First Pass at Trumponomics:
From a Reckless Monetary Policy to a Reckless Fiscal Policy

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Contrary to prior expectations, stocks soared and interest rates surged on the election of Donald Trump. (See Figures 1 and 2) It seems that both the stock and bond markets were pricing in the radical reversal in fiscal policy occasioned by his election while ignoring the negative impacts of his immigration and trade policies. Put bluntly, the markets are now anticipating stronger real growth, and at least for a while, higher inflation and higher interest rates. We believe that the markets have got it right with respect to direction.

Our first pass at Trumponomics, which still remains quite vague, makes the following policy assumptions:

- $300 billion/year annual mostly higher-end personal tax cuts effective in Q3.
- $200 billion/year corporate tax cut effective in Q3 with $50 billion of revenues associated with the repatriation of foreign earnings that quarter.

Figure 1 S&P 500, Nov. 26, 2015 - Nov. 26, 2016, Daily Data

Sources: Standard and Poor's via Bigcharts.com

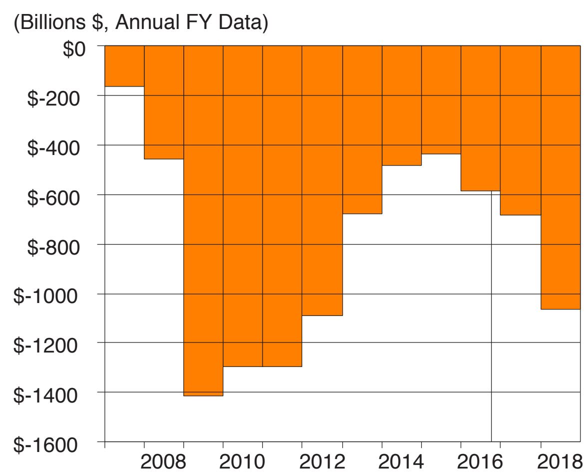
Figure 2 10-Year U.S. Treasury Bond Yield, Nov. 26, 2015 – Nov. 25, 2016, Daily Data

Sources: Bigcharts.com

- $20 billion/year infrastructure program effective in Q4.
- $20 billion in higher defense spending in 2018.
- $20 billion/year Medicaid/ACA cuts effective in Q4.
- Relaxed energy, environmental and financial regulation.
- Modest changes to immigration except for border wall/ fence.
- Modest changes to trade policy yielding net reductions in food and aircraft exports phasing in starting mid-2017.

The net result is a massive fiscal stimulus on an economy at or very close to full employment and is directionally what a host of liberal economists have been advocating for the past five years. To be sure the mix of tax cuts and spending is far different from what they desired, but make no mistake this is real or even reckless fiscal stimulus. How so? **The federal deficit will roughly double to over one trillion dollars by 2018**. (See Figure 3) Simply put, an economy operating at full employment should not have a deficit equal to 5% of GDP; the budget should be in balance or in surplus. Thus, in the next recession the federal deficit will make the deficits associated with the financial crisis look small. **In a way going policy will be the mirror image of the past five years as the reckless zero interest rate/QE policy gives way to its fiscal equivalent**. Further, Europe will follow the U.S. with more aggressive fiscal policies to meet the growing populist challenge.

