

Reflation (rē-'flā-shən): restoration of deflated prices to a desirable level. In economics, to increase the amount of money in use in a country's economy.

It is well documented how poorly the political forecasting community fared in the recent Presidential election that showed Clinton with a more than 90% likelihood of winning on November 7th. It turns out that the investment analyst community's ability to forecast was just as abysmal. It was almost unanimously held that if Trump pulled off the upset on November 8th the markets would shoot first (sell) and ask questions later.

That outcome appeared to be confirmed in the early hours of November 9th when the futures markets closed at "limit down" and Asian stocks lost nearly 5%. Surprisingly, when the markets opened the next day instead of a massive sell off the markets staged one of the greatest reversals of all-time closing more than 1,000 points higher than the futures had suggested.

The basis for the dramatic turnaround in investors' appetite for risk appears to be confidence that President Trump will be successful in reflating the U.S. economy with a complicit Congress. It is clear the country voted, knowingly or not, to move in a different direction and the consequences, good and bad, will take some time to figure out.

Virtually all stock indices have surged to new all-time highs on the expectation of:

- Higher growth rates in the U.S. leading to an increase in corporate profits.
- Rising wages for U.S. workers not driven by raising the minimum wage but based on market forces.
- Higher inflation and interest rates.
- A shift towards "De-Regulation" particularly with the stifling Obamacare mandates.
- Tax cuts for both individual taxpayers and U.S. corporations.
- Massive fiscal stimulus through government spending on infrastructure.

The very smart folks at Gavekal created a decision tree that allows investors to determine their best course of action depending on how they see the U.S. economy

today and the Fed's response. The global economy has become so inter-connected that even if you accurately forecast higher growth and inflation you have to factor the impact of a stronger dollar on U.S exports and what that does to stock prices.

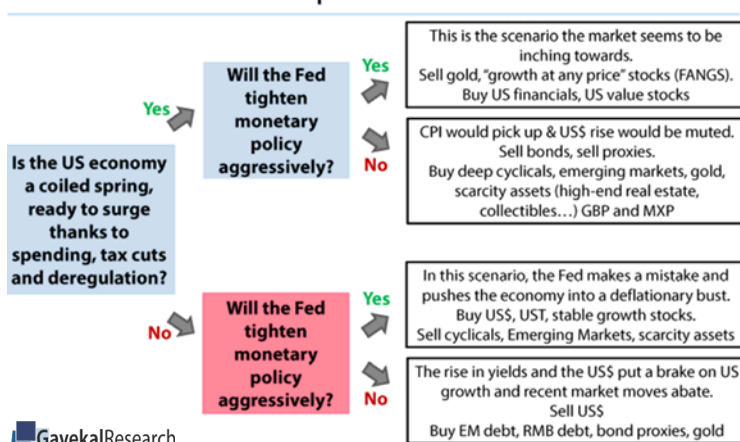
Animal spirits may be released in investors but it is occurring at a time when the current bull market is already very long in the tooth. The current bull is over 7.5 years old, more than double the median advance of 3.6 years with only the bull market of the 1990's technology boom exceeding the current advance. No one can be certain if the current rally results in a reinvigorated bull or is simply prolonging the inevitable bear waiting to come out of hibernation.

The two policies on Trump's economic agenda that give us the most hope bring with them the greatest risk. There is a sense that as country we are pushing all our chips to the middle with the hope that the "river" card will allow us to prevail. The first policy is tax cuts for individuals and corporations. Nearly everyone agrees that greatly reducing the taxes on the repatriation of profits makes sense. As long as U.S. corporate tax rates remain

among the highest in the developed world corporations are going to leave profits offshore. Apple could be incentivized to bring \$200 billion of profits held in Ireland to the U.S. but if they use the cash to buy back their own stock will that increase economic growth? Taxpayers may see a bump in their take-home pay but if they use that to save for retirement or pay down debt how would the economy benefit? The hope is that lower corporate taxes encourage companies to invest in new technology, new manufacturing or R&D that creates jobs and spurs growth. In the same way, increasing discretionary cash flow can lead to higher spending and boost GDP and opportunity.

