Eastern Bank
wealth management

ON OUR MINDS

For What It's Worth

Michael A. Tyler, CFA, Chief Investment Officer
December 27, 2016

There's something happening here,
What it is ain't exactly clear.
The battle lines are being drawn –
Nobody's right if everybody's wrong.
It's time we stop – hey! What's that sound?
Everybody look what's going down.[1]

The dust is finally settling from the tornado that swept America last month, and indeed there's something happening here. The details may not be exactly clear, but the political battle lines are being drawn even as a new consensus economic view seems to be emerging. That view (whether you love it or hate it) includes accelerated economic growth, larger federal deficits, wider income inequality, higher inflation, rising interest rates, and a stronger dollar.

Will this scenario come to pass? Although we've received conflicting signals from President-Elect Trump and his team, we do have enough evidence on the table to begin assessing the outlook for the U.S. economy and for our financial markets.[2] In other words, it's time we look at what's going down.

The emerging consensus view is based on expectations of a fundamental shift in U.S. economic policy. On the fiscal (taxes and spending) side, the mood on Capitol Hill has been one of restraint ever since the 2011 debt ceiling fiasco and budget sequester.[3] With Trump's election, even a Republican-led Congress now seems ready to follow the new President into large-scale infrastructure projects and tax cuts – both of which can act as huge stimulants to private-sector activity and economic growth.

On the monetary side, the Federal Reserve has been exceptionally accommodative since late 2008, keeping interest rates at crisis-level lows long after the economy has fully recovered from the recession. This attitude, too, seems to be changing. Fed Chair Janet Yellen has signaled that last week's interest rate hike will not be a "one-and-done" event as it was last year, but rather will mark the onset of a more traditional tightening cycle.

---

[1] Stephen Stills was actually writing about the Sunset Strip riots of 1966, but his words seem equally applicable to the post-election state of America exactly a half-century later.

[2] We will publish our formal review of 2016 and our 2017 investment strategy next month, as we do every January. This commentary should perhaps be seen as a "sneak preview" or a work-in-progress toward that review.

[3] Even the more expansionist policies embodied in the 2008-09 stimulus legislation under Presidents Bush and Obama were muted by the lack of "shovel-ready" projects; the money was appropriated but not spent in the most effective ways.

In a nutshell, then, what's going down is a complete reversal of U.S. economic policy from the past several years: Congress is shifting from restraint to stimulus, while the Fed is shifting from stimulus to neutral.[4] It is this reversal that leads to the emerging consensus view of economic outcomes.

President-Elect Trump has promised a trillion-dollar infrastructure investment program and a multi-trillion-dollar tax cut. While many traditionally conservative Republican members of Congress will fight back against this heterodox program, it seems likely that some version of a large spending bill and tax cut will be enacted next year. From this starting point, the rest of the emerging consensus view falls into place with seeming inevitability:

- Higher spending and lower tax rates will certainly stimulate the private-sector economy into faster growth, but they will also create wider budget deficits; lower tax rates will produce lower tax revenues (even after allowing for job creation and rising incomes), while the spending increase exacerbates the gap between revenue and expenditure.

- A big infrastructure program will create more jobs, straining an already tight labor market. Construction workers and low-skill manual laborers are in especially short supply. More economic activity, coming at a time when the unemployment rate is already down to 4.6% and labor force participation is shrinking, would likely lead to higher wage rates and therefore more inflation.

- Corporate profits have long been expected to rise substantially in 2017, propelled by higher oil prices and some price inflation. The combination of faster overall GDP growth, higher profits, and inflation would likely drive stock prices higher, thereby exacerbating income inequality in this country.

---

[4] At a recent seminar, I was privileged to sit on the same panel as the Boston Fed's chief economist, Dr. Paul Willen. He described the Fed's recent activity as the equivalent of taking a foot off the gas pedal, but not yet applying the brake pedal. The Fed is coasting, in his view, but not yet braking an overheating economy. The economy-as-automobile metaphor was hardly original, but it got me thinking about other ways in which the U.S. economy can start moving faster.

For starters, if the Fed is the "driver" whose feet are working the pedals, I would posit that Congress is the transmission: By up-shifting to a higher gear (i.e. by cutting taxes or by spending money on infrastructure and other projects), Congress can jump-start faster economic growth; conversely, downshifting as it did with the budget sequester can decelerate the economy sharply (and create huge stress on its moving parts, too).

To pursue this metaphor just a bit further, consider the vast scope of federal regulations that has crept deeper into nearly every occupation or business, best exemplified by the two thousand pages of the Dodd-Frank Act regulating financial institutions. From an economic perspective, this regulatory creep is the equivalent of throwing sandbags into the trunk of our metaphoric automobile; they are pure deadweight, with some benefit in certain situations (driving in wet winter weather, in the case of literal sandbags) but mostly detracting from the vehicle's performance.

And finally, perhaps the most important determinant of the economy's speed is the quality of the gasoline – consumer and business demand for goods and services. A richer blend of gas, like a more optimistic consumer or corporate CFO, can drive higher spending and higher economic growth.

