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Trump Program Could Be Icing on the Economic Cake

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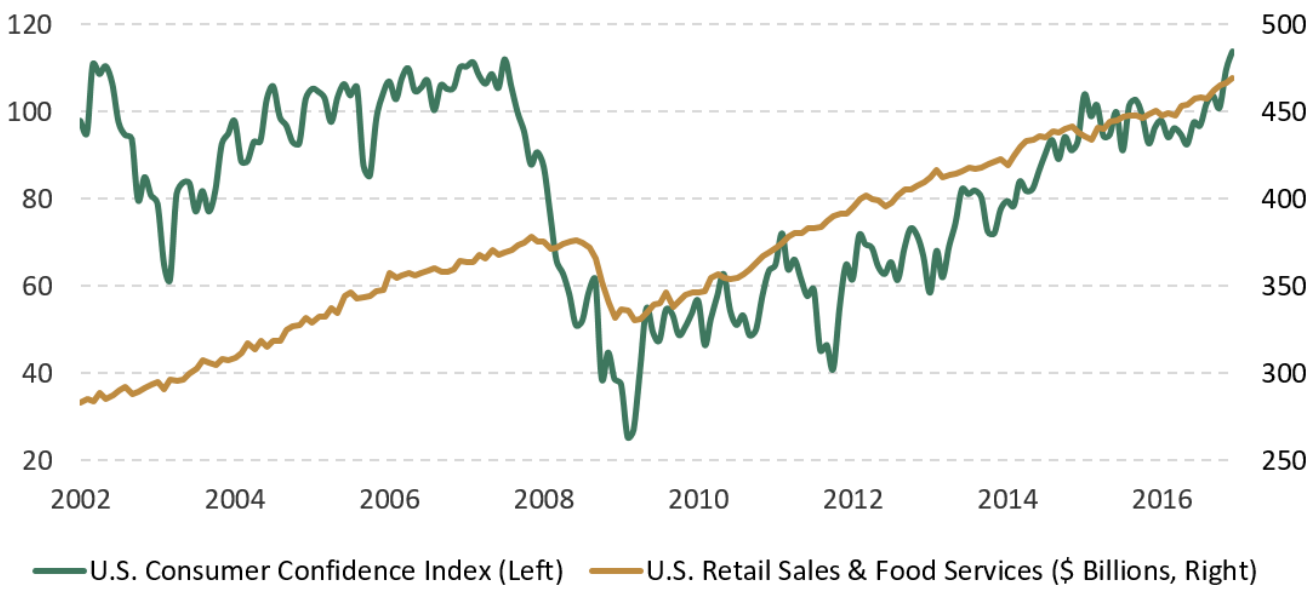
In the days following the surprise election of Donald J. Trump, “animal spirits” were unleashed. U.S. equity prices surged ahead and interest rates rose. Large company stocks have gained over 9% since the low in early November, while small company stocks, as gauged by the Russell 2000 Index, have been over 18% higher for the same time period. Meanwhile, long-term government rates increased nearly 70 basis points. Last year’s recession fears were fueled by low energy prices, a dramatic reduction in energy sector capital spending, and the strong dollar. However, even before the election, the economy was showing signs of stirring. Now, those recessionary fears have given way to an even more constructive outlook for the U.S. economy. A prevailing view is that the Trump program, once enacted, could be a boost to the U.S. economy, inflation, and the U.S. dollar, adding further momentum—the icing on the proverbial cake—to the economic recovery already underway.

Gauging the Current Outlook

It might be instructive to look at some indicators to see what they might be saying about the economy.

