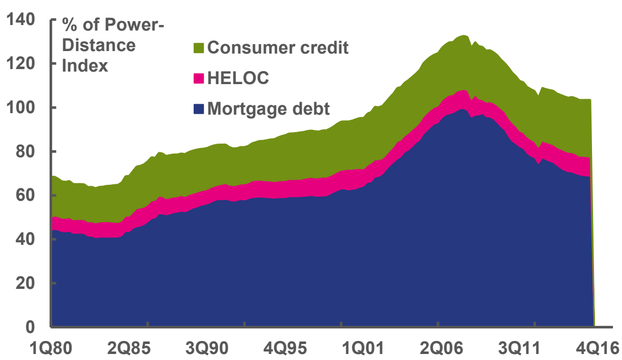
The broader economic outlook

Our expectation of fiscal stimulus is likely to provide a boost to economic activity that will likely prolong the economic cycle. Looking further ahead, we are sceptical that the proposed fiscal stimulus will provide a longer-term lift to economic growth.

Government stimulus now looks likely to buffer the economy from consumer headwinds that we anticipate to grow over the coming 18-months. We have been concerned about growing signs of late-cycle behaviour in certain household measurements (rising delinquencies in sub-prime auto loans, for example). Our forecasts include an impending deceleration in consumer spending into 2018 as future wage growth acceleration fails to keep pace with rising inflation, resulting in slower real income growth for households. Such a deceleration is likely to weigh on consumer spending over the coming years, something that is likely to weigh on an already fragile corporate sector.

Tax reform looks set to lift corporate earnings significantly and should lead to some rise in business investment spending. Faster growth is also likely to result in a modestly faster outlook for wage and hiring growth, moderating the expected slowdown in household real incomes. Nevertheless, this underlying dynamic is why we think GDP growth remains relatively subdued at around 2% over the coming years.

Exhibit 4
Household borrowing



Source: Datastream and AXA IM Research

Household borrowing could propel growth further. While auto-loans and student debt have driven consumer credit to new highs as a proportion of disposable income (above financial crisis levels), revolving credit is some way below recent highs. A renewed confidence in the economic outlook may lift short-term borrowing. Moreover, mortgage lending has been restrained with tighter credit conditions on all but the most pristine credit scores (*Exhibit 4*). Any signs that a Trump administration would de-regulate the financial industry to affect an easing in mortgage credit conditions (or related housing equity loans) could unlock a fresh wave of borrowing. Trump has also discussed changing the basis of student loans, which could also have an impact on borrowing, although likely on a smaller scale. The prospect of a quicker pace of household borrowing adds upside risks to our growth outlook.

Looking further ahead, we are not convinced that the proposed fiscal stimulus will deliver a higher longer-term US growth rate. Corporate tax reform risks proving an

[4] Politico, Sept 2016

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ineffective use of government borrowing. We assume a low fiscal multiplier, in keeping with the observed impact of Bush's tax cuts before. As such, output increases are likely to be relatively modest and US debt: GDP is likely to rise by more than under other, more effective forms of stimulus (for example infrastructure spending, government spending, or income boosts to low income households). The form of this stimulus thus raises the longer term risks to growth associated with higher debt levels.

The reaction in productivity growth will also be key. Faster productivity growth would further boost wage growth, make monetary policy more stimulative and reduce some of the inflationary constraints on the economy, all of which would underpin a faster longer-term growth rate. But, we are cautious of the amount of business investment Trump's proposals will elicit. We are also concerned that more structural restraints on productivity growth, including demographics, labour mobility and indebtedness, will remain.

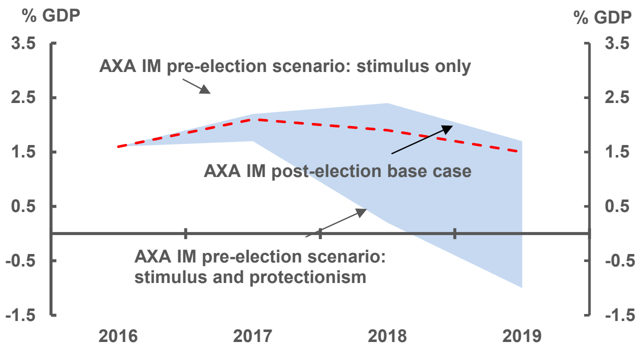
Nevertheless, even a short-term elongation of the US economic cycle is welcome. This will give a greater opportunity for domestic reflation. It should be associated with some normalisation of monetary policy (see below) and thus reduce downside risks to the outlook. It will also provide a more stable economic environment to allow other regions of the globe to enact further recovery and transition, indirectly reducing further downside risks to the US economy.