Figure 3 Federal Deficit, FY2007-FY2018F

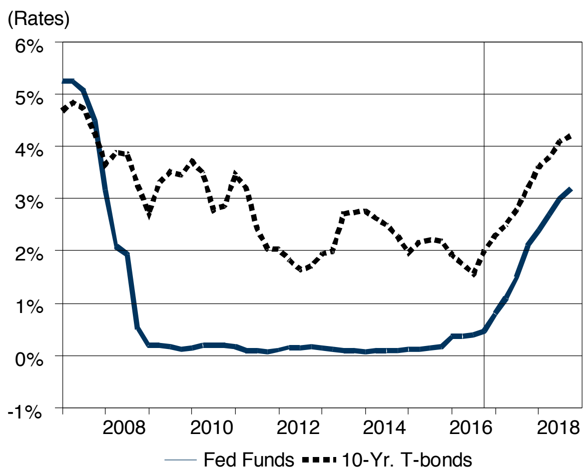


Sources: Office of Management and Budget and UCLA Annual Forecast

In response to higher inflation and the exploding federal deficit, the long quiescent Fed will become more aggressive with respect to monetary policy. This month's expected increase in the federal funds rate will be followed up with many more pushing the rate up to above 2% by the end of 2017 and above 3% by the end of 2018. (See Figure 4) **Remember President Trump has two vacancies to fill right away and Chair Yellen's term expires in January 2018**. Trust me, we will have a much different Fed under

President Trump. Similarly, the yield on 10-year U.S. Treasury Bonds is forecast to exceed 3% by the end of 2017 and 4% by the end of 2018. **We know this sounds aggressive but it looks like we are in for, what economists call, a regime change**.

Figure 4 Federal Funds vs. 10-Year U.S. Treasury Bonds, 2007Q1 -2018Q4F

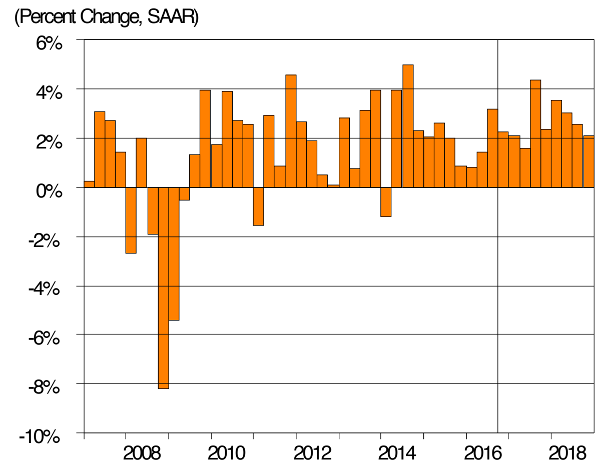


Sources: Federal Reserve Board and UCLA Anderson Forecast

With $500 billion in tax cuts arriving in the third quarter of 2017, we expect economic growth to accelerate from the recent 2% growth path to 3% for about four quarters. Thereafter, growth will slip back to 2%. (See Figure 5) Why so little? First it is hard to stimulate an economy operating at about full employment and second the higher interest rates we foresee will begin to bite. In order to maintain 3% growth or higher the economy will need a productivity miracle. Whether that will come, as the Trump partisans expect, from the supposed supply-side effects of the tax cuts and the proposed regulatory reforms, remains to be seen. We would also note that our forecast is likely higher than what Trump's Democratic opposition would expect.

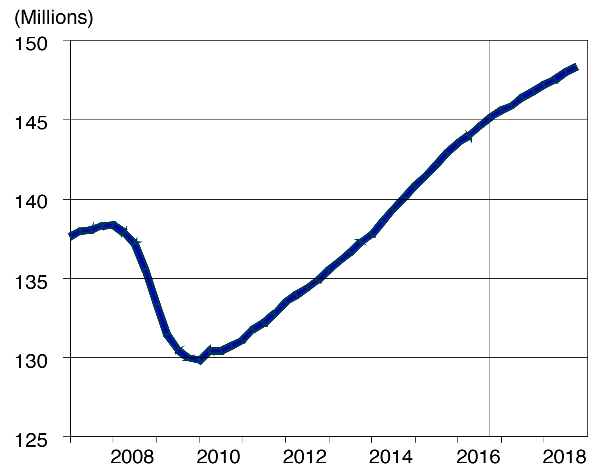
In this environment, employment will continue to grow with job growth on the order of 140,000 a month in calendar 2017 and 120,000 a month in calendar 2018. (See Figure 6) **To be sure, if the new administration follows through with its campaign rhetoric to engage in mass**

