ECONOMICS: US PERSPECTIVES

WILL TRUMP'S FISCAL PLAN CHANGE THE BENIGN NATURE OF THE BUSINESS CYCLE?

+ Joseph G. Carson, US Economist and Director—Global Economic Research, joe.carson@abglobal.com

The main objective of Donald Trump's fiscal plan is to strengthen the economic growth cycle. His proposals for tax cuts and increases in spending on infrastructure and defense are important and carry with them positive implications for the economy. But investors also need to recognize that this shift in fiscal policy could easily change the benign (low inflation and low interest rate) nature of the business cycle.

Business Cycles

For the past 40 years, I have tried to understand and forecast the changing nature of business cycles. It has been a humbling experience. For example, the length and speed of business growth cycles are never uniform. Even so, each cycle has recurring features, such as certain sectors leading the growth cycle in the early years and other sectors in the later years. However, it's the unique feature of a cycle that's hard to predict, and that's what ultimately defines each cycle—and determines where most of the money is made and, in some cases, lost.

Perhaps the most notable feature in the current cycle, in our view, has been the unprecedented weakness in nominal government spending (*Display 1*). In fact, over the past six years, there has been essentially no growth in nominal spending at the federal level and only a 1% annual average gain when the spending of the state and local government sector is included.

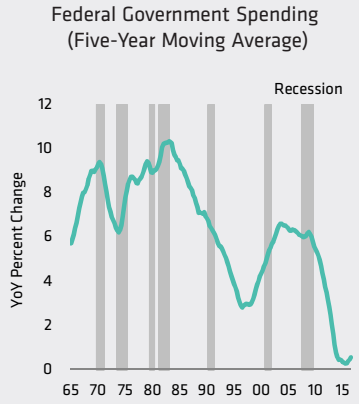
The weakness in government spending directly and indirectly dampened the pace of the recovery, delayed the rebound in cyclical inflation and forced monetary policy to remain relaxed far longer than in past economic growth cycles.

Fiscal Policy and Monetary Policy

The role of government spending (or fiscal policy) in the economic growth and inflation cycles has often been overlooked and underappreciated. Former Federal Reserve chairman Paul Volcker, who championed the disinflation process in the US, often argued that fiscal policy is a complement to and not a substitute for a successful monetary policy. Further, he believed that restraining government spending was an essential component of the Federal Reserve's anti-inflation program to not only restrict the rate of inflation, but also to sustain it at a slower pace.

Essentially, Volcker was arguing that for policymakers to bring about a sustained deceleration in inflation, they needed to slow nominal gross domestic product (GDP) growth. And since government spending was a direct driver of nominal GDP growth, spending restraint at the government level had to occur if a monetary policy program of slowing inflation were to work without "crowding out" private sector activity in the process.

Display 1
Trump's Plan Would Reverse Weak Government Spending



Through September 30, 2016
Source: Bureau of Economic Analysis and Haver Analytics

The past six decades of government spending and GDP data seem to support Volcker's assessment. Since the mid-1980s, nominal federal government spending has averaged 3.7%—less than half the growth rate of the prior 25-year period. Such a sharp deceleration of nearly 400 basis points in government spending had a direct impact on the growth rate in nominal GDP, which was cut roughly in half

as well. More important, of the roughly 400-basis-point deceleration in nominal growth, 300 basis points occurred in the price component.

There's no question that monetary policy played a tremendous—perhaps the central—role in navigating a successful and sustained lower rate of inflation over the past three decades. But a more restrained pace of government spending clearly contributed to the outcome.

Reversal of Fortune

Trump's economic policy proposals have the potential to significantly reverse these trends. Indeed, nominal federal government spending will likely gain a large and sustained boost if Trump gets his increases in infrastructure and defense spending passed by Congress. At this point, it's hard to gauge the size of the increase without more details from the new administration.

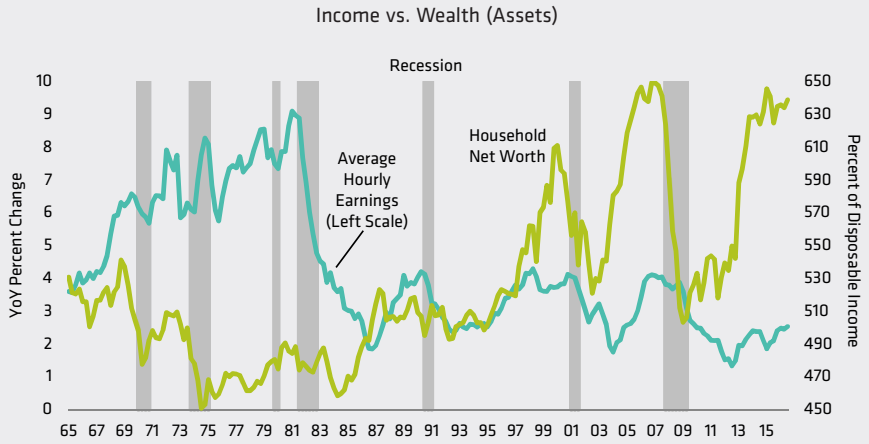
However, it's a relatively safe bet that the growth rate of government spending will be faster over the near term. And it's the rate of change in nominal government spending that's critical in assessing the outlook for economic growth, inflation and interest rates. Even if the Trump plan results in lifting nominal federal spending to the pace of the last 30 years (i.e., close to 4%), that still represents a significant change from the negligible, if not negative, pace of the past six years. And to put it in a larger historical context, an acceleration of 400 basis points would roughly reverse the deceleration that has taken place since the mid-1980s.

Investment Implications

Over the past 30 years, the moderation in government spending, nominal GDP and inflation cycles has had a profound and powerful effect on the level of interest rates. That, in turn, has had a significant impact on the annual returns of real and financial assets. But that's not surprising, since the basic pricing mechanism for financial assets (or assets that are valued based on future income streams) is the change and level of interest rates.

Display 2

Trump's Plan Should Help the Economic Cycle but Pressure the Asset Cycle



Through September 30, 2016
Source: Haver Analytics, US Bureau of Labor Statistics and US Federal Reserve Board

Simply stated, the owners of assets have experienced outsize gains during this low-inflation and low-interest-rate environment. One way to illustrate the relative outperformance is to compare the gains in real estate and equity holdings on household balance sheets relative to household disposable income (*Display 2*). Both measures capture new flows (i.e., additions to the workforce boost income, and new purchases increase asset values) as well as wage and price gains.

From 1985 to the present, household holdings of real estate and corporate equities posted an annual average gain of 8.2%—almost 300 basis points above the gain in household disposable income. Conversely, in the three decades leading up to 1985, the average annual gain in household disposable income was 8.7%—100 basis points over the average gain in real estate and equities.

Inflection Point

History says that the pricing of real and financial assets results from a combination of forces reflecting economic, political (fiscal policy), financial (interest rates) and liquidity trends. The US is on the verge of making a significant change in its fiscal policy. This could have important implications for the growth and inflation outlook, as well as the general stance of monetary policy and the supply and direction of liquidity. If all these changes exert a large impact on the level of interest rates, there could be a significant repricing of asset values.

The central elements to monitor are the shape and scale of the administration's fiscal plan, as these may well alter the benign nature of the business cycle.

It's worth noting that Trump's team has more business experience than any administration in the past 50 years. Consequently, the new team will likely be pragmatic and results-oriented—and not get bogged down in lengthy philosophical or legislative debates.

The business of business is business. Simply stated, it's to get results from decisions. Negotiations will still include due diligence, verification and scenario analysis, but in a time frame that is relatively short.

Stay tuned. It's going to be a new approach and a different ride. ■