11 August 2017

Economic fundamentals are solid. Policy uncertainty clouds the view.

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Topic summary

- Global economic outlook

- US policy environment
  - Fed monetary policy
  - Fiscal policy prospects
  - Political repercussions

Global growth snapshots

US real GDP growth around 2.2% this year and next (vs 1.5% in 2016)

- Solid consumer spending remains the driver of economic growth, as confident, employed consumers open their wallets, supported by moderate income gains and positive wealth effects.
- A moderate recovery in business investment is expected in 2017.
- Net exports are likely to deteriorate, subtracting from growth.
- A significant fiscal policy boost to growth from tax cuts and/or infrastructure spending in 2018 is unlikely given lack of consensus in DC.
- Core CPI inflation to rise, hitting 2% Fed inflation target next year.

Europe: growth expectations have been revised up (+2.0% in 2017)

- Domestic demand remains resilient helped by lower energy prices.
- Fiscal austerity lessened and credit conditions improving as banks adjust.
- ECB monetary policy is stimulative. Tapering QE asset purchases likely in 2018.
- The post-Brexit shock (uncertainty damps business investment) likely leads to slow growth for the UK (+1.6% in 2017 +1.3% 2018).

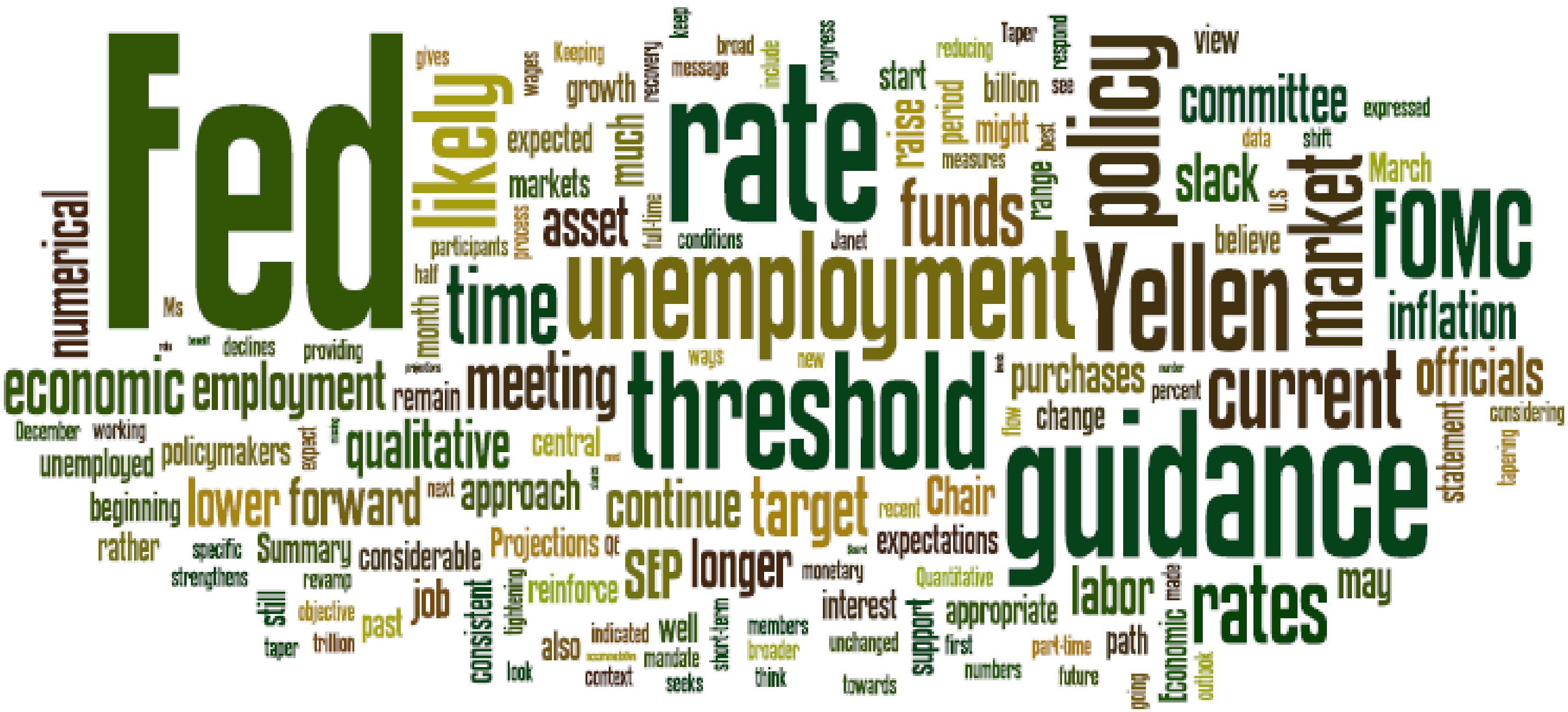
Global snapshots

- **Chinese growth is expected at 6.7% this year.**
  - Q1 GDP accelerated to 6.9%YoY and Q2 saw the same pace of expansion, reflecting fiscal easing and positive contributions from trade. Output in industry accelerated yet household consumption lagged.
  - Risks have decreased, on balance, and can be successfully mitigated by policy. Leverage is high; corporate debt is the main problem. Oversupply in the real estate market is declining.
- **Japan economic expansion picks up speed (+1.3% in 2017).**
  - Domestic demand growth (consumer spending, public investment driving growth.
  - CPI and wage inflation remain subdued.
- **Emerging markets: growth near 4.5% this year.**
  - The gradual and limited acceleration of economic growth remains on track. Political risks and protectionist fears have moderated. Risks: oil prices, global stocks and possible surprises from the Trump Administration.

