Written on 11/22/16

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Corporate Federal Credit Union

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Economic Update
November 2016

By Andrew Kohl

Commentary

Donald Trump's surprise election victory sent the markets into a frenzy. The initial reaction was one of panic. As it was becoming increasingly clear that Trump would become the next U.S. president, stock futures plunged. Dow futures were down more than 800 points (over 4%), at their lowest point, on election night. When the markets opened the next day, sentiment began to change. The focus shifted away from fear of the unknown and towards the potential for expansionary policies that could lift economic growth. The positive sentiment has continued ever since, with equities up 4% (to reach an all-time high) and the ten-year Treasury rate up fifty basis points since election day.

Trump's economic agenda has two main elements. The first element is focused on economic stimulus. He ran on a package of lower taxes and higher infrastructure spending (among other things) to help spur the economy. Trump's latest tax plan largely resembles the one proposed by Paul Ryan (the Speaker of the House). The principal feature of the plan is the reduction in the number of individual income tax brackets from seven to three. Each income level would be at a lower tax rate than where it stands today. There would also be several others changes regarding deductions and credits. The net impact would be a reduction in the household tax burden of approximately $250 billion per year.

Trump's tax plan also incorporates changes to the business tax code. The major shift is a large drop in the corporate tax rate from 35% to 15%. In addition, his plans have called for a one-time tax break for companies that repatriate their cash balances held overseas. The net impact, if all the household and business tax changes discussed above were enacted, would be to increase the federal debt by approximately $5 trillion over the next ten years (roughly 20% in debt/GDP terms). Given that large of an impact, we expect some of the proposals to be watered down. Since it only takes a simple majority in Congress to pass through tax changes (and Republicans have full control), we do expect some tax cuts to get enacted at some point in 2017.

The other piece of Trump's economic stimulus is increased infrastructure spending. Here, his plans are less clear. During the campaign, he stated that he would double Clinton's plan for $250 billion in spending over five years (and mentioned differing amounts on several other occasions). We do expect Trump to follow through on at least some additional infrastructure spending. We hope that he designs a plan to get private businesses involved and chooses projects that have the highest potential to boost the economy's productivity.

The second element of Trump's economic agenda is trade policy. Trump railed against the "bad deals" that the U.S. has accepted on trade over the last several years. In particular, he has pointed to China and the NAFTA trade agreement. Presidents have a wide latitude to impose tariffs on trade. Therefore, we expect President Trump to impose higher taxes on goods imported from China and Mexico in relatively short order. Hopefully, the magnitude of the increase will be much smaller than what he mentioned while campaigning. Protectionist trade policy hurts the domestic economy through higher prices and slower productivity growth.

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The net impact of Trump's economic agenda is likely higher growth and inflation in the short term. The longer run implications look much less positive as his policies are likely to increase debt and lower productivity. The markets seem to be ignoring the long-term at the moment, but we expect a pullback once the total impact of his policies on the economy is factored in.

Fixed Income Outlook

The Treasury curve rose substantially and steepened since election day. The ten-year Treasury rate is at its highest level since July 2015 and is up 100 basis points in a little over four months. The two-year Treasury rate is at its highest level since April 2010. The market is now pricing in a 100% probability of a Fed rate hike on December 14. The market is now expecting two hikes per year over the next two years. We agree that a December hike is essentially a done deal. Even before the Trump election, we thought that a hike was highly probable.

There has been much discussion about what the impact to the Fed may be under a Trump presidency. There was some thought that Janet Yellen would resign (which she quickly quelled). It does seem increasingly unlikely that she will stay on beyond her term when it expires in February 2018. Many in the market have assumed that her replacement will be an inflation hawk given Trump's claim that the Fed was "not doing their job" by keeping interest rates so low. We beg to differ since he would rather not have a Fed president that potentially offsets his growth policies with substantially higher rates. The biggest impact that Trump will have on the Fed will be on the regulatory side since he will be able to choose two new Fed governors once he takes office (since two seats currently are vacant). This will likely lead to some loosening of the current regulatory rules given the Fed's expanded role for bank supervision.