The second policy is the massive government spending on infrastructure planned. From building "The Wall" to improving the nation's roads, bridges, and airports Trump has suggested he will spend \$1 trillion and expects a sharp rise in growth as a result. If successful, the tax base will expand and government revenues will increase. If this does not materialize, we will simply find ourselves in a worse debt situation than we are today.

The Trumpflation decision tree



Can President Trump Reshape the U.S. Economy?

(Editor's Note: The views expressed here are those of S&P Global's U.S. economics team. While these views can help to inform the ratings process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria. This report is an update of our Oct. 19 article titled "The U.S. Election: A Look At Candidates' Economic Plans" and references information from various economic research we have previously published. In the coming weeks, as the details of various President-elect Trump's proposals become clearer and the prospects of congressional approval are better understood, we will incorporate likely policy changes into our new baseline forecasts.)

From one perspective, the election of the first modern president who has never held elected office, filled a top government position, or achieved a high military rank represents a historic moment. While the popularity of candidates from the private sector has increased dramatically in recent election cycles, only President-elect Donald Trump has made it to the country's (if not the world's) top job.

His election was the culmination of countless hours of hard work and dedication in a run for office that was as rough-and-tumble as any in recent memory. And yet it marks only the beginning of a level of labor that could make the campaign seem like a picnic in the park.

In January, President-elect Trump will begin leading a country that has been deeply divided for more than a decade. It's fair to say the battles over such things as the Affordable Care Act, the Supreme Court vacancy left by the death of Justice Antonin Scalia, immigration, trade, and the country's place in a world increasingly susceptible to terrorism have been contentious at their best, and downright vitriolic at their worst. Much of this animosity stems from Americans' frustration with an economy whose recovery from the Great Recession has been uneven and altogether slower than any expansionary period of the last half-century.

While job gains have been steady and headline unemployment is half of its postrecession peak, low labor-force participation masks some underlying weakness, and wages have yet to rise commensurate with job growth. While consumer spending has strengthened and the housing market has rebounded nicely, businesses remain cautious, keeping capital expenditures low. And while the possibility that the U.S. will soon slip back into recession is, in our view, still remote, a benchmark interest rate near zero gives the Federal Reserve little room to maneuver using conventional monetary policy should the economy again suffer a contraction.

Against this backdrop, President-elect Trump will likely make progress only slowly—even with a Republican majority in both houses of Congress. Indeed, history dictates that very few presidents' campaign pledges make it into law as originally shaped, and that may be truer than ever now that compromise seems to have become a dirty word on Capitol Hill. The new president will need to reach across the aisle to Democrats, many of whom have already promised their constituents to obstruct him at every turn. Within his own

party, there are a number of lawmakers who support free trade and who likely won't respond favorably to his isolationist talk. Here, he may receive a lot of support from Democrats who have traditionally disliked trade deals such as the Trans-Pacific Partnership (TPP). Nonetheless, S&P Global Ratings believes President-elect Trump has an opportunity to bolster the world's biggest economy in a number of ways, including tax reform, increased investment in infrastructure, and energy policy, just to name a few. Here, we briefly outline our views on the issues we think will occupy much of the new president's time in the White House, and how he has suggested addressing them.

Fiscal Policy

During his campaign, President-elect Trump has said he plans to lower taxes in a number of ways, including collapsing the current seven federal income-tax brackets to three, with lower rates. His proposals would do this while repealing the alternative minimum tax and reducing the corporate tax rate to 15%, from today's 35%. One of his early proposals reportedly would have diminished federal tax revenues by more than \$10 trillion; his later proposal would do so by a smaller \$5.8 trillion, according to the Committee for a Responsible Federal Budget (CRFB). The national debt is currently more than \$14 trillion, or near 77% of GDP, and the CRFB estimates that the new president's plan would add an additional \$5.3 trillion over the next decade. He argues that lower taxes would boost private-sector incentives.

The plan would reform the individual income tax code by lowering marginal tax rates on wage, investment, and business income. Furthermore, it would broaden the individual income tax base. In addition to lowering the corporate income tax rate to 15%, the plan would modify the corporate income tax base. Finally, he has said he would eliminate federal estate and gift taxes.