Figure 5 Real GDP Growth, 2007Q1-2018Q4F



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

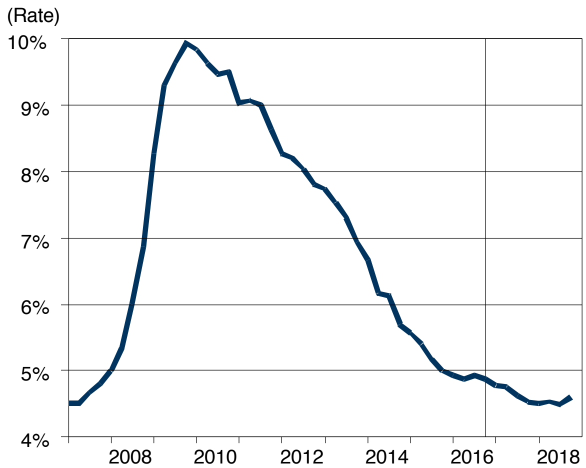
Figure 6 Payroll Employment, 2007Q1-2018Q4F



Sources: Bureau of Labor Statistics, UCLA Anderson Forecast

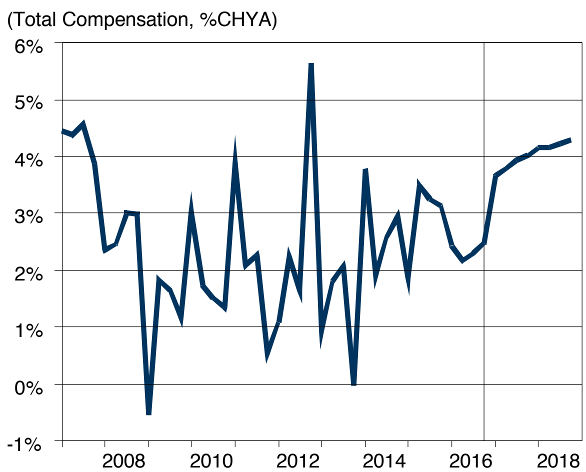
deportations then job growth and the economic activity associated with it would be far slower than what we forecast. The unemployment rate is forecast to fall to around 4.5% by the end of 2017 and remain there through 2018. (See Figure 7) Further, as the labor market tightens wage growth will accelerate to 4% or more from the middle of 2017 on. (See Figure 8)

Figure 7 Unemployment Rate, 2007Q1-2018Q4F



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

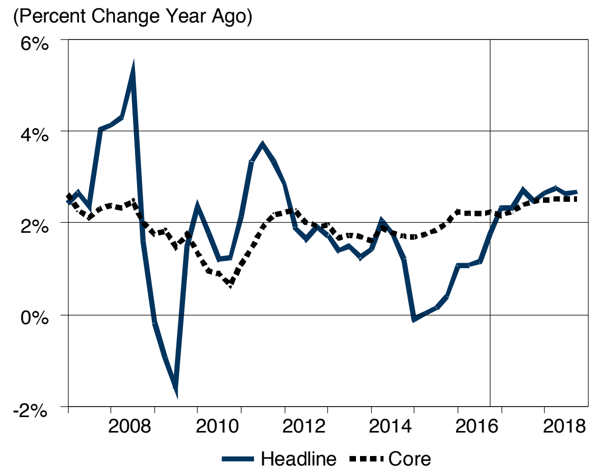
Figure 8 Compensation/Hour, 2007Q1-2018Q4F



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

With year-over-year core inflation already rising above 2%, it should be no surprise to anyone that this rate will accelerate to at least a 2.5% pace; a forecast we view as conservative. (See Figure 9) As oil prices rebound, headline inflation will approach 3%. Therefore if we are roughly right about the economy operating at full employment with an unemployment rate of 4.5%, inflation exceeding 2.5% and

Figure 9 Consumer Price Index, Headline vs. Core Inflation, 2007Q1-2018Q4F



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

the prospect of a one trillion dollar annual federal deficit, it should surprise no one that interest rates would be heading much higher.

