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THE UNITED STATES POST-ELECTION

"People like changing masters, always hoping to find someone better", Machiavelli

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Bruno Desgardins ***8 November 2016***

Since 2008, the US contribution to global growth has represented only one-third that of China, 12% versus 36%, and this worries many Americans who believe they detect a loss of influence of the leading global power. A weaker economic recovery than in previous cycles, an erosion of middle-class purchasing power, widening inequalities, concern over the sustainability of the cycle, and resentment at globalization regarded as a job destroyer are all partly to blame for tilting the US election. As this campaign progressed, the improbable became potential, then possible, probable and finally a reality. Some will be surprised or indignant, and will deplore or even condemn this; we can understand and share the views of Machiavelli, who added to the quotation at the head of this note "…they have hardly struck one down and raised up another than they become disenchanted, realising that they have exchanged a one-eyed horse for a blind horse". But, without minimizing the risks and drawbacks of this presidency, without being complacent or blinding ourselves, let us try to analyse objectively the prospects for the US economy and for markets.
This note aims to summarize the main aspects of Donald Trump's programme and their implications, and also to show that the US economy is not on the eve of a recession: the Fed should be able to raise its policy rates.

- ***Main aspects of Trump's programme: "I mistrust the mindset of the system, which is the enemy of integrity", Nietzsche.***

  - This statement by Nietzsche clearly summarizes the spirit in which Donald Trump conducted his campaign. Alternation is a constant of American political life. Apart from at the end of the Reagan presidency, a party has never kept power after two terms of office. Obsessed by the idea of decline, haunted by the prospect that in 2050 Spanish will be the most widely spoken language in the country, many middle-class Americans expressed their mood in this vote for a man who did not belong to the Republican Party and had not been in politics before.
  - Budget policy: Of the two candidates, it is Donald Trump who had the most expansionary budget policy, because he spoke of a $1,000 billion infrastructure plan, without any details regarding the implementation schedule. Overall, he plans to increase government spending by around three percentage points of GDP, or $500 billion per year, and therefore make the budget deficit worse. One worry is the plan's financing, because potentially $9,500 billion in tax revenues could be missing on a ten-year horizon.
  - Fiscal policy: Donald Trump appealed to Wall Street when he mentioned the idea of a 15% flat tax compared with a current corporate tax rate of 35%; he won votes when he suggested simplifying income tax, reducing the maximum rate from 39.5% to 35% and reducing the

number of tax brackets from seven to three, 12/25/35%, and when, like Hillary Clinton, he proposed facilitating the repatriation of the $1,000 to $2,000 billion in cash held by American multinationals abroad. It is clear, for personal income tax, that Donald Trump's measures aim more at simplification than a frank reduction, because the highest tax bracket at present is 39.5%.

- Wage policy: Donald Trump has proposed increasing the federal minimum wage by around 40% from $7.25 to $10 per hour. He will also have to think about the 40 million American workers who benefit from no pension system, and about pension under-provisioning which is estimated to amount to $10,000 billion.
- Industrial policy: Donald Trump has announced that he wants to increase US energy independence, i.e. stimulate production of coal and oil.
- Trade policy: Although the country is already not the most open economy, Donald Trump is worrying when he speaks of pulling out of the World Trade Organization, terminating the recent Trans-Pacific Partnership with eleven regional governments, returning to protectionism, very high duties of 45% on imports of Chinese products and 35% on Mexican products. The two latter countries account for one-quarter of US trade, and China accounts for half of the US trade deficit.

Undoubtedly, protectionist measures can result in extra inflation and, fundamentally, one can only be surprised to see a dominant economy preach in favour of protectionism.

Historically, protectionism is demanded by economies in the take-off phase, Germany in the 19th century at the instigation of ***Friedrich List***, and emerging economies in the 20th century. At present, the United States could gain from this by protecting sectors in decline, but would lose in all the most sophisticated sectors, which would be exposed to measures of retaliation or would incur increased costs of imported components.

It is well known that the Americans export four times less to China than they buy from it, and that, for the Chinese, exports to the United States represent one-fifth of their foreign sales. But imagine the consequences of a Chinese boycott of the US civil aerospace industry or of a disruption of deliveries of the 4% of Apple's iPhone components produced in China. Imagine that the Americans could no longer export their soybeans because the Chinese decided on an embargo. Imagine that the Chinese were to stop buying US Treasury bonds and sell their stock of US bonds, estimated at $1,300 billion. Generally, Donald Trump will be unable to ignore the fact that more than one-third of the revenues of companies in the S&P500 are generated abroad. We know that the American president can, by himself, decide on unilateral measures, customs duties or quotas, but we hope that Trump will decide not to compromise 80 years of a free-trade policy favourable to the United States, and will not return to the bad old days of the Smoot-Hawley Tariff, enacted at the start of the 1930s. Adopting protectionism would destroy more jobs in buoyant sectors than it would protect in sectors in distress.