- Wider budget deficits would require that the Treasury issue more bonds to finance them; concurrently, lower tax rates would erode the U.S. government's credit quality. A growing supply of weaker bonds would cause bond prices to fall and interest rates to rise.

- The combination of higher interest rates and a faster private-sector economy would attract more foreign capital, driving up the value of the dollar.

If the U.S. economy plays out according to this script, the response of financial markets should be equally predictable. Accelerating corporate profits will lead to higher P/E multiples, and higher valuations of higher earnings translate into much higher stock prices. Industries most favored by infrastructure investment might outpace those for whom demand is more inelastic, so industrial and materials stocks would outperform consumer staples stocks. Similarly, higher interest rates would presumably help the stock prices of those companies that benefit from rising rates (i.e. banks that borrow short and lend long) and hurt the stock prices of others (i.e. REITs and utilities whose high future dividend payouts would be worth less in current dollars).

In fixed income, the script suggests that duration loses and credit wins. That is, most bonds would suffer losses as interest rates rise, but those with longer maturities would suffer the most; long-dated bonds would see the greatest reduction in the value of distant coupon payments. As the national debt expands, the credit quality of the U.S. Treasury might be perceived as diminishing, leading to price markdowns on government bonds; yet as fiscal stimulus kicks in and corporate profits rise, the quality of corporate debt would improve (especially if companies can repatriate cash held abroad). In effect, the gap (or spread) in interest rates between government and private-sector debt would narrow, with the biggest spreads narrowing the most.

Interestingly enough, in the weeks since the election we have seen the country's stock and bond markets move sharply in exactly the directions this emerging consensus view would predict. Stocks – especially financial and industrial stocks – have been on a tear, while bonds have been crushed; November was the worst month in 14 years for the U.S. bond market.

On the other hand…

As Ella Fitzgerald and Louis Armstrong so memorably sang on their 1958 version of *Porgy and Bess,* "it ain't necessarily so." The rosy Trumpian outlook has embedded within it the seeds of many potential adverse outcomes. Indeed, the President-Elect's notorious ideological fluidity suggests that he may ultimately endorse a seriously compromised legislative agenda; he wouldn't be the first President to see Congress bend his proposals into occasionally unrecognizable forms.

The first hurdle, of course, is Congress itself. Substantial differences exist between what we think we know of Mr. Trump's plan and what we have seen concretely in House Speaker Paul Ryan's proposal. Congressional Republicans arguably owe as much loyalty to Mr. Ryan as they do to Mr. Trump, so the process of shaping a final legislative package could become as ugly as the Democrats' public wrangling over what eventually became the Affordable Care Act. Potential confirmation fights over Mr. Trump's Cabinet appointees and a Supreme Court Justice could also poison relationships in Congress right from the start of his administration.

Perhaps in his honeymoon period, Mr. Trump can still persuade Congress to cut taxes and to enact a major infrastructure spending bill. Such a program would create jobs, and its effects could indeed ripple through the economy over an extended period of time; it's not unreasonable to anticipate GDP growth accelerating over this period from around 2% (where it was stuck for most of the past three years) to over 3.5% for a couple of years.

Near-term gains could cause long-term problems. It's not clear that the economy could sustain such rapid growth without continued fiscal stimulus. Yet the government may not be in a position to continue deficit spending for very long: As interest rates rise and the size of the national debt increases, the Treasury's debt service costs could suddenly explode. To put this in perspective, the U.S. national debt doubled in the period from 2007 to 2014, due mainly to the higher spending to pull the country out of the deep 2008-09 recession. Yet the annual interest payments on that debt remained almost exactly flat, because interest rates came down so sharply over the same period.

Looking forward, the reversal of monetary policy (i.e. the first rate hikes in a decade) and the effects of inflation could cause our national debt service requirement to double, thereby forcing Congress to limit spending on discretionary items (including the military) or to raise taxes. Any of these outcomes could essentially wipe out the economic gains that investors clearly expect in the early years of the Trump Presidency. It's simply not possible to borrow our way to permanently faster economic growth; the piper must be paid.

The politics of immigration confounds the economics. Mr. Trump's signature campaign promises to deport undocumented residents and to restrict new immigrants would undermine his economic goals. Decades of data show that GDP growth is most directly linked to population growth and labor force growth: the best way for our society to create and consume more of everything is to have more people doing the creating and consuming.[5] Native-born birth rates are low and declining further; in fact, the Census Bureau reported this week that the U.S. population grew by only 0.7% in the past year, the slowest growth rate since 1937. Immigrants, whether documented or not, are earning and spending money in the U.S., and they are paying far more in taxes than they are drawing in government services – especially at the federal level.[6] Mr. Trump's goals of deporting several million undocumented people and closing the door to other immigrants are fundamentally incompatible with his goal of accelerating economic growth rate.

---

[5] Please refer to our *On Our Minds* commentary, "The U.S. Economy: Why 2.0% is the New 3.5%", May 22, 2016, for more analysis of the linkages between population, labor force, productivity, and economic growth.

