

Extreme Makeover

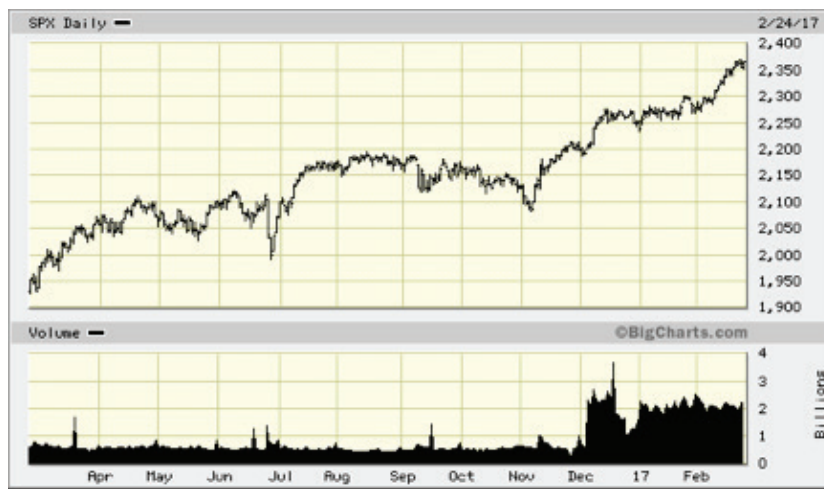
Second Pass at Trumponomics

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March 2017

Despite all of the chaos coming out of the early days of the new Trump Administration, stocks continued to rally on the prospects for “pro-growth” tax cuts, regulatory reform and infrastructure spending. (See Figure 1) However, the rally in bond yields and the dollar stalled as those markets began to exhibit a higher degree of skepticism about

President Trump’s still vague proposals and the ability of the Congress to expeditiously pass them. (See Figures 2 and 3) As a result we have pushed back the effective date of the tax cuts to the first quarter of 2018 compared to the third quarter of 2017 that we previously forecast.¹

Figure 1 S&P 500, Feb. 25, 2016 - Feb. 24, 2017, Daily Data



Sources: Standard and Poor's via Bigcharts.com

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Figure 2 10-Year U.S. Treasury Bond Yield, Feb. 25, 2016 - Feb. 24, 2017, Daily Data



Sources: Bigcharts.com

Figure 3 Dollar Index, Feb. 25, 2016 - Feb. 24, 2017, Daily Data



Sources: Bigcharts.com

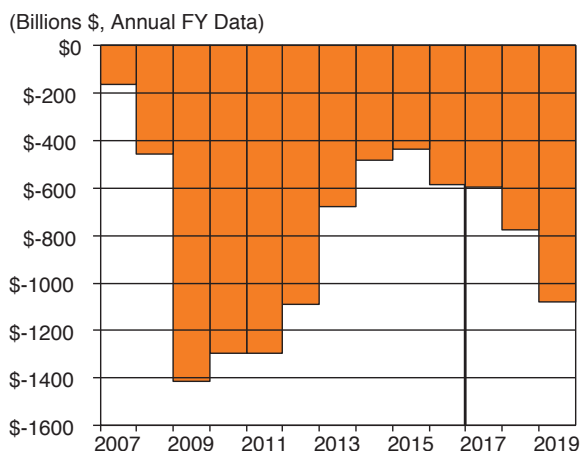
Similar to last quarter, we are still penciling in about \$500 billion/year in personal and business tax reductions, a repatriation holiday for accumulated foreign earnings, increased defense and infrastructure spending, Medicaid cuts, relaxed regulations, modest changes to trade and immigration policies, and reductions in food and aircraft exports as several trading partners react to the policy changes. It remains to be seen to what extent the Affordable Care Act will be amended and its impact on the giant healthcare sector. Further, because of the controversy that it has engendered, we do not believe that Congress will pass a border adjustment import tax combined with exempting export sales from corporate taxation.

We have, however, become more concerned about the administration's tone with respect to trade and immigration policies. The changes could be far more drastic than what we are now anticipating, thereby increasing the risk level to our forecast. The roll-out of the administration's partial travel ban and the scandal surrounding the firing of the national security advisor certainly were not confidence building measures.