President-elect Trump's plan favors high earners, with the top 1% getting about 47% of the tax cuts, according to the Tax Policy Center. Compared with the middle class and poorer Americans, high-income households save a greater portion of their income than they spend. Therefore, the effect on overall consumer spending would likely be less than if a tax cut was targeted to low-income households, who historically spend more of what they receive. The new president has also said he supports increased infrastructure spending and vowed to increase defense spending and child-care assistance, while stopping cuts to Medicare, Medicaid, and Social Security. However, the revenues potentially lost to the government from his proposed tax cuts would likely mean either less money for the government to spend or a widening federal budget gap.

It's worth noting that all of this comes as the government's borrowing limit (so called "debt ceiling") is set to run out in mid-March, and that the often toxic environment on Capitol Hill has in the past raised the risks that any resolution will be dragged out until later in the year. As such, the Treasury Department could once again need to conduct various "extraordinary measures" to postpone the need to raise the debt ceiling until Congress can reach a compromise. (To

Can President Trump Reshape the U.S. Economy? *continued*

complicate matters, Fed Chairwoman Janet Yellen's term will end in February 2018.) That said, the Republican majority in both halves of Congress diminishes this likelihood--though we may still be in for a bumpy ride.

Tax Reform

Much of the debate about the need to overhaul the U.S. tax code has focused on historically high income inequality and the need to "make the wealthy pay their fair share of taxes." And rightfully so: Income inequality in the U.S. has been increasing for the past several decades. According to the Organization for Economic Cooperation and Development (OECD), the average income of the richest 10% of Americans is 19 times that of the poorest 10% (as of 2014), meaning the U.S. ranks third in income inequality by this measure among advanced nations, with only Mexico and Chile having more unequal income distributions. We believe this level of income inequality is weighing heavily on U.S. GDP growth.

S&P Global Ratings agrees, conceptually, with recent talk across the party lines of using tax revenue to invest in infrastructure. We have proposed a major step in U.S. tax reform that would give American companies a window in which to repatriate funds at a zero tax rate, with a commitment that they invest 15% of the money in infrastructure repair and refurbishment (see "Rebuilding Through Repatriation: How Corporate Cash Can Save America's Infrastructure," published Oct. 5). Toward this end, Democratic New York Senator Charles Schumer said in an interview with Bloomberg News on Nov. 7 that there is "a possibility of compromise for international tax reform provided it's attached to a broad, strong infrastructure bank."

Either way, it's evident that a tax code that has gone effectively unchanged in 30 years--and was designed for a manufacturing-heavy economy rather than today's service- and technology-oriented one--is in dire need of reform. It's clear just how onerous and outdated the tax code is when we consider that it is keeping American corporations from repatriating the more than \$2 trillion they hold overseas (the Government Accountability Office [GAO] now estimates untaxed offshore earnings are \$2.6 trillion).

Most major countries tax their companies only on profits they earn at home, with foreign earnings subject to the rates of the jurisdictions in which they operate. American firms, by contrast, pay U.S. taxes on income generated anywhere in the world, while generally being allowed to defer taxation on foreign earnings by parking the money overseas. And American companies pay some of the highest tax rates in the world. At 35%, the U.S. federal statutory corporate tax rate is higher by half than the EU average top corporate tax rate of approximately 22.5%. (That said, large multinational U.S. corporations rarely pay the top federal tax rate of 35%; in fact, the average effective U.S. corporate tax rate was about 14% from 2008-2012, according to the GAO.)

During his campaign, President-elect Trump said that he would "eliminate job-killing regulations" and "have massive tax reform and simplification." He has discussed offering corporations a one-time tax holiday to entice American firms

to repatriate some of the more than \$2 trillion (and hundreds of billions of dollars in potential tax revenue) sitting outside the U.S.

Both Sen. Schumer and Rep. Paul Ryan of Wisconsin, the Republican speaker of the House, have expressed their support for broader tax reform that would channel funds toward infrastructure investment. But while there is bipartisan agreement among key senior policymakers on the need for tax reform, the details on what that would look like will almost certainly complicate matters.

While Hurdles Abound, Opportunities Can Be Found

That President-elect Trump has a long row to hoe with regard to enacting his economic proposals seems self-evident, especially given the mood of Americans struggling to succeed in an economy still recovering from the Great Recession. The difficulty he will likely face in persuading his opponents on the left (and many in his own party) to push through his plans will make the already-difficult job of governing especially challenging.