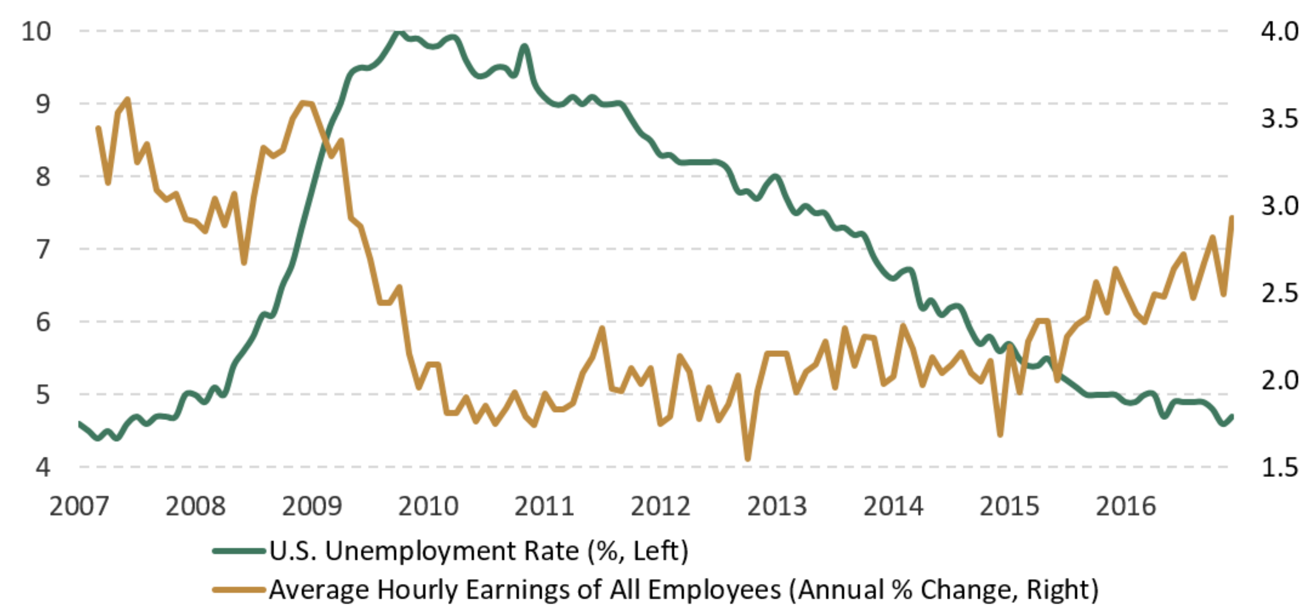
1. ***The U.S. consumer has been a driving force.*** **Even before the U.S. elections, consumer confidence (see Chart 1) had been surging ahead. Not surprisingly, retail sales have ticked higher along with the gains in confidence. Underlying consumer fundamentals point to further gains ahead for consumer spending. The current unemployment rate at 4.7% remains at a cyclical low, and earnings are now growing at a rate near 3% (see Chart 2). Consumer spending would be expected to add 1-1.5 percentage points to growth in 2017.**