Trillion Dollar Annual Deficits Ahead

The impact of a large tax cut on an economy at or very close to full employment will be to explode the federal deficit. We expect the federal deficit to exceed a trillion dollars in 2019 which would amount to about 5% of GDP. (See Figure 4) Simply put, there is not enough slack in the economy to enable the 4% economic growth the administration is calling for and it will likely lead to more inflation.

Figure 4 Federal Deficit, FY2007 - FY2019F

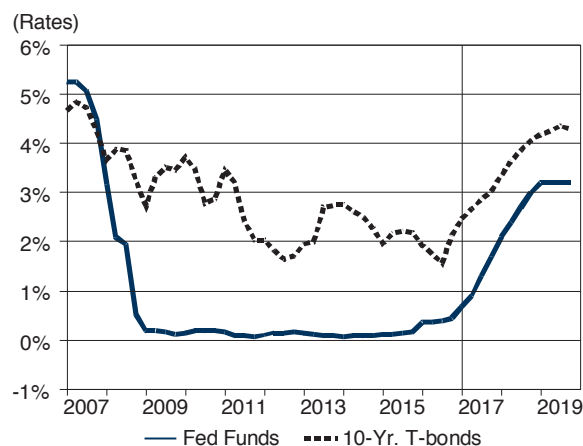


Sources: Office of Management and Budget and UCLA Anderson Forecast

The Fed will become More Aggressive

As of April there will be three vacancies on the seven member Federal Reserve Board which will likely be filled by more hawkish and less economics-oriented members. The era of the very easy Bernanke-Yellen Fed is over and that will be confirmed when Chair Yellen's term expires in January 2018. Moreover, with inflation rising we expect that even under Chair Yellen the Fed will become more active in raising the Fed Funds rate and we believe that the Federal Open Market Committee will increase the fed funds rate by 25 basis points in March. By yearend, the funds rate is expected to approach 2% and reach 3% by the end of 2018. (See Figure 5) Similarly the yield on 10-year U.S. Treasury bonds is forecast to increase to 3% by yearend and exceed 4% by yearend 2018.

Figure 5 Federal Funds vs. 10-Year Treasury Bonds, 2007Q1 - 2019Q4F



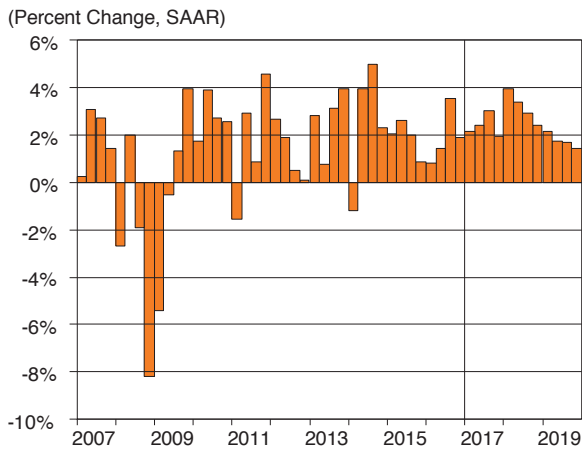
Sources: Federal Reserve Board and UCLA Anderson Forecast

2018 GDP Growth Spike that Fades

With \$500 billion in tax cuts arriving in the first quarter of 2018 we expect a short-term growth spike that will soon fade as the economy bumps against its full employment ceiling. Our forecast calls for real GDP growth of 2.4%, 3.0% and 2.2% annual growth in 2017, 2018 and 2019, respectively. (See Figure 6) And note that real growth really trails off on a quarterly basis in 2019 as higher interest rates weigh on the economy. As we noted last quarter, in order for growth to be sustained at 3%, the economy requires a "productivity miracle." The administration believes that its

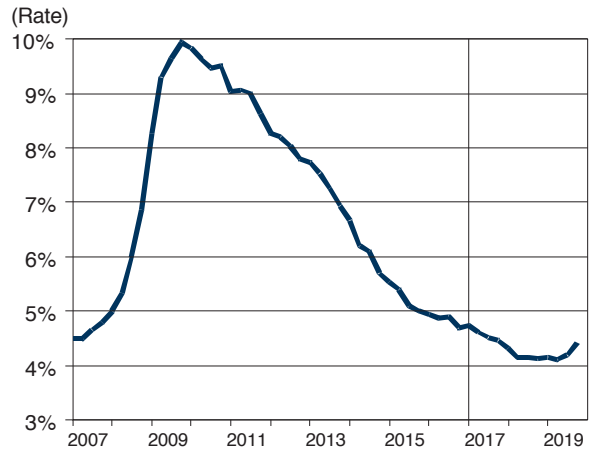
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Figure 6 Real GDP Growth, 2007Q1 - 2019Q4F



Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 8 Unemployment Rate, 2007Q1 - 2019Q4F



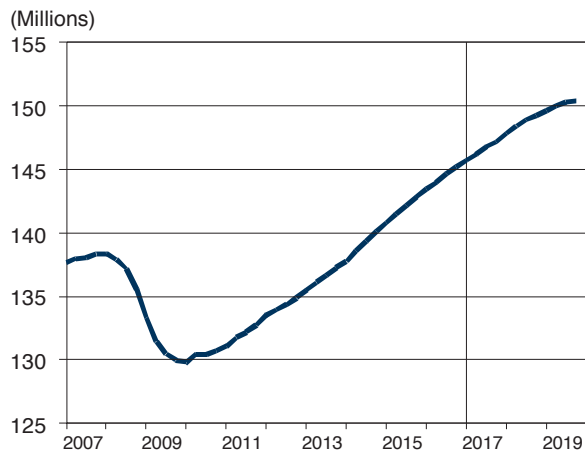
Sources: U.S. Bureau of Labor Statistics, UCLA Anderson Forecast

tax and regulatory reforms will enable a sustainable growth pick up. We, on the other hand, remain skeptical, but, of course, we can't rule it out.

In this environment, the labor market will remain robust with job growth coming in on the order of 170,000 a month in 2017 and 2018, before trailing off to about 110,000 a month in 2019. The recent increase in the labor force participation rate has made us more optimistic about job growth over the near-term. (See Figure 7) In tandem with

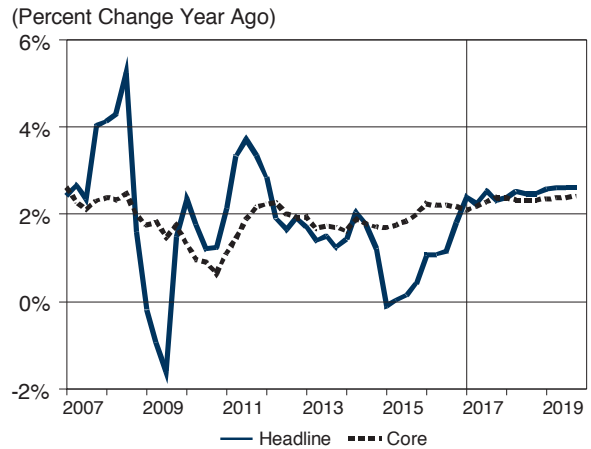
the job gains the unemployment rate now looks like it will bottom out at 4.1% in late 2018, before gradually rising. (See Figure 8) Of course, if the administration embarks on a large scale deportation program for unauthorized immigrants, employment growth will be far slower than what we are now forecasting. Moreover, should the administration restrict the issuance of H1-B visas for highly-skilled immigrants, there would be negative consequences for high-technology industries.