That said, the new president has an opportunity to enact economic reforms that could have effects lasting for a generation or more--and we think the Republican majorities in Congress will help him in many respects. Whether this will be enough remains to be seen, but one thing is certain: The truly hard work begins Jan. 20.

Interim Update and Comment—November 2016

The outcome of the national election does not change our view on the trajectory of the economy for the next four to six quarters. Markets are repricing because of the assumption that lower taxes, less regulation and higher deficit spending will provide a positive demand shock, followed by a surge in inflation.

The most potentially dynamic component of the Trump plan is the reduction in tax rates. The plan calls for a \$500 billion decrease in taxes over the next ten years. With a tax multiplier of -2 , there would be a lift in economic growth of \$1 trillion over the next ten years for an economy that is on a growth path of about \$5 trillion over that same time frame. As such the annual growth could be boosted from \$500 billion a year to \$600 billion. This stimulus will take a considerable amount of time to work through the economy and the positive contribution requires that monetary conditions remain favorable, not adversarial.

The Reagan tax cuts of the early 1980s are quite instructive on this point. That tax cut was far larger in relative terms than what is being proposed and since the federal debt was so much less than it is currently, the tax multiplier was more negative, approximating -3 . Additionally, the Reagan tax cuts were being implemented while interest rates were falling sharply. Even with fiscal and monetary conditions working in tandem, the economy was very slow to respond. The Republicans lost control of the US Senate in the 1984 Congressional elections and their numbers in the House were reduced. Also, Fed Chairman Volcker was required to orchestrate a major decline in the dollar under the Plaza Accord of 1985 and interest rates did not reach their cyclical low until 1986.

Additionally, initial conditions (which is an economics term for all the other factors that influence economic growth) are negative and have become more negative recently. The economy is extremely over-indebted, turning even more so this year. In the latest statistical year, debt of the four main domestic non-financial sectors increased by \$2.2 trillion while GDP gained only \$450 billion. Debt of these four sectors (household, business, Federal and state/local) surged to a new high relative to GDP. This will serve as a restraint on growth for years to come. Also, the economy is in an expansion that is 6 1/2 years old. This means that pent-up demand for virtually all big ticket items is exhausted – apartments, single family homes, new vehicles and plant and equipment. Rents are falling as a result of a massive apartment construction boom. Reflecting a huge stock of new vehicles and significant easing of credit standards, the auto market appears saturated. Vehicle sales for the first ten months of this year have fallen slightly below last year's sales pace. New and used car prices are down 1.2% over the past year. The residential housing market appears to have topped out even before the sharp recent

advance in mortgage yields, which will place downward pressure on this market.

The recent rise in market interest rates will place downward pressure on the velocity of money (V) and also the rate of growth in the money supply (M). This is not a powerful effect, but it is a negative one. Some additional saving or less spending will occur, thus giving V a push downward. So, in effect, the markets have tightened monetary conditions without the Fed acting. If the Fed raises rates in December, this will place some additional downward pressure on both M and V , and hence on nominal GDP. Thus, the markets have reduced the timeliness and potential success of the coming tax reductions.

Another negative initial condition is that the dollar has risen this year, currently trading close to the 13 year high. The highly relevant Chinese yuan has slumped to a seven year low. These events will force disinflationary, if not deflationary forces into the US economy. Corporate profits, which had already fallen back to 2011 levels will be reduced due to several considerations. Pricing power will be reduced, domestic and international market share will be lost and profits of overseas subs will be reduced by currency conversion. Corporate profits on overseas operations will be reduced, but with demand weak and current profits under downward pressure, the repatriated earnings are likely to go into financial rather than physical investment.

The psychological reaction to Trump's unexpected victory along with the worsening initial conditions means that the upcoming tax package may do little more than contain the additional negative momentum developing within the economy. Additional deficit spending for

infrastructure also carries a negative multiplier. This is confirmed by recent scholarly research. Let's say, for the purpose of argument, that the multiplier is a small positive. It will take a long time to develop the preliminary engineering and design work to identify the projects and even longer to hire the contractors. So even if the multiplier were not negative, the benefit seems to be well into the future.