Chart 1: U.S. Consumer Confidence Index & Retail Sales *As of 12/15/2016*



Source: Thomson Datastream

Chart 2: U.S. Unemployment Rate & Earnings *As of 12/15/2016*

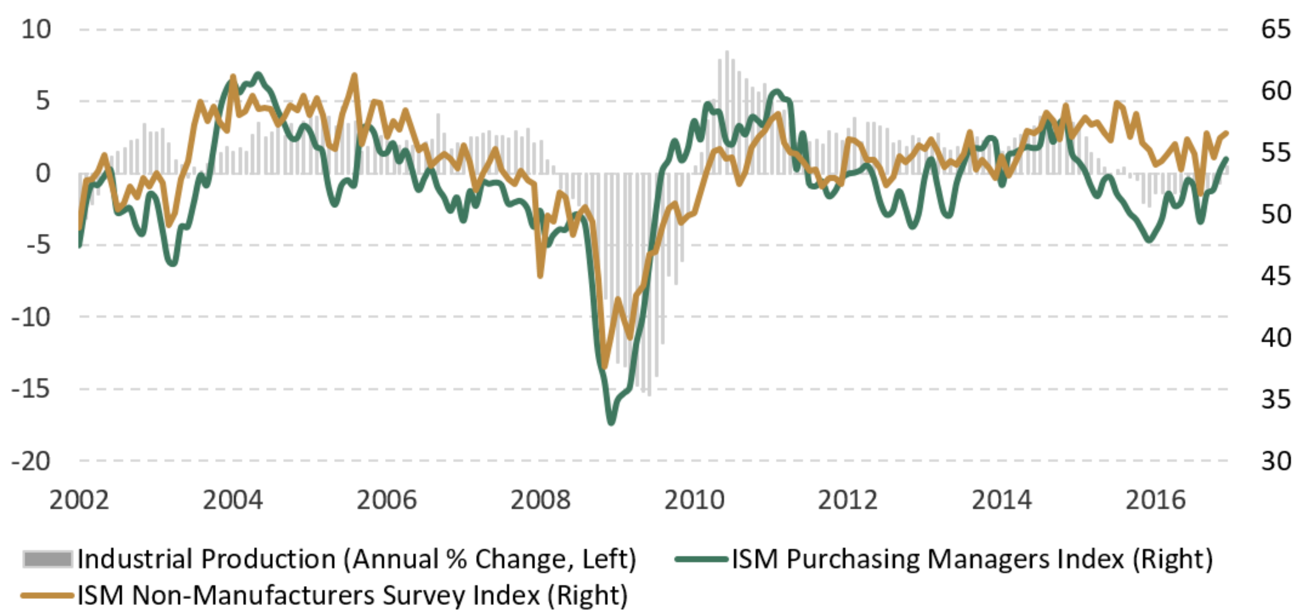


Source: Thomson Datastream

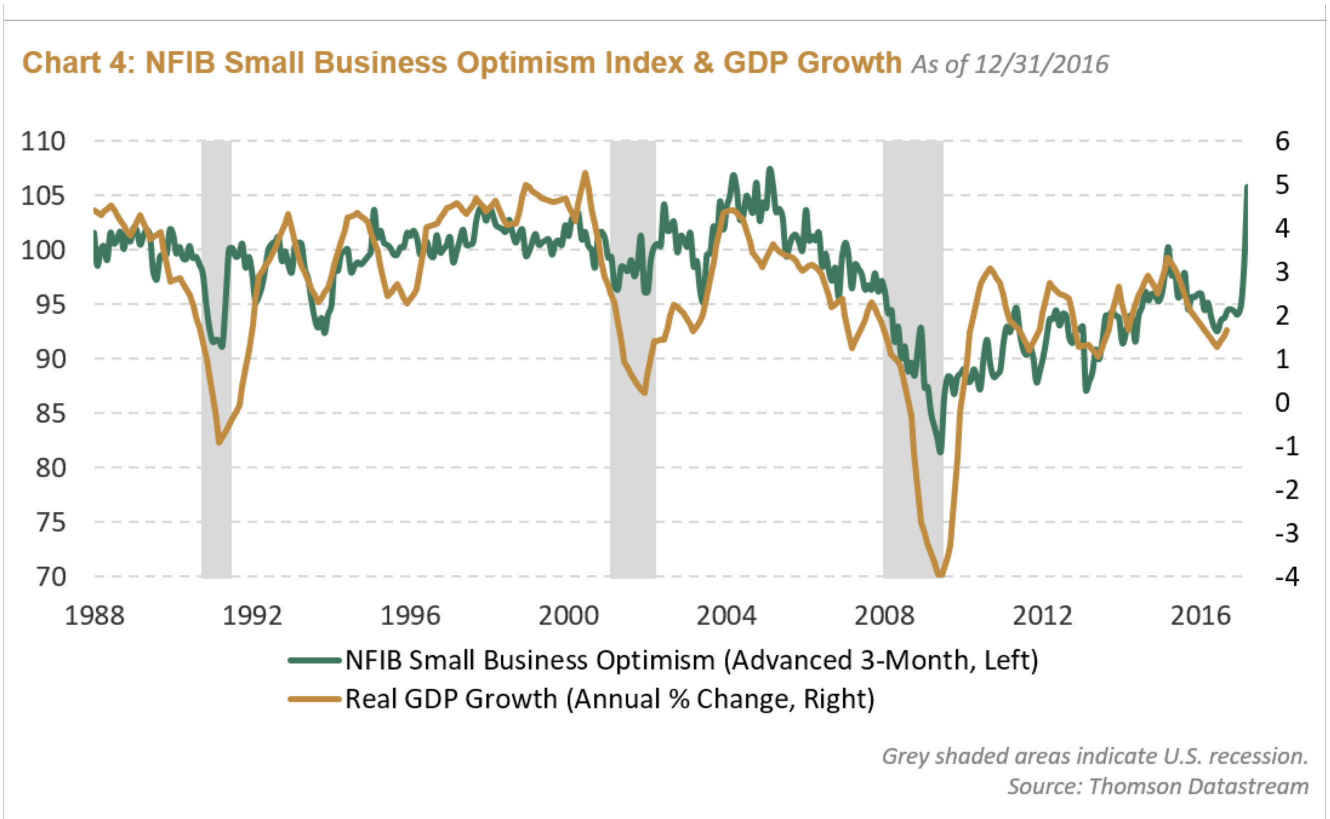
2. ***Business surveys have shown early signs of recovery.*** **The Institute for Supply Management (ISM) Purchasing Managers Indexes (PMI) bottomed in August 2016 (see Chart 3). Both manufacturing and services have moved from contracting activity to expansion. Even industrial production has recently gained, following nearly a year of contraction. However, the current level of capacity utilization does not suggest a boom in business spending. A capacity utilization rate closer to 80% would tend to be a harbinger of an improved capital spending outlook. Nonetheless, Duke University's Fuqua School of**