Figure 7 Payroll Employment, 2007Q1-2019Q4F



Sources: U.S. Bureau of Labor Statistics, UCLA Anderson Forecast

Figure 9 Consumer Price Index, Headline vs. Core Inflation, 2007Q1-2019Q4F

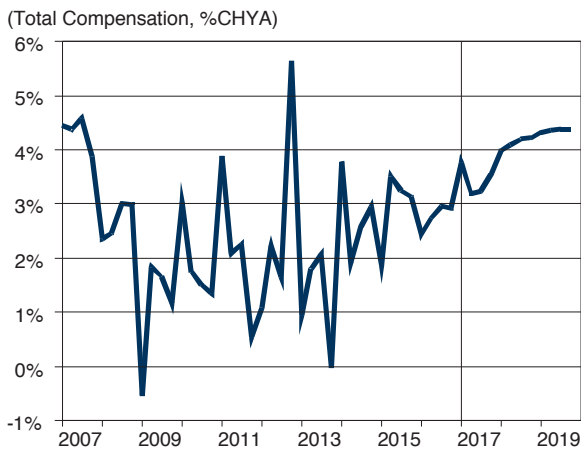


Sources: Bureau of Labor Statistics, UCLA Anderson Forecast

Inflation on the Rise

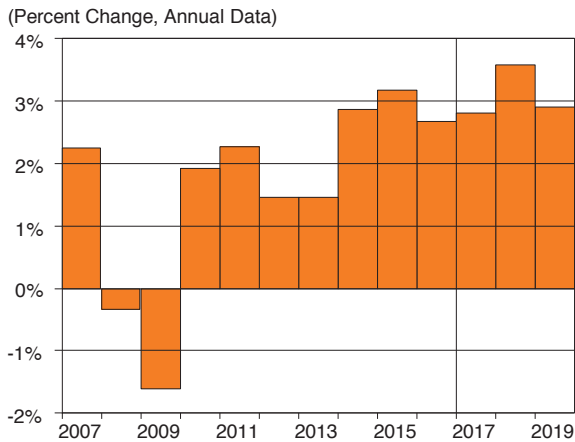
Both headline and core inflation rates as measured by the consumer price index are already increasing at a 2%+ clip. It will not take much for inflation to ramp up to between 2.5% - 3%. (See Figure 9) Oil prices continue to rebound and the very tight labor market will bring with it rising wages. (See Figure 10) Although we were too early in our prior forecasts in predicting accelerating wage inflation, we now believe that the table has been set for sustained 4% annual increases in compensation. We believe that the unusually slow 0.1% increase in average hourly earnings reported for January was a fluke and it was inconsistent with other labor market data.

Figure 10 Compensation/Hour, 2007Q1 - 2019Q4



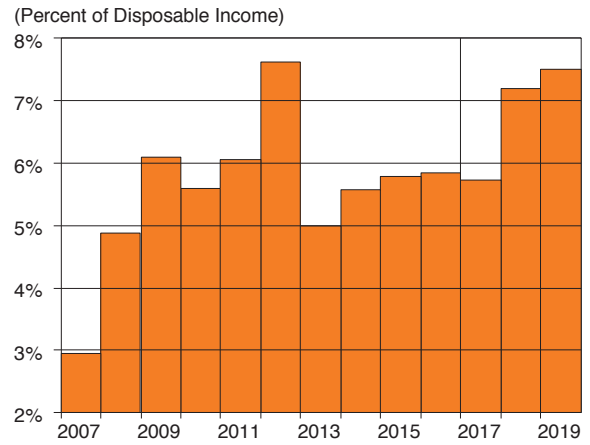
Sources: U.S. Bureau of Labor Statistics, UCLA Anderson Forecast

Figure 11 Real Consumption Spending, 2007 - 2019F



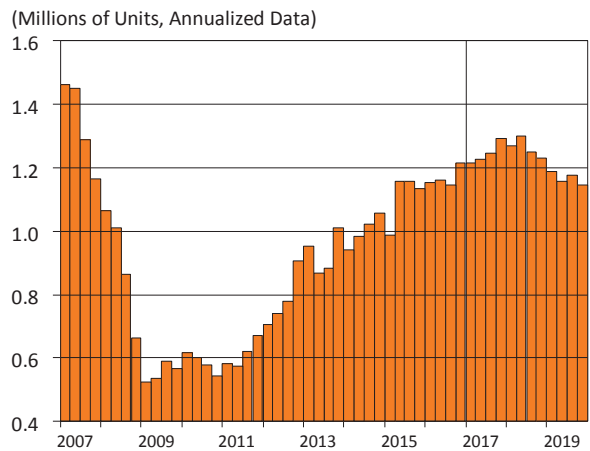
Sources: U.S. Department of Commerce, UCLA Anderson Forecast