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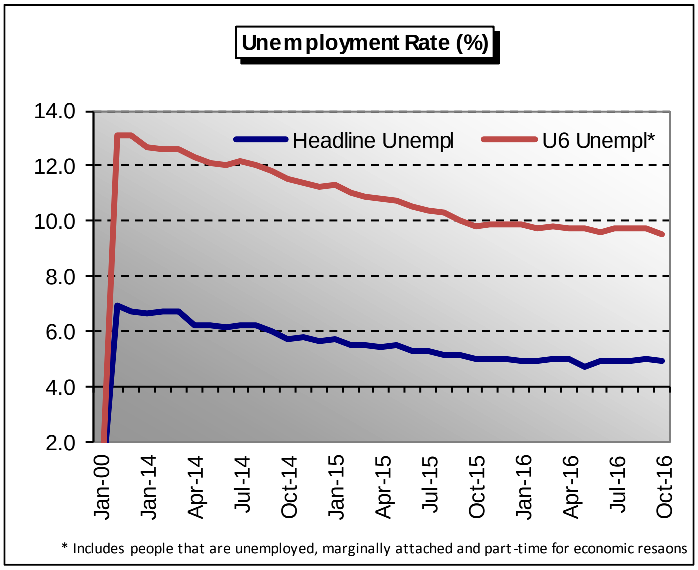
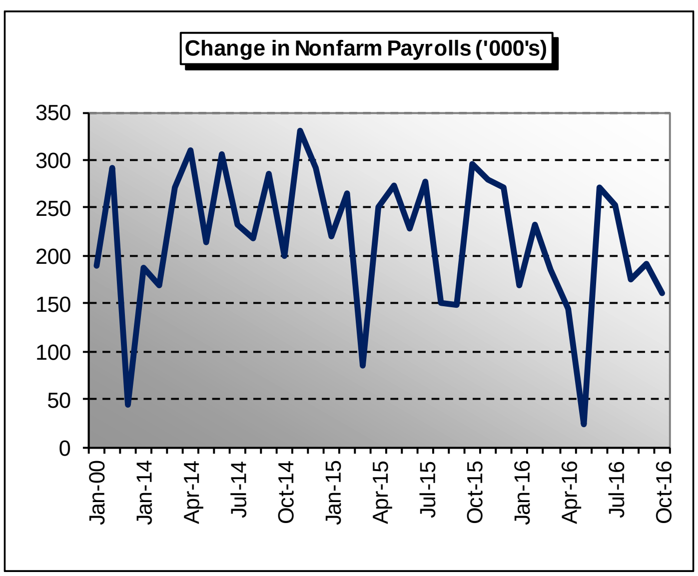
Labor Readings
(Data source: Bloomberg)



Unemployment Rate Declines to 4.9%
The unemployment rate in October decreased from 5.0% to 4.9%. The decline was mainly driven by a fall in the labor force. The main takeaway from the Household Employment Report was that wage growth came in stronger than expected and hit a seven-year high. The year-over-year increase in average hourly earnings was 2.8% versus an expectation of 2.6%. Higher wages should help to spur consumer spending and prolong the economic recovery.



Job Gains Continue at a Steady Pace
Payroll growth in October continued near the same pace seen over the last few months. Payrolls increased by 161,000 jobs versus an expected gain of 173,000 jobs. In addition, the previous two months were revised upwards by 44,000. The gain in jobs, coupled with strong wage growth, is pointing towards a Fed hike in December.

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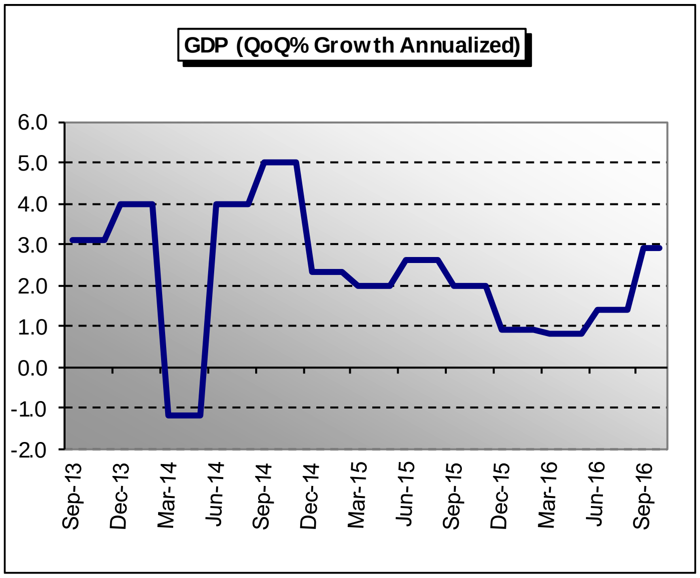
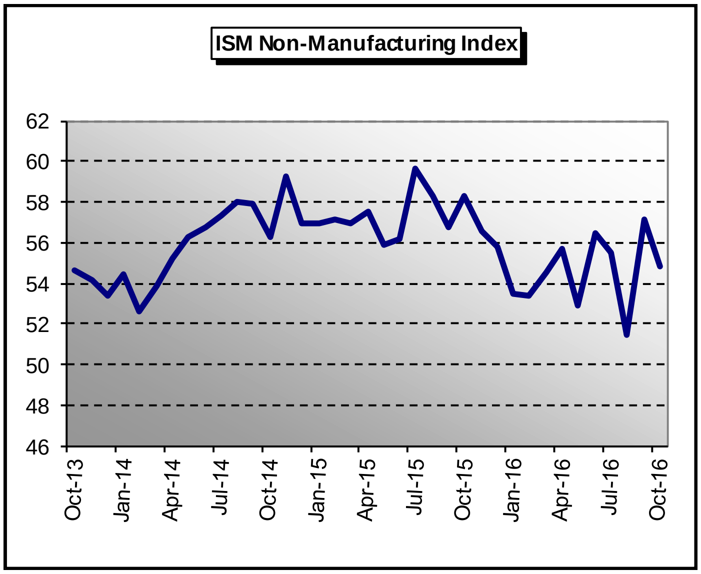
Economic Growth Readings
(Data source: Bloomberg)