- Monetary policy: Donald Trump is worrying when he considers replacing Janet Yellen, which could mean a loss of independence for the Fed. On both sides of the Pond, this is a subject of debate. We remember that ***Larry Summers***, who served under the Bill Clinton administration, recently raised questions on this subject.
- Banking policy: Trump plans to abolish the Dodd-Frank legislation, and this should boost the banking sector.
- Defence policy: Donald Trump has proposed increasing the defence budget, which is currently 3.3% of GDP, by 15% by adding $80 billion, but he irritates his partners when he says he wants to confine NATO to the security of the United States, when he wants to allow Japan and South Korea to build a nuclear arsenal to ensure their defence, when he wants to rent out American assistance to the Europeans and when he expresses a preference for Saddam Hussein and other autocrats.

  Regarding European defence, in line with Trump's views and in favour of a European defence policy, remember that, in its statutes, NATO planned that each Member State should devote 2% of its GDP to defence. At present, those who fulfil this commitment are rare, namely, Greece, the United Kingdom and Poland, and, close to this level, France. The others do not spend sufficiently. At this stage, therefore, we can merely reflect on the words of ***Montesquieu: "States do not have a soul, they merely have interests"***.
- Migration policy: If it were effective, the restriction of immigration would create tensions in the labour market and would exacerbate wage inflation, because Trump wants to send 11 million immigrants back home.

- ***Disappointing economic growth***:

- Despite several recessions, average US growth was 3.5% annually between 1948 and 2007. Since 2010, despite $3,000 billion injected by the Fed and $1,000 billion borrowed by the Treasury Department, average annual growth has been only 2.1%. Calculated on a per capita basis, real income growth was 5x higher in the Clinton presidency than in the Obama presidency, not to mention the Kennedy presidency when the ratio was ten times higher.
- Some incorrigible optimists will object that, since the trough in the spring of 2009, the cycle has never been as long, with 87 months of expansion, far longer than the average expansion cycles of 58 months recorded since 1945. Others will argue that more than 14 million jobs have been created since 2010, that as of the end of 2013, private waged employment had regained the level of 2007, at 116 million (123 million today), that the unemployment rate of 4.9% is close to a situation of full employment and that wages are growing at a 2.8% clip year-on-year, and even more for those people employed in the retail sector and in low-skilled jobs.
- Disappointing employment and wages:

  - Weakening momentum of productivity gains per hour worked: these gains were 2.8% per year between 1994 and 2003, then 1.3% until 2010, 0.4% per year since 2011 and even declined in the last three quarters.
  - Widening inequalities: This is unfavourable to consumption, because while the poorest 90% have a savings rate of 0, the most affluent 5% post a rate close to 50%. As we have known since Keynes, the marginal propensity to consume declines with income growth, and Emmanuel Saez provides us with the figures.
  - Median income growth: The statistics provided by the Census Bureau showing median income growth of 5.7% in 2015 could seem impressive, but it should be remembered that this figure remains 2.5% lower than the 1999 figure, and unfortunately this is more significant. Between 1973 and 2015, the inflation-adjusted median hourly wage (Economic Policy Institute) has been stagnant, at +0.1% per year. Never in history has the percentage of those in the 18-34 age group living with their parents, one-third, been as high, and this reveals sluggish income growth.
  - The low labour force participation rate: only 62.6% compared with 66% in 2007. Two-thirds of the jobs created in recent years have been part-time jobs. 5.8 million workers can find nothing better than part-time work. The actual unemployment rate is therefore 9.5%, close to the European level and well above the low of 7.9% in December 2006.
- Disappointing manufacturing employment:
  - Employment: Since the signature of the NAFTA agreements in 1992, the famous agreement between the United States, Canada and Mexico denounced by Donald Trump, one out of four factory jobs have disappeared. This represents 4.5 million jobs, of which 1.5 million since the 2007 crisis. One might perceive an industrial renaissance in manufacturing job creation, 122,000 in 2009, 310,000 in 2015 and even more in 2016, especially since the people recruited are now more skilled, but manufacturing industry represents only 12% of GDP. Job creations in the United States at present are in the service sector.
  - Volumes: Manufacturing production, in volume terms, is still 6% below the level reached in 2007.
  - Global market share: The United States now accounts for only 18% of global manufacturing production, far from the 22% share it had in 2005.
  - Where Donald Trump's analysis is mistaken is when he attributes these job losses to free trade, to competition from emerging countries such as China. The main cause is automation, the substitution of capital for labour, and this trend will continue. And incidentally, far greater manufacturing job losses can be expected in emerging

countries. Irrespective of any protectionism, the robotization underway in developed countries is a great asset at a time when wages are increasing rapidly in China.

- **Interest rates and Fed policy**:

If the Fed hesitates and is reluctant to raise its rates meeting after meeting, and if it still has $4,000 billion on its balance sheet, this is because the economic indicators are contrasting. In favour of an interest-rate hike are the confidence indicators, job creations, the unemployment rate, signs of an acceleration in wage growth +2.8% year-on-year, perceptible especially for those who change jobs (+4% year-on-year according to the Atlanta Fed), the vigour of business innovation, property price inflation in the commercial sector which is worrying some members of the Fed Council, and service price inflation, which at 3.1% exceeds the core inflation level of 2.2%. More lacklustre are the recent fall in durable goods orders and retail sales, but above all margin erosion, rising default rates and weak growth in investment.

