



Interim Update and Comment

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**by Van Hoisington and Lacy Hunt
of Hoisington Investment Management**

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 now. Under present conditions, it is our judgment that the declining secular trend in Treasury bond yields remains intact.

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