Playing Defence Around 'Trumponomics'

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Financial markets may well come to re-think the virtues of what has come to be billed as 'Trumponomics'. This is likely to be a dominant theme into 2017 and it is in no small part due to the fact that markets have gotten carried away in such fashion as to risk short-circuiting the good parts of what the new Trump administration may achieve while ignoring the downside risks.

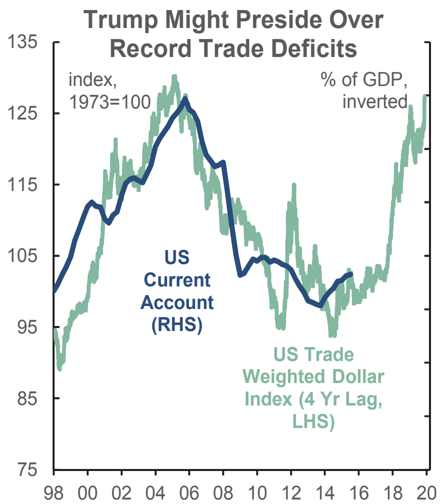
Because of this, there is still merit to portfolio diversification that includes defensive equity sectors and fixed income instruments while hedging against the risk of a USD overshoot. The risks that I see potentially unfolding could also set a rather different backdrop for the 2018 Congressional mid-term elections. Each is reviewed below.

TRUMP COULD PRESIDE OVER A RECORD TRADE DEFICIT

Imagine President-elect Donald Trump presiding over the largest broadly defined trade deficit in US history. This is likely in dollar terms, and quite likely when the deficit is expressed relative to the size of the economy over time. Also imagine Trump being in office come the next Presidential election when Americans might be importing more of their purchases from abroad than ever before.

Enter chart 1. There is a highly correlated, roughly four year lag between movements in the trade-weighted US exchange rate and movements in the current account balance of the broad US economy. This is the broadest two-way definition of the sum total of transactions with the rest of the world and mostly includes exports net of imports plus net investment income. The deficit's improvement from prior depths reflects the lagged influences of past dollar depreciation. The speed with which the US dollar has climbed over the past couple of years and more recently has hampered US export competitiveness and cheapened the cost of imports in such fashion as to set the wheels in motion for a sharp widening of the trade deficit. It doesn't happen right away as such effects take time to work their way through slow-moving trade channels given recognition lags, contract lags, and the costs to diverting trade. But the forces already in motion may make for a fascinating set of headlines into the next Presidential election in 2020 as well as the Congressional mid-term elections in 2018. If this happens then it may risk voter backlash and/or an even more protectionist turn by the US administration as the mandate wears on. The catch-22 from the trade deficit's standpoint is that stronger effort to contain import growth against the dollar-fed wishes of American consumers could well invite retaliation from abroad that would a) restrain US export growth and thus either restrain or block deficit improvements, and b) damage confidence in the global economy.

Chart 1



Source: Scotiabank Economics.

In a broader sense, an explosion in the US twin deficits — trade and fiscal — would need to be funded from abroad and would thus risk making the US economy yet more dependent upon financing from China, Japan et al. Note the added irony: increased reliance upon foreign appetite for US debt under a Trump administration.

THE DOLLAR MAY CAP INFLATION

The strong dollar also represents either a cap on inflation or downside risk to future US inflation. This lies against the assertion that lessened spare capacity in the US economy, slightly faster wage growth and rising market-based measures of inflation expectations all portend a period of sustained acceleration of price inflation in the US economy. It wouldn't be the first time in the post-Global Financial Crisis (GFC) world that we've seen a false start to inflationary developments particularly of the market-derived variety.

Enter chart 2. It's not as compelling as the trade chart, but then again, it takes less time to happen. The last time the broad dollar index was this high, the US tech bubble wreck and the aftermath of the Asian financial crisis were driving sharp downward pressure upon import prices. I think a similar outcome is likely this time and it should unfold faster than the trade hit from the US dollar. Over the coming year we should see gathering evidence of a top in the Federal Reserve's preferred measure of inflation (the core PCE deflator) followed by renewed downsides.

HOUSING TO TAKE A HIT

Most of the significant jump in US mortgage rates since the end of September occurred in the aftermath of the US election. US new home sales were weakening even before the election and will face added downside risks in the wake of the election.