[6] The Internal Revenue Service does not cooperate with any immigration agencies because it doesn't want to lose the tax revenues that come from undocumented immigrants. Most immigration lawyers advise their clients to obtain Tax Identification Numbers (which is easy to do) and to keep careful written records of their incomes, federal income taxes, and state income taxes. Having a TIN also forces a worker's employer to contribute its share of payroll taxes. (Eastern Bank does not employ undocumented workers; every employee has provided Form I9, representing that they are legally allowed to work in the U.S.) For undocumented immigrants, the goal of keeping records and paying income taxes is to build a written record that will support a claim to legal status if Congress enacts immigration reform with a path to citizenship. The large majority of undocumented immigrants pay federal income taxes yet receive, by statute, zero benefits in return. At the state level, these immigrants likewise pay income taxes but they do receive public education and, in some states, additional benefits.

A further immigration paradox is that Mr. Trump's promised federal hiring freeze will leave U.S. Citizen and Immigration Services without the staffing needed to find, process, and deport illegal residents. The agency already has a long backlog of cases and no resources to expand its reach.

International trade is a challenge. History has unequivocally shown that the pace of global trade is directly correlated with the rate of economic growth in the United States. Our domestic economy performs better – puts more people to work, raises overall incomes, and reduces income inequality – when we conduct higher levels of trade and reduce barriers such as tariffs.

The kind of protectionism that Mr. Trump espoused during the campaign is unambiguously bad economic policy. It destroys the very industries it intends to protect.[7] Saving jobs in the near term has historically translated into lost competitiveness, dulled innovation, stale products, and more lost jobs in the future.

Imposing high tariffs on imported goods will not cause consumers or businesses to switch to American providers of those goods, because in many cases there *are* no American providers; Apple is utterly reliant on Chinese manufacturers for critical components in its iPhones, for example. Tariffs would raise the prices for all competitors in a market, thereby depressing demand while aggravating inflation. This was tried once, and led to the Great Depression; in a different context, high import prices also had a role in the 1970s stagflation. Despite its populist appeal, Mr. Trump will have to choose between protectionism and growth – he can't have both.

Markets have their own agendas. Even if everything goes as well as the emerging consensus view predicts, there is no guarantee that securities markets will respond favorably. Markets are anticipatory mechanisms, and may well already reflect the best-case outcomes.[8] Meanwhile, exogenous factors will always be present and have their effects on supply and demand for securities. Not least, for example, is the profound change that has occurred in the U.S. Treasury bond market. Over the past year, the two largest participants in this market have flipped from buyers to sellers: The Federal Reserve has ended its "quantitative easing" program of buying new long-term Treasury bonds, and the People's Bank of China has been selling some of its stockpile of Treasury bonds in order to prop up the value of the yuan,[9] Without their ballast, liquidity could dry up and a short selloff could turn into a major bear market; that, in turn, could short-circuit the growth cycle investors are expecting to unfold smoothly.

---

[7] A recent study of Latin American economies is eye-opening. As reported in the Wall Street Journal, "Since 2010, Latin America's open economies – tied together in the Pacific Alliance, which groups Mexico, Colombia, Peru, and Chile – have grown by an accumulated 29.7%. Meanwhile, members of Mercosur, the protectionist trade bloc led by Argentina and Brzil, grew 19.4%." (Source: Taos Turner & Paul Kiernan, "The Price of Protectionism," *The Wall Street Journal,* November 26, 2016.) While there are many obvious differences between Latin America and the United States, this is but one of numerous studies showing that import tariffs exacerbate domestic inflation, while other trade barriers discourage innovation and lower standards of living.

[8] Certainly, the markets reflect the upturn in corporate profits that began well before the election, and that can be attributed entirely to higher energy prices and healthy consumer confidence.

[9] During the campaign, Mr. Trump accused China of manipulating its currency in exactly the opposite direction in order to support its export industries. If anything, China's currency management has helped U.S. exporters.

Paranoia strikes deep –
Into your heart it will creep.
There's a man on TV over there,
Telling me I've got to beware.
It's time we stop – hey! What's that sound?
Everybody look what's going down.

In the weeks since the election, progressive news and social media have been in full-throated despair that the apocalypse has come, while conservative outlets have made their peace with the new political order. Financial markets have moved sharply in exactly the directions that the emerging economic consensus would predict. That makes us nervous, since there's many a slip 'twixt cup and lip – and Mr. Trump hasn't even been inaugurated yet.

We have suggested throughout the past year that corporate earnings will grow handsomely in 2017 after a soft 2016, and we still think so; that outlook supports current stock prices and suggests that corporate bonds will hold their value better than government bonds. Even so, we wouldn't be surprised to see a mild stock pullback in the weeks ahead, especially if investors see an opportunity to take advantage of anticipated lower tax rates in 2017 and sell their winners early.

We will publish our formal year-end review and 2017 investment strategy later in January. In the meantime, we wish you a very happy holiday season and a prosperous new year.