POST-ELECTION ECONOMIC PERSPECTIVE

NOVEMBER, 2016

The U.S. elections confirmed that a global populist movement has largely been mobilized to reject the very institutions that pledged to protect their interest as the economic revolution continues to evolve. As with the Industrial Revolution at the turn of the 20th century, the People's party may be short-lived if the solutions offered don't change their plight. We hope that President-elect Trump can close the gap of partisan politics.

Preliminary Economic Implications of the U.S. Election

Although it may be far too early to develop a portfolio strategy based on both a Trump presidency and a GOP sweep of both houses, the economic landscape appears at first blush to be a mix of demand-side and supply-side economics. Of course most economists would agree that the former tends to be inflationary, while the latter tends to be disinflationary. That's the theory. In practice, we will all find what the net result of combining various elements of both policies will do to inflation. On the demand side, President-elect Trump proposes to spend $1 trillion on infrastructure over the next 10 years. On the supply side, he proposes to slash the corporate tax rate. He also intends to reduce income tax rates on personal incomes, which can have both inflationary demand-side and disinflationary supply-side effects.

On balance, we think the disinflationary supply-side effects will offset some, but not all, of the inflationary demand-side effects of Trumponomics. That certainly should greatly reduce the risk and fears of deflation. If this statement becomes the reality, the logical conclusion would result in the end of the 35-year bull market in bonds this year, when the 10-year yield bottomed at a record low of 1.37% and is already reversed, up above 2.2%.

Much of that backup was attributable to the perception that, no matter who won the presidency, there would be more fiscal stimulus. Now that Trump has won, markets have declared that fiscal stimulus is now a foregone conclusion.

Inflation versus Disinflation Digested: Globalization vs. Protectionism

Since the end of the Cold War, we have argued that Globalization is inherently disinflationary. Now we are starting to see headlines such as "Goodbye, globalization." One fund manager wrote in a recent note to clients, "globalization, competition, internationalism are now firmly in the retreat. Inflation and protectionism promise a future which is not as kind to financial assets as QE and deflation has been." It is true that protectionism can be inflationary, as long as it doesn't trigger a depression, which would be deflationary. The Smoot-Hawley Tariff of June 1930 caused a depression and a collapse in commodity and consumer prices. A similar period in economic history was during the Reagan years when the administration pursued policies that seemed protectionist at the time. Our major trading partners were pushed to adopt fairer trade practices in exchange for free trade with the U.S. The end result was that the U.S. economy continued to grow, and inflation remained subdued. We believe that will likely be the outcome of the current protectionist sentiment. So we expect that globalization will survive the latest onslaught.

The Labor Market

In November, Federal Reserve Vice Chairman Stanley Fischer said that in his view "the labor market is close to full employment." He added that it wouldn't take much by way of job gains to maintain the unemployment rate near 5%. That's because he expects that the labor force participation rate will continue to decline due to the "likely drag from demographics." Specifically, he emphasized that employment gains of as low as 65,000 to 115,000 would be "sufficient to maintain full employment." Even if participation rates were to remain unchanged, Fischer said a range of 125,000 to 175,000 monthly job gains would prevent unemployment from edging up.

Keep in mind that nonfarm private payroll employment gains have averaged 200,000 over the past six months. The unemployment rate has been around 5% since last fall. Strong labor market indicators were also evident in the latest labor surveys; and the rate of job openings has exceeded levels experienced during two of the past three cyclical peaks. Layoffs fell to the lowest levels on record and people quitting jobs hit a record high in the latest readings. This is not surprising, since these most recent stats are highly correlated with the Consumer Confidence Index, which although lagging could jump higher now that the elections are over. This all points to higher wage inflation and the Atlanta Fed confirms this showing that median wage growth jumped up 4.2% y/y in September, with average hourly earnings for all private industry workers rising 2.8% y/y during October, the highest since June 2009. Trumponomics could put more upward pressure on wages given that most labor market indicators suggest that the economy is at full employment. There is already a shortage of construction workers that will be hard to fill.

The Dollar, Oil, and other Commodities.

In the aftermath of our elections, we have observed a rising dollar and falling oil prices that should help to moderate inflationary pressures in the labor market. On a trade-weighted basis the dollar is now up over 24% from the lows in the summer of 2014, coupled with the fact that OPEC is unable to agree on production cuts. All of which are depressing the price of oil. Trump's commitment to "lift the restriction" on the U.S. energy industry could potentially put the lid on the effectiveness of the Mideast oil cartel for years to come. So what's going on with the Commodity Research Bureau (CRB) raw industrials spot price index which has been on a tear since the election? The coincident move up in both a rising dollar and commodity prices is unprecedented. As inflationary expectations are rising they are bound to put downward pressure on non-petroleum import prices.

Over the past couple of years, there has been a widening consensus that secular stagnation is here to stay. Keynesian economists, like Larry Summers and Stanley Fischer, have argued that the only way out is more fiscal spending. Supply-siders have championed less government and tax cuts as the only sure way to revive growth. Trump of course had proposed to do both while campaigning. And if he succeeds in boosting real economic growth, it might not be inflationary if it is based on productivity. The argument made is that better economic growth could very well prove that the supply side of productivity can deliver more output, thus limiting inflation.

Summary

In recent months, the Federal Reserve has signaled that monetary policy can't do much more to lift economic growth. They've suggested that they would like to see more fiscal stimulus to boost real GDP growth as well as productivity. The Fed seems to conclude that a fiscal response should boost the so-called "real neutral interest rate," which would allow the Fed to normalize monetary policy. While the latest election results show that the country is more conservative than had widely been recognized, the FOMC has remained mostly dovish with leanings toward liberal politicians. However, they now have to get along with a populist president with conservative leanings in the White House. While more than a handful of Fed officials shudder at that prospect, Trump might have appeared on the scene to make the FOMC's wishes come true by declaring a goal of doubling the rate of real GDP growth to 4% per annum. Will a Trump victory break gridlock in Washington, and will this change the mindset of the current Fed's monetary policy (slow pace of rate increases), reflecting their position that productivity growth remains sluggish? No doubt Trump's election has effectively discounted a rate hike at the December FOMC meeting, and the rallies in stocks and commodities and the selloff in bonds suggest that the markets are anticipating that tighter monetary policy will be offset by an easier fiscal policy.