Enter chart 3. There had been a nice recovery underway in new (and existing) home sales that started to lose momentum in the run-up to the election and, if history is any guide, new home sales could well be back down below a half million at an annualized rate in 2017 which would stop the housing recovery dead in its tracks. Mortgage growth was already on frail footings before this rate shock and will likely struggle to continue to achieve growth next year. Housing is key to US consumer confidence and retirement planning.

NO HOMECOMING FOR MANUFACTURING

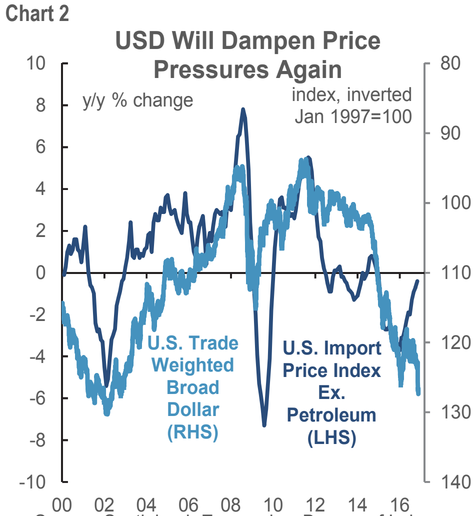
In order for Trump's protectionist bias to result in bringing manufacturing "home", we perhaps need to overlook the fact that domestic manufacturing inventories remain high. Produce more at home when you can't move the product you've already got on the shelves? Bring home inventories from abroad on top of it?

Enter chart 4. Domestic inventories are still bloated relative to domestic shipments not only in manufacturing but also across the whole supply chain as this ratio has eased only slightly of late and remains at its highest since 2001 excluding the GFC spike in '08-'09. I think it's unlikely that American manufacturers will produce more at home when the cost savings abroad are compelling, short of draconian protectionist measures that impose a serious erosion in real US wages. The broad inventory ratio across manufacturers, wholesalers and retailers remains at its highest since before the just-in-time movement's drive toward lowering this ratio to 1.25 before the GFC and in its immediate aftermath, before inventories began running up again in 2014-16. It's not clear how much of this inventory build is desired versus an overshoot in a still-moderate growth environment for the US economy, but I suspect it's a little of both.

INFRASTRUCTURE'S EXAGGERATED EFFECTS

The infrastructure spending proposals are not a fundamental game changer for the US outlook. They are unlikely to hit until at least 2018 and probably later yet. There

Chart 2



Source: Scotiabank Economics, Bureau of Labour Statistics,Federal Reserve.

Chart 3

Source: Scotiabank Economics, Bankrate.com, National Association of Realtors.

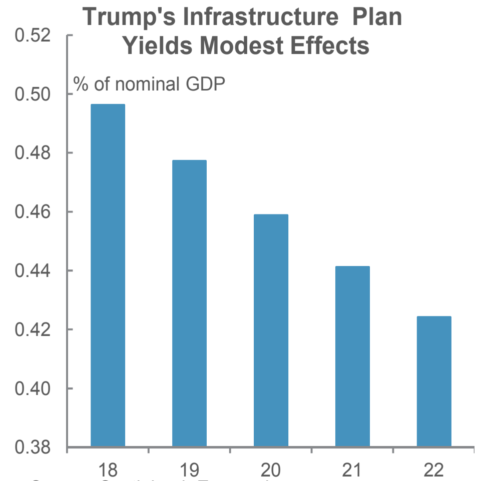
Chart 4

Source: Scotiabank Economics, U.S. Census Bureau.

are big question marks over how such spending will be financed and how private money may respond to incentives. And the growth effects are likely to be transitory.

Enter chart 5. The effects on growth last for a year or two, after which simply maintaining infrastructure spending will preserve levels of activity but not add to growth. US$1 trillion in infrastructure spending over a decade means an average $100 billion impact per year in a US$19 trillion economy before deflating infrastructure spending relative to broad GDP. As usual in economics, big numbers need more than 140 characters to put them into context relative to the size of the market over time.

Chart 5



Source: Scotiabank Economics.