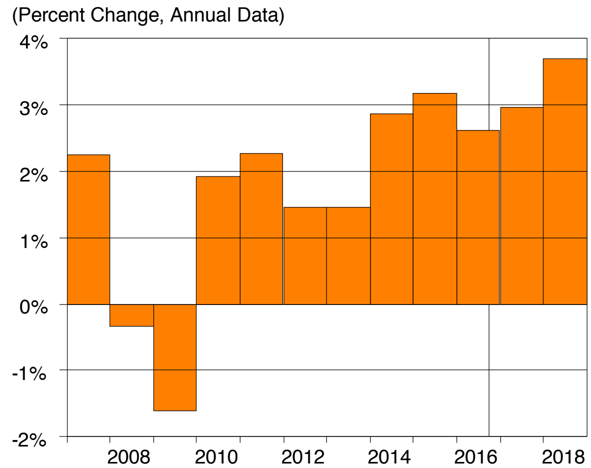
The Good, the Bad and the Ugly

The Good

The economic growth we envision will be powered by rising consumption, equipment and defense spending. Real consumption spending is forecast to increase at 3% and 3.7% in 2017 and 2018, respectively compared to 2.6% this year. (See Figure 10) Consumption growth will be dampened by an increase in the saving rate as high-end consumers stash some of their tax savings and benefit as well from the rise in interest rates. (See Figure 11) The saving rate rises from 5.7% in 2016 to 7.6% in 2018.

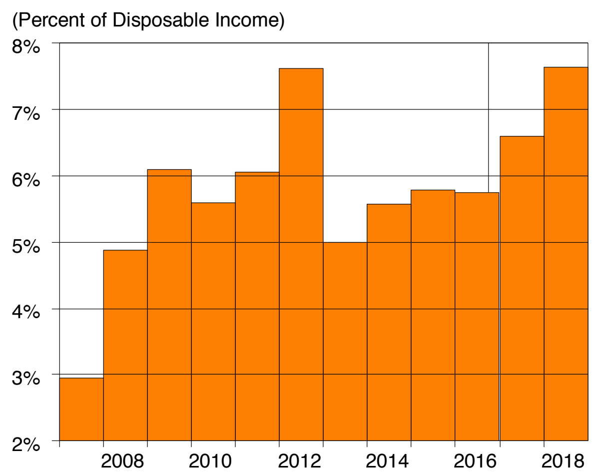
Responding to lower corporate taxes and the likelihood of 100% expensing for tax purposes, equipment spending is forecast to rebound from a 2.2% decline in 2016. Although we may be on the conservative side here, we are forecasting increases of 4.5% and 6% in 2017 and 2018, respectively. (See Figure 12) Although the Trump plan includes 100% expensing for buildings along with the elimination of the business interest deduction, we are not

Figure 10 Real Consumption Spending, 2007 -2018F



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

Figure 11 Saving Rate, 2007–2018F

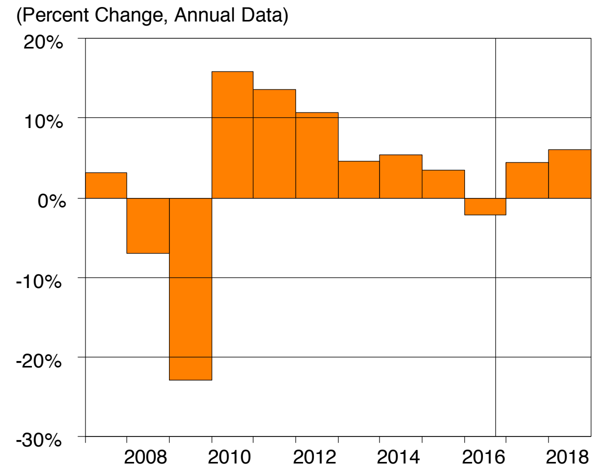


Sources: U.S. Department of Commerce, UCLA Anderson Forecast

sure this part of the plan will be enacted. This aspect of his plan raises a host of issues too geeky to discuss here.