Balancing these factors, we forecast US GDP growth of 1.6% for 2016, 2.1% for 2017 and 1.9% for 2018. This is modestly below consensus forecasts that see growth of 2.3% in 2017 and 2018. We assume something closer to trend of just over 1.5% in 2019 (*Exhibit 5*).

Exhibit 5

GDP forecast in context of pre-election scenarios

US growth outlook (with pre-election scenario range)



Source: AXA IM Research

And what it means for the Fed

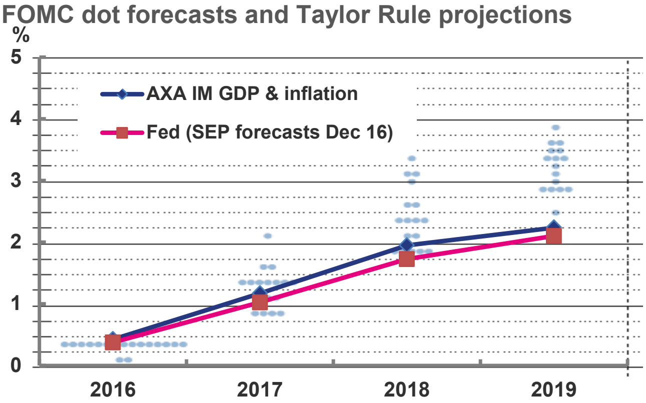
We expect inflation to rise as GDP expands in excess of trend, in an economy that we consider to already be operating around full capacity. While we recognise that the precise path of oil prices will influence the headline outlook, we forecast CPI inflation at 1.8% in 2017 and 2.5% in 2018.

The combined outlook of above trend GDP growth and rising inflation is also likely to prompt the Fed to raise rates more quickly and we have materially increased the outlook for FFR over the coming years in anticipation of the new administration's policies. Illustratively, we use a simple Taylor Rule model to quantify the impact of our projected activity and inflation rates on policy[5]. We calibrate our model by comparing this with the Fed's December projections (*Exhibit 6*).

Exhibit 6

Simple Taylor Rule implications for policy

FOMC dot forecasts and Taylor Rule projections



Source: Federal Reserve Bank (FRB) and AXA IM Research

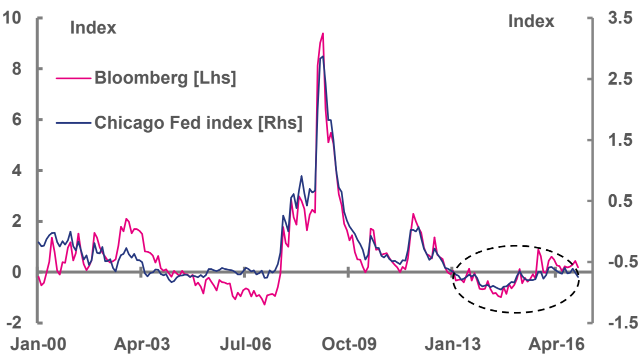
In the short term, we are more cautious in our outlook for Fed policy than such a simple model would suggest. Financial conditions have tightened in anticipation of an improvement in economic conditions. As noted, trade-weighted dollar is already 3.25% higher and 10-year Treasury yields have risen by 73bps. This tightening is likely to offset some of the requirement for tighter monetary policy in 2017, before any policy changes begin to materially affect the economy.

Exhibit 7 illustrates the tightening in financial conditions witnessed since mid-2014. This contributed to the Fed raising the FFR just twice over this period, despite it forecasting eight hikes from the start of 2014. We continue to see risks from overseas adding to a tightening in US financial conditions, via dollar appreciation in 2017.