HOARDED TAX CUTS THAT DON'T PAY FOR THEMSELVES

If what they've done with energy savings is any guide, it's not at all guaranteed that US consumers will spend potential tax cuts after Trump takes office. This is not the Reagan era. Boomers are older now, and they're still recovering from the confidence and housing wealth shock incurred in 2008-09. They could well pocket the tax savings in preparation for retirement. The Fed is right with its recent communications for fiscal policy to emphasize productivity versus here today and gone tomorrow policies that may not work at all or may only incite near-term economic activity. How to pay for large tax cuts remains a mystery.

Enter chart 6. Tax cuts do not pay for themselves through magical self-financing effects on growth. Generally speaking over time, tax cuts and hikes have driven nearly immediate effects on revenues. A credible plan to recoup revenues lost due to tax cuts will be needed in order to avert a deficit blow-out. Reining in tax cut proposals and pursuing growth-dampening expenditure reductions are likely. Failure to do so would invite the wrath of the bond market as bond market environment of recent years should not be taken for granted in planning policy over the administration's time in office — and beyond.

Chart 6

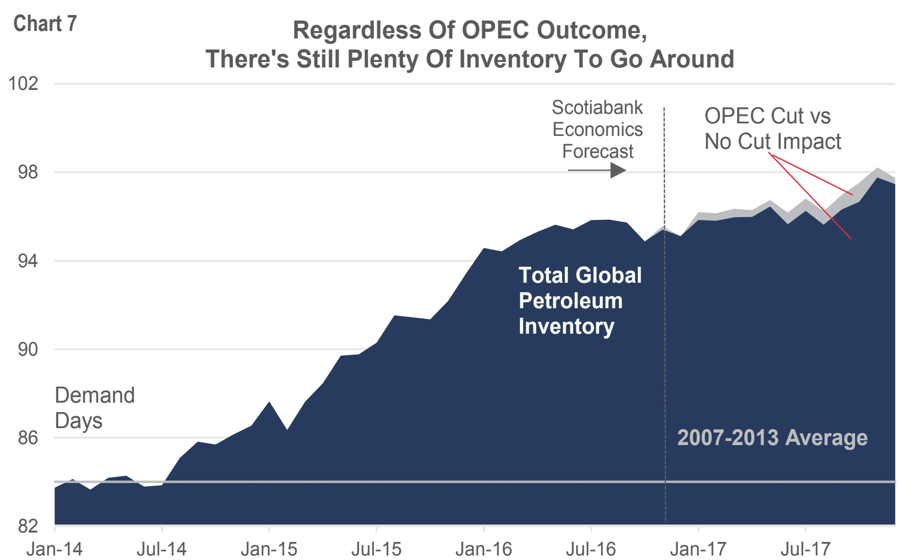
Source: Scotiabank Economics, Bureau of Economic Analysis, Congressional Budget Office.

MORE ENERGY SUPPLY MAY HURT PRICES

The net impact of a potential shift in US energy policy is difficult to determine. The potential re-introduction of sanctions against Iran may risk lessening global supply if no one else moves in to take their market share. That might be constructive to prices while potentially stoking geopolitical risks. Deregulating domestic energy sector development across oil, gas and coal could risk adding to already existing supply excesses, although there is widespread skepticism with respect to the likelihood of an industry response especially with respect to coal.

Enter chart 7. Even with OPEC production cuts, US petroleum inventories will remain high in 2017. Incentivizing greater energy production directly (through oil) or indirectly through other energy substitutes could further exacerbate such imbalances.

Chart 7



Source: Oil Market Intelligence, Scotiabank Economics.

A MORE DOVISH FED?

In addition to the potential risks listed above is the more difficult to assess evolution of potential trade shocks to growth and geopolitical instability that a Trump administration could pose to the world economic and political order.

Furthermore, should two vacancies on the Board of Governors of the Federal Reserve be staffed with hand-picked hawkish candidates and both Chair Yellen and Vice Chair Fischer be replaced with similarly minded individuals when their current terms expire in 2018, then a significant risk is an overly abrupt hawkish turn by the Federal Reserve and a policy mistake in the face of the uncertainties outlined in this article and elsewhere. I have confidence that the Federal Reserve will abide by its dual mandate in responsible fashion, but tinkering with it as part of a package of policy shifts by the new US administration is not a risk to be taken lightly. Indeed, the opposite risk of a more dovish Fed in the face of the serious risk of a dollar overshoot is plausible and perhaps sooner in 2017 than one might think.