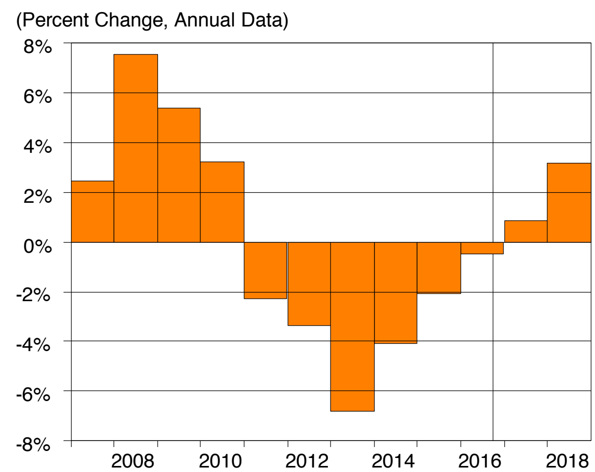
We have been forecasting a turnaround in defense purchases over the past two years. With the election of President Trump, it is upon us. After declining six years in a row, real defense spending is forecast to increase by 0.8% and 3.2% in 2017 and 2018, respectively. (Figure 13) This is one spending priority that is expected to achieve broad support.

Figure 12 Real Equipment Spending, 2007–2018



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

Figure 13 Real Defense Purchases, 2007–2018F

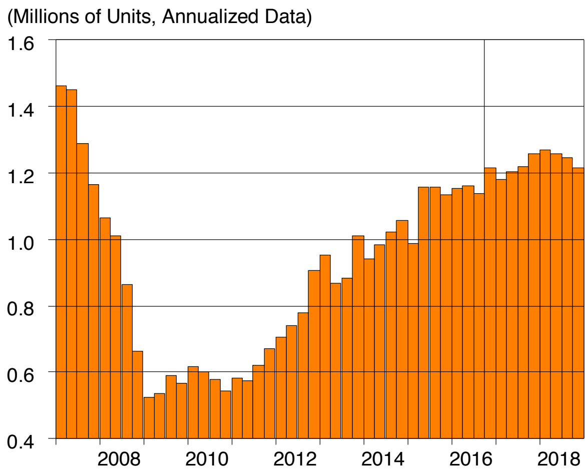


Sources: U.S. Department of Commerce, UCLA Anderson Forecast

The Bad

Housing activity will likely be a casualty of the economic environment we envision. The speed of the recent spike in long-term interest rates and the prospect of further increases will dampen housing demand. Instead of the 1.4 million level of housing starts that we were previously looking for in 2017 and 2018, we are now looking for a far more modest level of starts in 1.2 million – 1.25 million range. (See Figure 14) To be sure, this is an increase from 2016's estimated 1.17 million starts, but far below what we perceive to be underlying demographic demand of 1.5 million units per year.

Figure 14 Housing Starts, 2007Q1-2018Q4F



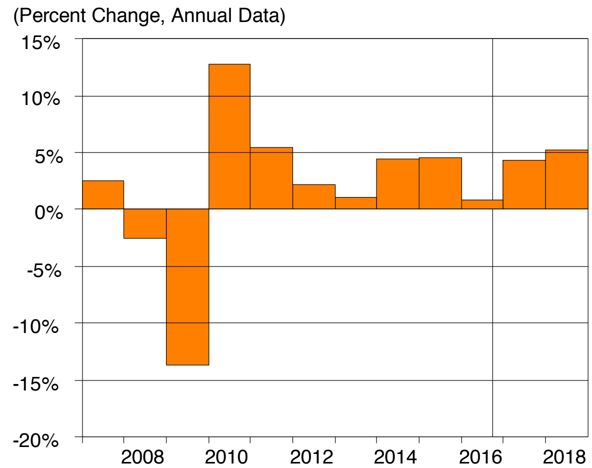
Sources: U.S. Bureau of the Census and UCLA Anderson Forecast