Exhibit 7

Tighter financial conditions forestalled FFR hikes

US Financial conditions indices



Source: FRB and AXA IM Research

5 We do not allow for an increase in the neutral rate over this period, although we and the Fed consider this likely and this would add to the need for further rate increases.

That said, our expectations of fiscal stimulus from the new administration have led to a material appreciation in our rate outlook to 1.75-2.00% by end-2018.

Implicitly our rate forecast assumes no material change in the assessment of the underlying neutral rate. An increase in this rate (reflecting rising productivity growth or easier credit conditions) would create an upside risk to our forecasts.

Within this outlook, we explicitly assume that the Fed continues to reinvest maturing long-term asset (QE) holdings to maintain the current size of its balance sheet. The Fed is currently committed to maintaining this policy until the normalisation of rates is “well underway”, something we consider to mean at least in excess of 2% and hence into 2019. However, a new administration questions this assumption.

We anticipate some increased government scrutiny of the Fed’s balance sheet policy. President-elect Trump’s monetary policy observations have focused on rates. Senior advisors to Trump and Vice-President-elect Pence have been more critical of the Fed’s balance sheet policy[6]. This reflects a longer standing antipathy of some Republicans to the Fed’s use of balance sheet policy in the face of conventional policy reaching its effective lower bound.

We also see an increasing risk of government influence over the Fed. Such influence might be exerted externally, particularly as Congress looks likely to pursue its “Audit the Fed”[7] campaign. Or influence could be applied internally. Over the next 18 months, the Fed could see between two and five new governors appointed to the Board of Governors: Congress will seek to fill the Fed’s two current vacant seats. President-elect Trump has suggested he will not reappoint Fed Chair Yellen in February 2018, which may see Yellen resign her governor’s position. Moreover, Fischer’s term as Vice Chair expires in June 2018. Finally, Congressional appointment of a Vice Chair for Financial Stability could displace Governor Tarullo, who has performed this role over recent years. While the precise number of new Fed appointees is uncertain, the possibility of replacing the Fed Chair and several key members could change the current balance of the FOMC[8] and with it the Fed’s reaction function.

We therefore acknowledge a risk that the Fed responds to future economic developments differently. Specifically, this could include a re-prioritisation of the role of balance sheet narrowing in its tightening strategy. Materialisation of this risk, or a perception of a greater chance of this, would risk putting further upward pressure on longer-term interest rate term premia.

Conclusion

The election of Donald Trump has provided a catalyst for change in financial markets. While doubts remain over the new administration’s policy priorities, early signs suggest a focus on tax reform and a scaling back of the campaign protectionism that we feared would negatively impact the supply-side of the economy. While we are cautious of the likely scale of stimulus, relative to campaign promises, we have tentatively lifted our expectations for GDP growth over the coming years to 2.1% in 2017 and 1.9% in 2018 as fiscal stimulus prolongs the economic cycle.

This would echo previous Republican presidents’ tax cuts, namely Reagan’s in the 1980s and Bush’s in the 2000s. However, contrary to these stimuli, Trump’s proposed boost is to an economy that we believe is already operating close to full capacity. This is likely to contribute to a faster rise in inflation, which we forecast to rise to 2.5% in 2018.

The combination of faster growth and higher inflation builds our expectations for further tightening by the Federal Reserve. However, we forecast only two rate hikes in 2017 as the Fed continues to adjust policy cautiously against a background of tightening financial conditions. We forecast three rate hikes in 2018, taking the FFR to 1.75-2.00% by end-2018.

Yet ahead of the president-elect’s inauguration, several risks persist. Uncertainty surrounding the new administration’s policies is high and will only begin to reduce materially after 20 January. Associated risks remain that Trump will still pursue the protectionism he threatened on the campaign trail. Congress could also balk at the deficits associated with Trump’s tax reform plans. Moreover, we highlight a risk that a change in personnel at the Federal Reserve could shift the Fed’s reaction function to upcoming events. As such, our central forecast for the outlook for US activity next year is fraught with greater uncertainty than usual. And we expect to fine-tune our assessment as more information on the new administration’s plans become available.

[6] For example, David Malpass (senior economic transition team adviser), Jeb Hensarling (House Financial Services Committee Chairman),

[7] “Federal Reserve Transparency Act 2015” (S2232)

[8] Federal Open Market Committee

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