Business survey of CFOs does point to growth in capital spending. Commodity price gains signal a firmer economic tone. Oil prices are up over 70% from a year ago, and the Baker Hughes rotary rig count has recovered from the lows of May 2016. Small business optimism (see Chart 4) surged in December following the election and, if sustained, could contribute to stronger economic growth. Small businesses remain the backbone of the U.S. economy and a prime source of job creation. Small businesses, according to the National Federation of Independent Businesses survey, plan to increase both employment and capital spending.

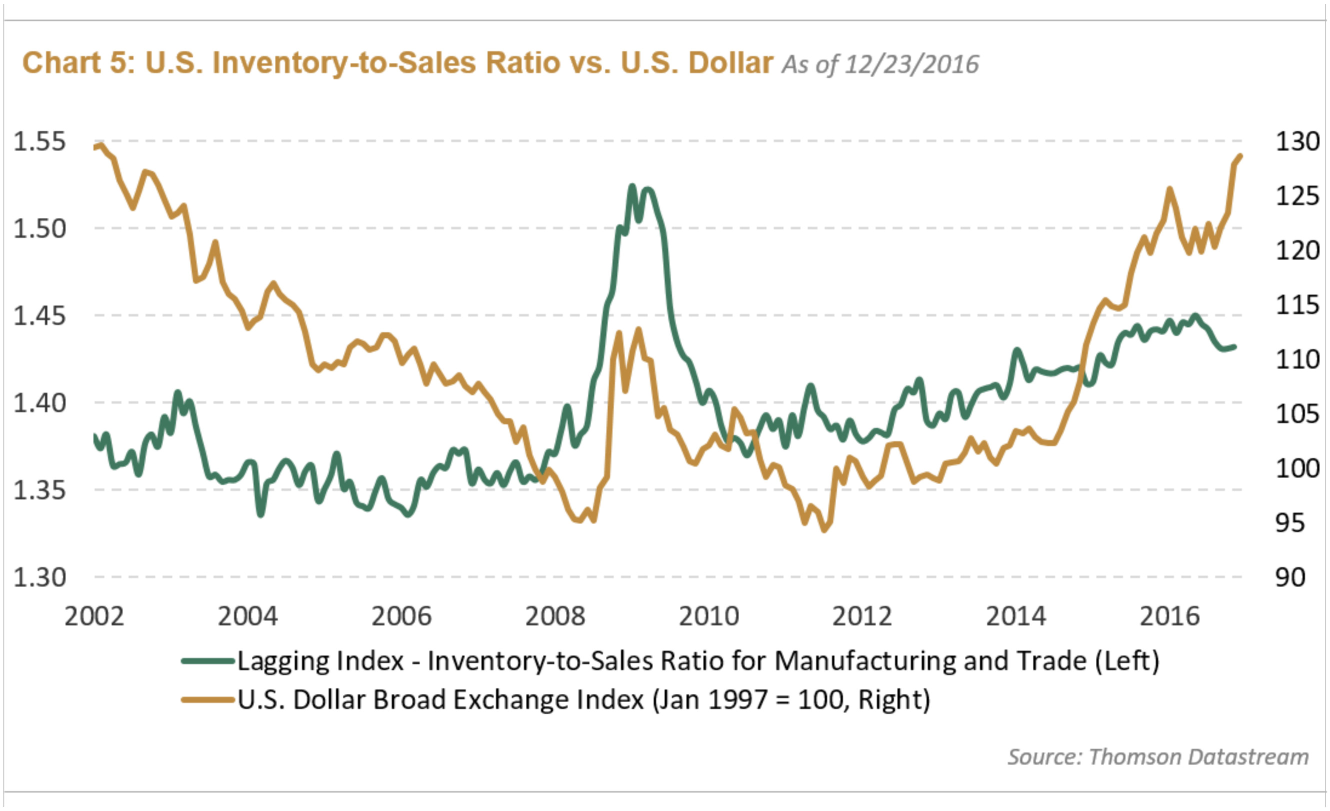
Chart 3: U.S. ISM Measures (Purchasing Managers) *As of 12/15/2016*