Figure 12 Saving Rate, 2007 - 2019F



Sources: U.S. Department of Commerce, UCLA Anderson Forecast

Figure 13 Housing Starts, 2007Q1 - 2019Q4F



Sources: U.S. Bureau of the Census, UCLA Anderson Forecast

Consumer Spending Strong, but Housing Stalls

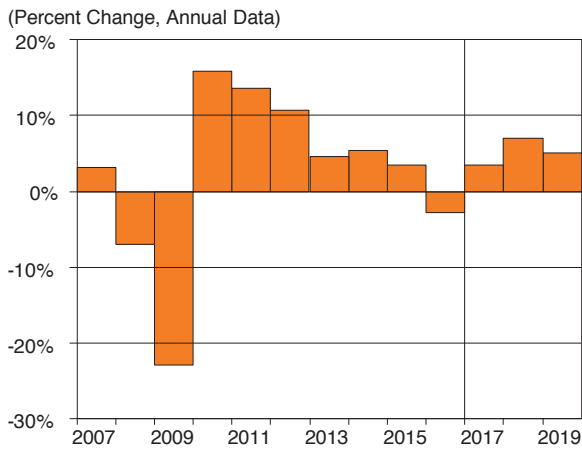
The growth in consumer spending has been strong since 2014 and automobile sales have been running at a record rate. (See Figure 11) Now throw in a large tax cut and real consumer spending will ramp up from a forecast 2.8% increase this year to 3.6% in 2018. In this tax cut fueled environment, the saving rate will exceed 7%. (See Figure 12) However, housing starts will plateau out in the 1.2 – 1.3 million unit range. (See Figure 13) Simply put, the rise in interest rates will offset the positive factors of higher employment and wages. By 2019, the rate on the 30-year fixed rate mortgage is forecast to exceed 6%, up from the current 4.25% and the recent low of 3.5%. Moreover, because there

are numerous signs that high income multi-family housing is becoming over-supplied, that once white hot sector of the economy will soon cool.

Capital Spending Rebounds in the Face of Export Weakness

With the prospect of a general reduction in corporate income taxes and the likelihood of 100% expensing, equipment spending is forecast to rebound from a 2.8% decline in 2016 to increases of 3.5% and 7.1% in 2017 and 2018, respectively. Equipment spending will also be buoyed by the recovery in oil and gas drilling being spurred on by the rebound in oil prices.

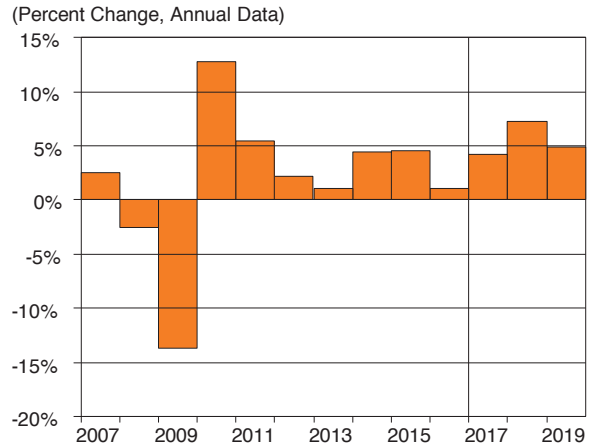
Figure 14 Real Equipment Spending, 2007 - 2019



Sources: U.S. Department of Commerce and UCLA Anderson Forecast

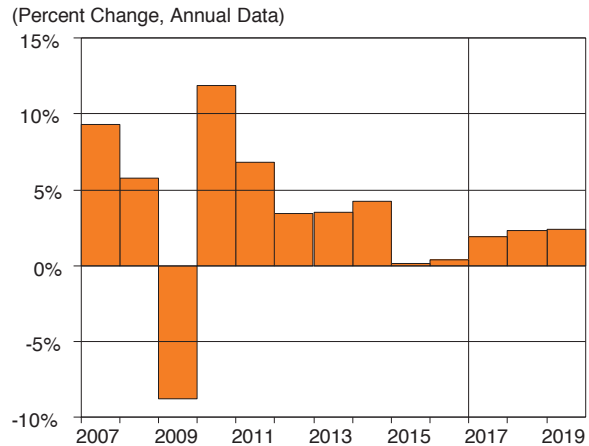
On the other hand, despite all of the rhetoric coming out of the administration, the strong dollar and the large tax cuts will ignite an import boom. After increasing by only 1.1% in 2016, imports will increase by 4.3% and 7.3% in 2017 and 2018, respectively. (See Figure 15) On the other hand, export growth will be minimal as the high dollar and retaliation from the administration’s protectionist views by some of our trading partners will limit export growth especially in the aircraft and agricultural sectors. (See Figure 16)