The Fed's independence could be threatened if Donald Trump decided not to renew Mrs Yellen's term of office in February 2018 and if he appointed a more hawkish chairman.

- ***The market: Many investors consider it expensive, but this must be relativized:***
  - <u>Doubts</u> are aroused by the rise of the S&P500 which, since 1981, has been three times greater than nominal GDP growth. To this we may add an average PER of more than 17x, a decline in earnings for more than four quarters, share buybacks which are close to $600 billion per year, poor earnings quality - masked by these buybacks which penalize investment and long-term growth, deteriorating corporate debt ratios, and worsening default rates for speculative bonds: 5.5% according to Moody’s, which is more than twice the rate observed in Europe. The other thorny subject is student debt, $1260 billion, which has more than doubled since 2008 and 11% of which is in default.
  - <u>But the US economy is not threatened by imminent recession:</u> Six points
    - On the domestic level, the economy remains very open to innovation and driven by consumption, 70% of GDP, as attested by automotive sales of 17.4 million, still high (as a reminder, 10.9 million in 2009).
    - The real estate sector: real estate prices, after falling by around 30%, are close to the highs seen in July 2006. This rise in prices is the result of a shortfall in supply and not of strong demand. Housing market investment accounts for not even 4% of GDP, versus 6% in 2006. Building permits, at approximately 1.1 million, are only half the 2007 level. Inventories of unsold homes are at their lowest level since the year 2000, while construction needs are estimated at 1.4 million. The percentage of home

ownership, 62.9%, is far below the peak of 2004 (69.2%), and in fact it is at its lowest level in 50 years. New house sales are unlikely to collapse, as they did between the peak of July 2005 (1.40 million transactions) and the low of February 2011 (270,000). Rents are rising by around 4% year-on-year, which means improved returns for landlords.

- Household debt: at $12,200 billion (including $9,500 billion in real estate), or 110% of gross disposable income, it is far below the level of a country such as the United Kingdom (155%), or even that of the United States in 2007 (134%). This decline, between 2007 and this year, is largely due to the expulsion of 11 million households from their homes, but thanks to the rise in stock markets and real estate, household wealth, at 5x GDP, is at its highest level since 1999. Thanks to low interest rates, the cost of household debt servicing is now equivalent to only 10% of disposable income, far below the 13% level seen in 2011. Due to wage growth, demand should remain positive. And because of low interest rates, the household savings rate of 5.1% is satisfactory in relation to recent averages.
- Public debt: public debt will reach a new record at the end of 2016, at $19,150 billion, or 105% of GDP, after spiralling by $8,300 billion since the start of the Obama presidency. This ratio is higher than in France or Spain. But, like elsewhere, the cost of debt servicing is moderate, and the budget deficit, expected at 3.2% this year, or $590 billion, is no more worrying than that of France.
- The situation of companies and banks: No major risks here. The banks are better capitalized than in 2007 and the corporate default rate on loans is low, at 2.1%.
- Sensitivity to the Chinese economy: A recession in China would have less impact on the United States than on other major countries, since US exports to China represent only 1% of GDP, i.e. a percentage half that of Germany and Japan.

- ***The stock market***:

- According to Moody's, corporate cash at the end of 2015 amounted to $1,700 billion, but share buybacks, at $500 billion each year, equivalent to 15% of the market capitalization since 2009, are harmful to the manufacturing outlook because they consume part of the cash flow or even exacerbate debt ratios, and they create no value for shareholders. Moreover, in one year corporate debt has increased by $850 billion, to $6,600 billion.
- Sector rotation is boosting pharmaceutical stocks, recently penalized by the prospect of Hillary Clinton being elected, and now on attractive relative P/E ratios. Infrastructure stocks, infrastructure-related construction stocks, banks - given the prospect of abolition of the Dodd-Frank Act, and US oil exploration companies are likewise boosted.

<u>Conclusion</u>: ***"This great blindness we all have regarding ourselves", Molière***

To end this note, we hope that Donald Trump will think about these words by Célimène to Arsinoé in Molière's play *The Misanthrope*, and thus avoid the pitfalls ahead of him. On this condition, we can remain optimistic regarding the future of the United States and take a longer-term view: Why is the US market the most resilient when markets plummet? In the past 120 years, the United States has been the leading economy in the world with around one-quarter of global production. Although China will soon post a larger GDP than the United States, this will remain relatively insignificant, because per capita GDP will still be one-fifth that of the United States. The United States still has strong advantages: demographics, with an expected population of 450 million in 2050, versus 310 million at present and 40 million in 1870, research with a pre-eminent share of patents filed, and education with the persistent predominance of American universities on the global stage.

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