Source: Thomson Datastream



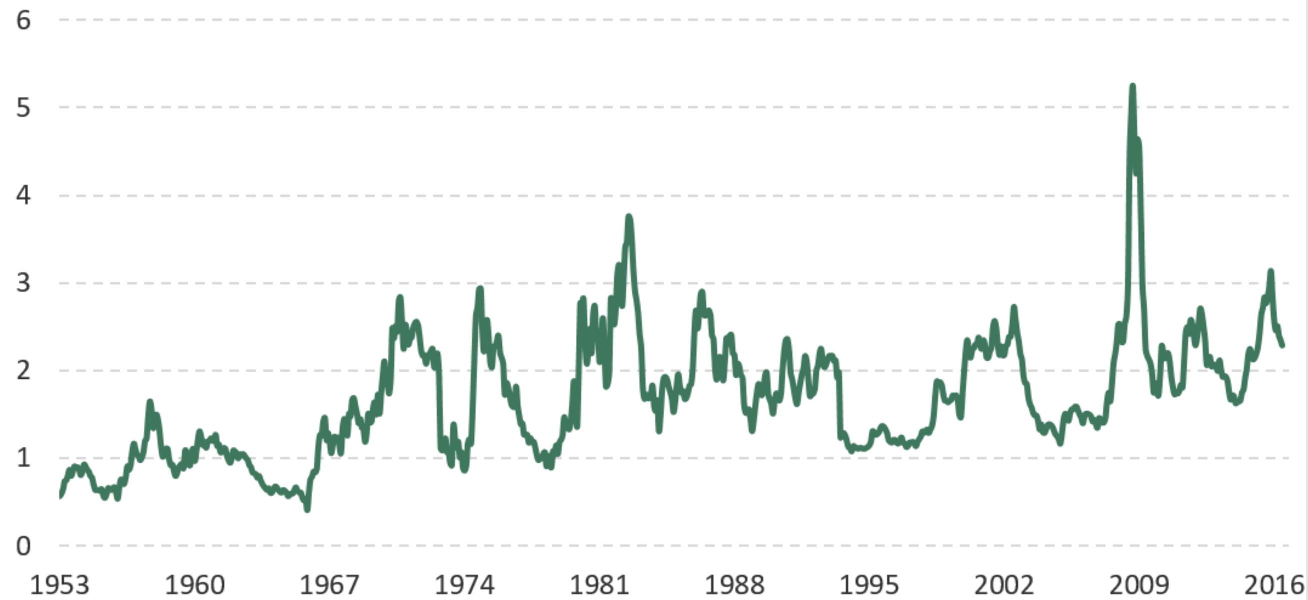
3. ***Inventory-to-sales ratio appears to have ceased rising.*** **One of the drags for the economy last year was the reduction in inventory as sales slowed (see Chart 5). Subsequently, the reduction in inventory contributed to a slowdown in economic activity. The inventory cycle appears to be turning positive for the economy. A drop in the inventory-to-sales ratio is typically interpreted as businesses not having enough inventory to meet sales. That shortfall usually spurs a pickup in production and, perhaps, more capital spending. The earlier strength of the U.S. dollar, which makes U.S.-produced goods more expensive, likely contributed to the earlier buildup in inventory. That force appears to be reversing now, as the U.S. dollar shrugs off the post-election euphoria.**



4. ***Financial conditions now are growth supportive.*** **The yield curve has begun to steepen, suggesting the system has ample liquidity to support the economy. M2 money supply is growing at a rate of over 6%. Furthermore, credit spreads have begun to contract, suggesting that investors are demanding a lower risk premium possibly due to growing confidence in the economy. The risk to supportive financial conditions is the future direction of monetary policy. The U.S. Federal Reserve (Fed) is expected to continue hiking interest rates in 2017, as the economy shows growing evidence of the better growth indicated by the metrics discussed above. Inflation has already begun moving higher, and the improved growth outlook raises expectations for higher interest rates ahead. The Taylor Rule, a forecasting model used to approximate how a central bank should alter interest rates in response to changing economic conditions, suggests that the Fed's policy rate should be much higher than it is currently.**