Figure 15 Real Imports, 2007-2019F



Sources: U.S. Department of Commerce, UCLA Anderson Forecast

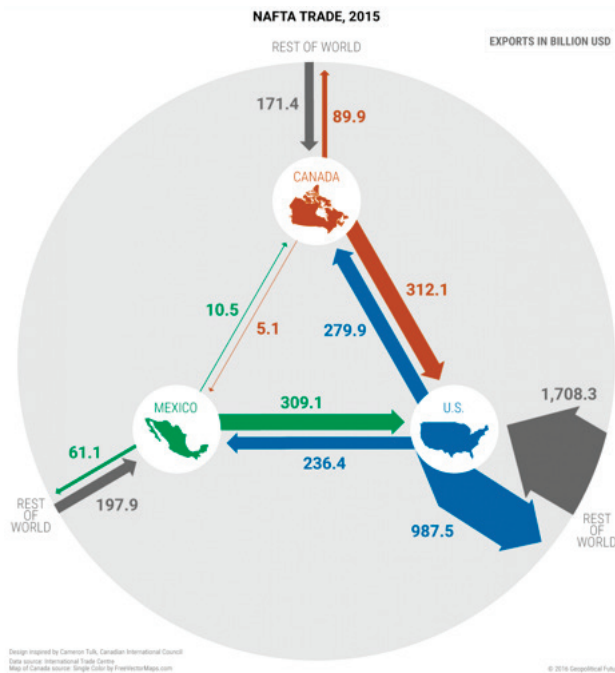
Figure 16 Real Exports, 2007-2019F



Sources: U.S. Department of Commerce, UCLA Anderson Forecast

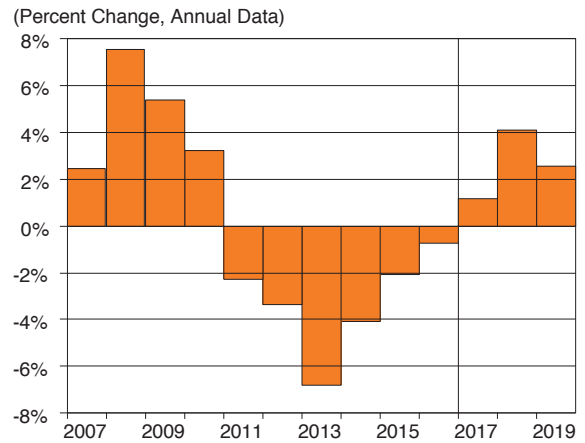
Moreover, the administration’s outspoken hostility to NAFTA, especially with respect to Mexico risks a major disruption in economic activity. In 2015, the U.S. exported \$236 billion to Mexico while importing \$309 billion. Aside from disrupting supply chains, a significant reduction in U.S.-Mexico trade would have significant macroeconomic effects. (See Figure 17)

Figure 17 Schematic of NAFTA Trade



Source: Geopolitical Futures

Figure 18 Real Defense Purchases, 2007 -2019F



Sources: U.S. Bureau of the Census and UCLA Anderson Forecast

Conclusion

We continue to believe that the election of Donald Trump represents a major regime change with respect to economic policy. We expect significant reductions in personal and corporate income taxes along with a relaxing of regulation in the energy, environmental and financial arenas. **However, because the economy is already operating at or close to full employment, the growth spurt caused by the policy changes will be short-lived but the deficits that they create will be with us for a long time.** Moreover, the policy changes will elevate both inflation and interest rates that will have a negative effect on the housing sector.

Because of the Trump administration’s rocky start, we have become more concerned about the risks associated with their stated trade and immigration policies. For the time being, we have not modeled in serious trade disturbances with our major trading partners and a reduction in the labor force caused by a significant change in deportation policies. Nevertheless, those risks are rising.

Defense Spending on a Roll

As we have been discussing for several years, the geopolitical threats coming from Russia, China, Iran and ISIS will force the U.S. to increase defense spending. After six years of real declines, defense purchases are forecast to increase by 1.2% in 2017 and then increase by 4.1% and 2.5% in 2018 and 2019, respectively. (See Figure 18) As we noted last quarter, this is one spending priority that is expected to receive broad support, especially with the increased hostility toward Russia coming from the Democratic Party. Further, with the administration pressing NATO members to increase defense spending to 2% of GDP, domestic defense outlays will be augmented by increased international demand.

1. See Shulman, David, “First Pass at Trumponomics: From a Reckless Monetary to a Reckless Fiscal Policy,” UCLA Anderson Forecast, December 2016.