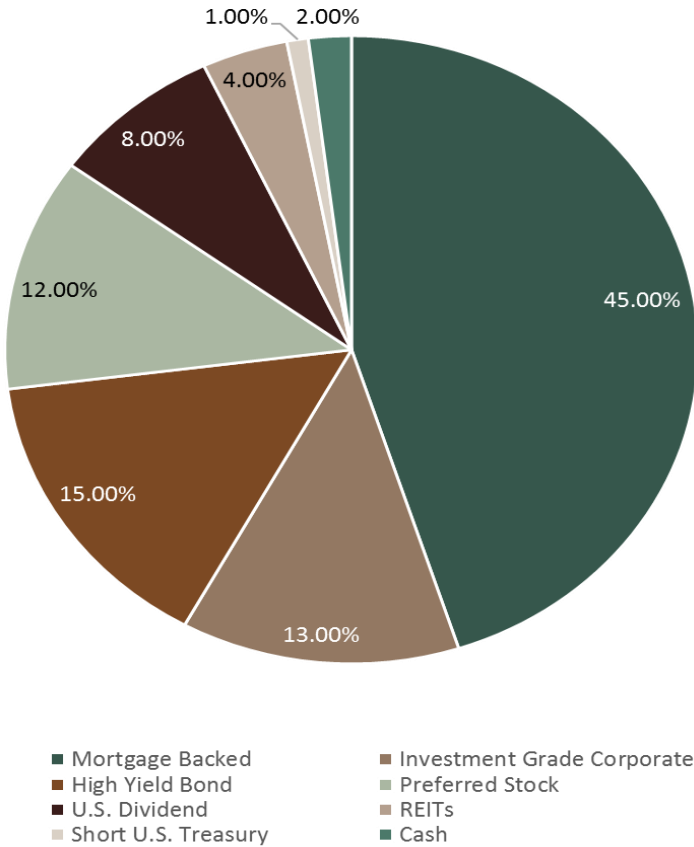
Markets have a pronounced tendency to rush to judgment when policy changes occur. When the Obama stimulus of 2009 was announced the presumption was that it would lead to an inflationary boom. Similarly, the unveiling of QE1 raised expectations of a runaway inflation. Yet, neither happened. The economics are not different. Under present conditions, it is our judgment that the declining secular trend in Treasury bond yields remains intact.

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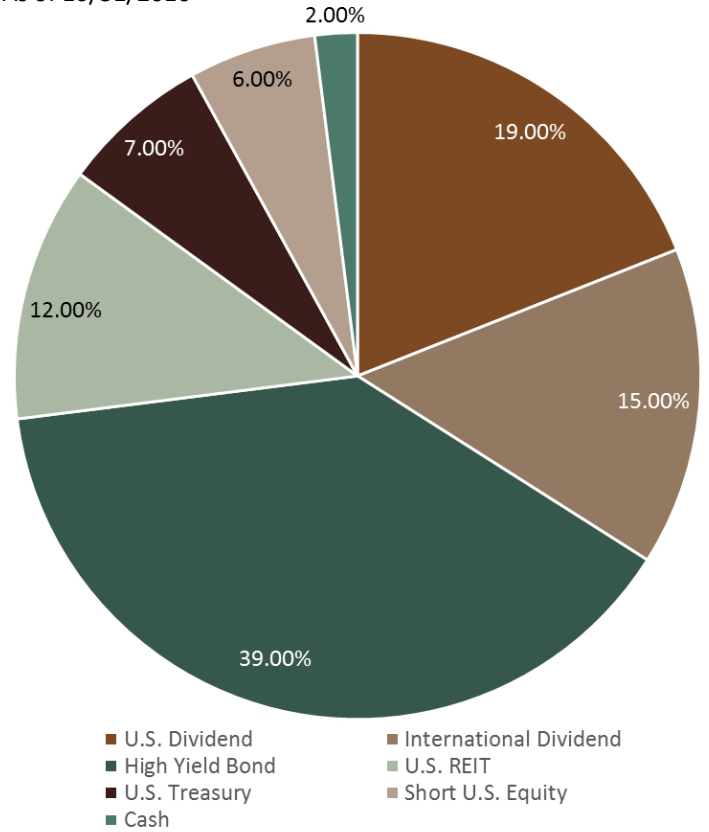
Income