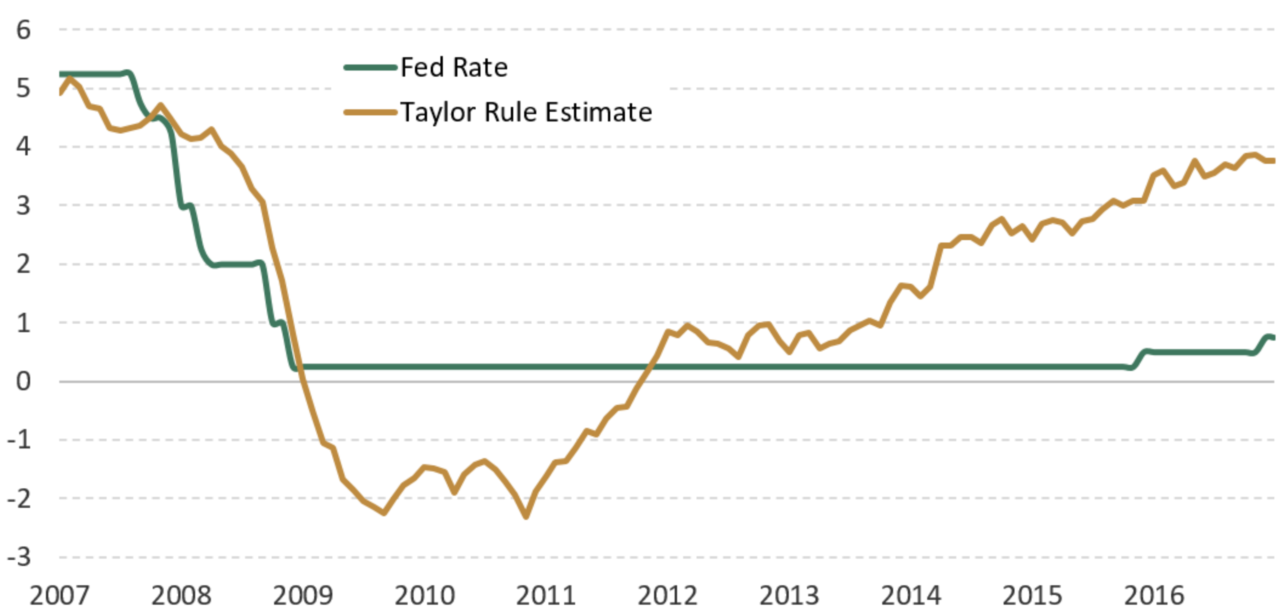
Chart 6: Moody's Bond Spread to U.S. Treasury Yield*

Corporate Bond Yield, Moody's BAA, As of 12/15/2016



**Adjusted to constant 20-year maturity.*
Source: Thomson Datastream

Chart 7: Federal Funds Rate & Taylor Rule Estimate *As of 1/23/2017*



Source: Bloomberg (© 2017, Bloomberg Finance LP)

Conclusion

Donald Trump’s surprising election victory required financial markets to factor in the new president’s program and what it could mean for economic growth. Clearly, a program that includes tax cuts, regulatory reform, infrastructure spending, and new trade policy would be expected to produce stronger growth. However, the economy was already showing signs of stronger growth prior to Trump’s inauguration. Inflation had been moving higher. The Fed had already started down a road to higher interest rates. How will Trump’s program enhance or accelerate the economic progress already underway? It is perhaps too early to speculate, since his plan remains in the embryonic stage. At face value, the Trump program, if and when it is enacted, will likely have a positive impact on U.S. economic growth, all other things being equal. The “other things being equal” include how aggressive the Fed will be in its rate-hiking program. After all, the economy as measured by the labor market is at or close to full employment, and Trump’s proposed fiscal stimulus would be implemented in the latter stage of the current economic expansion, which could be expected to contribute to inflation. However, even Fed Chair Yellen will have to see the specifics of the fiscal policy enacted before the Federal Open Market Committee (FOMC) makes a determination as to the policy response, which she asserted in her responses to reporter questions following the December FOMC meeting. Over the next weeks and months, the markets and the Fed should gain clarity on those proposals and better discern the possible economic impact. However, we would expect that his plan should enhance the improving outlook, partially in the latter half of 2017, based on how swiftly the program can be enacted, with the bulk of the impact hitting the economy in 2018.

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