The Ugly

Although President-elect Trump raged against imports and the trade deficit during the campaign, it looks like he will come up woefully short. Why? The consumer boom that his tax cuts will ignite will inevitably suck in imports. Further, the change in policy mix from monetary policy to fiscal policy triggered a rally in the dollar making imports cheaper and exports more expensive. **Recall where we started, we are not assuming a major trade war with our partners around the world. If we are wrong here we are likely wrong everywhere**. We are assuming that there will be minor tweaks to trade policy that would modestly reduce imports (mostly in the auto sector) and trigger modest retaliatory actions affecting aircraft and farm exports. As a result, imports continue to rise and exports flat-line. (See Figure 15 and 16)

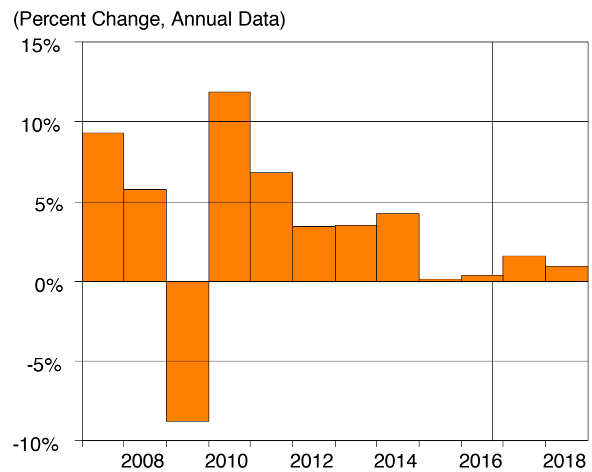
The slowdown in trade that we envision is, unfortunately, only the beginning as the broad postwar consensus favoring open markets has broken down. The bi-partisan collapse of the Trans Pacific Partnership (TPP) and the Brexit vote signaled that we are moving to a more protectionist world and the age of ever increasing globalism is over, at least for now. The world will be a poorer place for it.

Figure 15 Real Imports, 2007-2018F



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

Figure 16 Real Exports, 2007-2017F



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

A Note on Infrastructure Spending

We do not believe that President-elect Trump's tax credit-based infrastructure plan will pass muster in Congress on the scale he is looking for. Simply put, he is proposing $137 billion in tax credits for private investors to fund major infrastructure projects. The problem is that in order for this to work it requires a revenue stream and there aren't any revenue streams associated with highway, bridge and tunnel, wastewater and transit maintenance. Thus we anticipate a more traditional infrastructure program amounting to a more modest $20 billion dollars a year of direct taxpayer funding.

We could very well be low here, but it will take time for an expanded infrastructure program to ramp up.

Nowadays, as President Obama discovered to his chagrin, there are very few “shovel ready” infrastructure projects around awaiting funding. We live in a world of environmental impact studies and Davis-Bacon Act labor codes regarding prevailing wages. Thus, if the President-elect wants quick action, Congress would have to waive or fast-track the environmental requirements and waive provisions of the Davis-Bacon Act. This would be a tough sell for the Democrats, but the Republicans are in the majority.

A Note on the Deficit

Several of my colleagues have cautioned me about the so-called “deficit hawks” in the Republican Party who would fight fiercely against the projected one trillion dollar deficit we are calling for in 2018. My response is that the Republicans want Trump to succeed and they won’t fight him. This is very similar to the evangelical wing of the Republican Party holding its nose and supporting Trump, whose life story certainly raised serious questions for that faction, in the general election against Hillary Clinton. Moreover, the Trump Republican Party is not the party of Reagan; it is more a Jacksonian working class party that cares more about jobs than deficits.

Conclusion

The election of Donald Trump signaled a major regime change in economic policy. We are transitioning from a reckless monetary policy to a reckless fiscal policy. In the short run that will bring with it more real growth and inflation along with higher interest rates. However, because the economy is operating at or close to full employment, the growth spurt will be short-lived and we will return to the 2% growth economy of the past seven years. However, we will be left with mega-deficits that will make it more difficult to fund the retirement and health programs that voters expect. And the real risk is that a more aggressive Trump Administration trade policy would trigger a growth killing trade war. Thus we would caution that because there are so many ill-defined moving parts there is a higher degree of uncertainty in this forecast compared to prior ones.