As of 10/31/2016



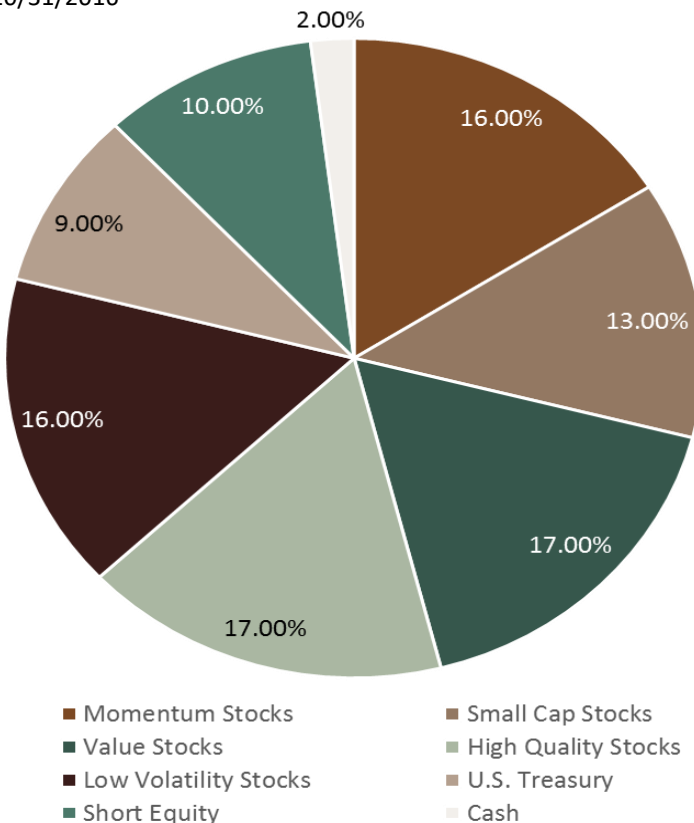
Balanced Income

As of 10/31/2016



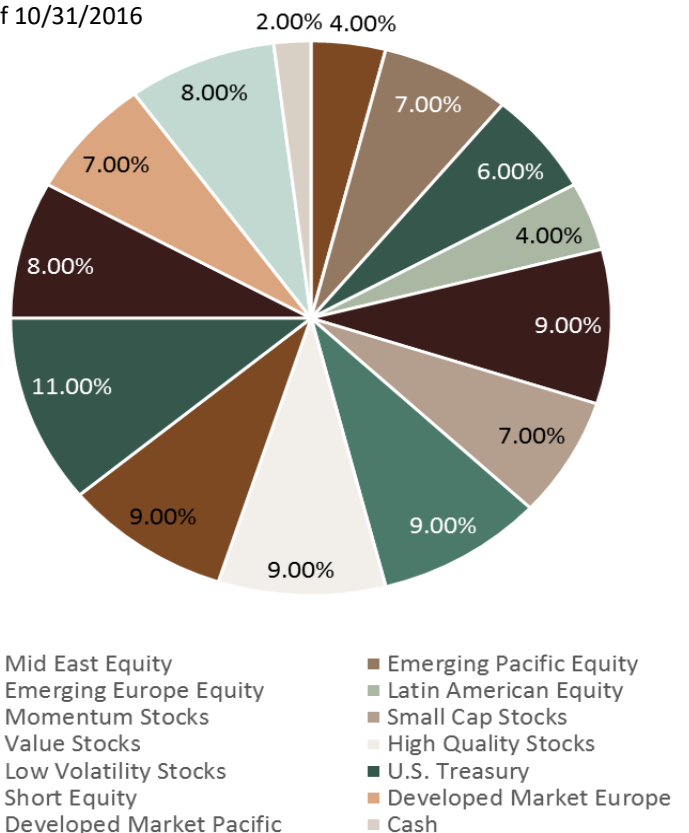
U.S. Growth

As of 10/31/2016



Global Growth

As of 10/31/2016



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