Economic Growth Rebounds
Economic growth bounced back sharply from the previous several quarters. The third quarter GDP growth rate was 2.9% versus an expectation of 2.6%. This was the strongest quarterly growth rate in two years. The improvement was largely driven by sizeable positive contributions from inventories and net exports. Consumer spending was weaker than expected, which provides some caution about growth going forward.



Service Industry Index Remains Strong
The ISM index for the service industry came in slightly below estimates, but remains in solid growth territory. After the largest jump ever in the index in September, the gauge was bound to retrace some of the gain. It appears that the large drop in August was more of an aberration than an indication of general weakness in the service sector.

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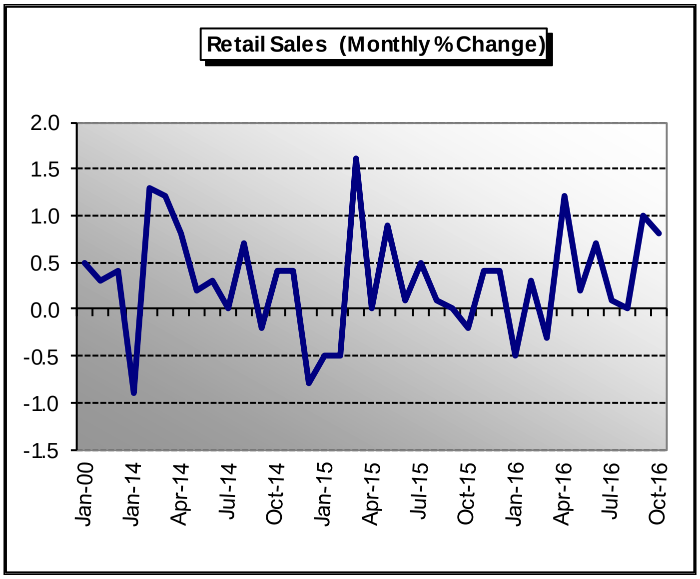
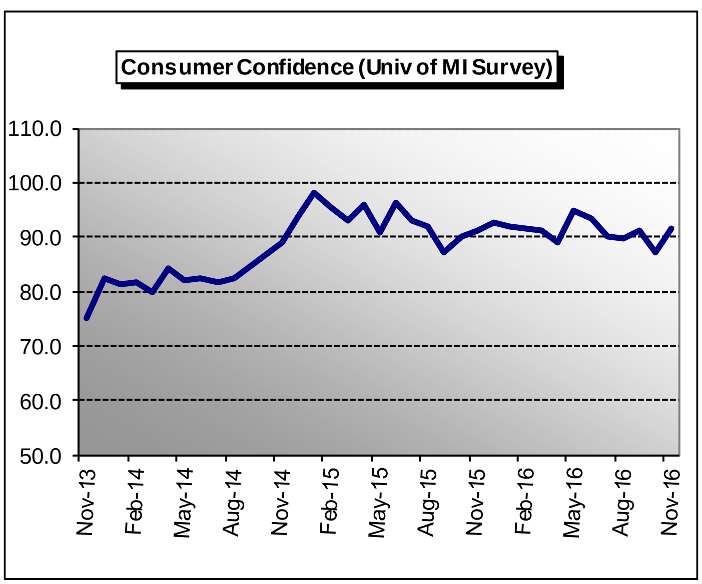
Consumer Readings

(Data source: Bloomberg)



Retail Sales Beat Estimates

Retail sales rose more than forecasted in October. In addition, September was revised upwards. This created the largest two month increase in over two years. Gains were broad-based again in October as 11 of the 13 major sales categories showed improvement. The report highlights that the consumer sector continues to show strength and drive the economy.



Consumer Confidence Gains

Consumer confidence rose to a five-month high just prior to the election. Inflation expectations also rose. The change in inflation expectations over the next year was the largest gain since February 2015. Given the unexpected Trump victory, it will be interesting to see which direction confidence moves when the final November survey results are released on November 23.