Policy environment

- Central Bank monetary policy: less accommodation
- Fiscal policy prospects: limited by budget deficit
- Political repercussions: protectionism?

Monetary policy: gradual tightening ahead



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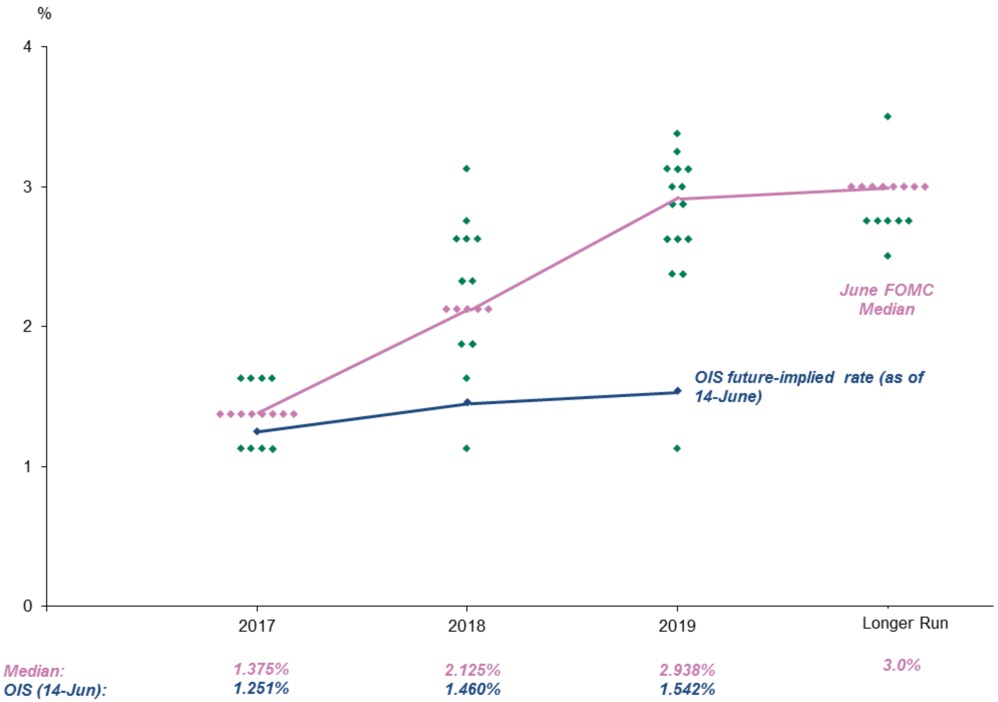
Fed policy outlook: a gradual pace of interest rate hikes

- The Fed sees the economy running close to its potential, which calls for gradual rate hikes.
- Fed policymakers anticipate one additional rate hike this year and three in 2018, moving near the equilibrium Fed funds rate of 3% at the end of 2019.
- We look for the next rate hike in December as the Fed monitors progress towards its inflation objective.
- The Fed is expected to announce next month that it will begin shrinking its balance sheet.

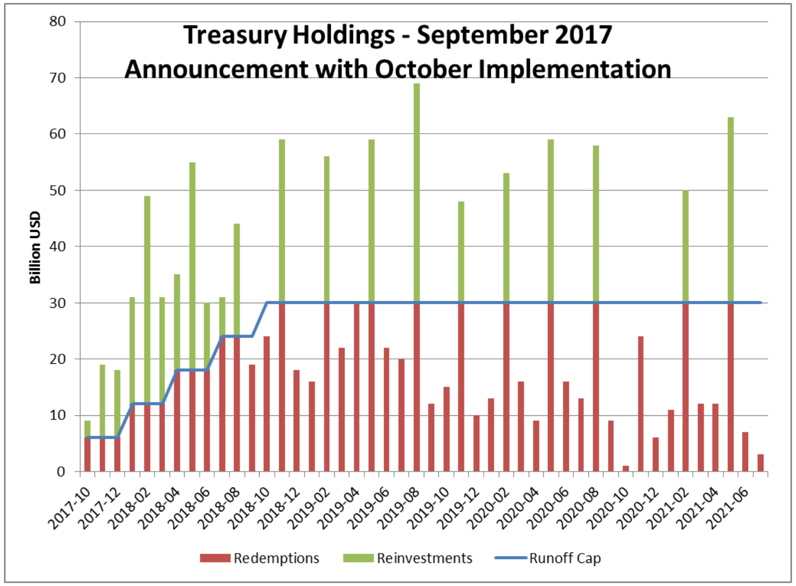
June FOMC dot plot for Fed funds rate

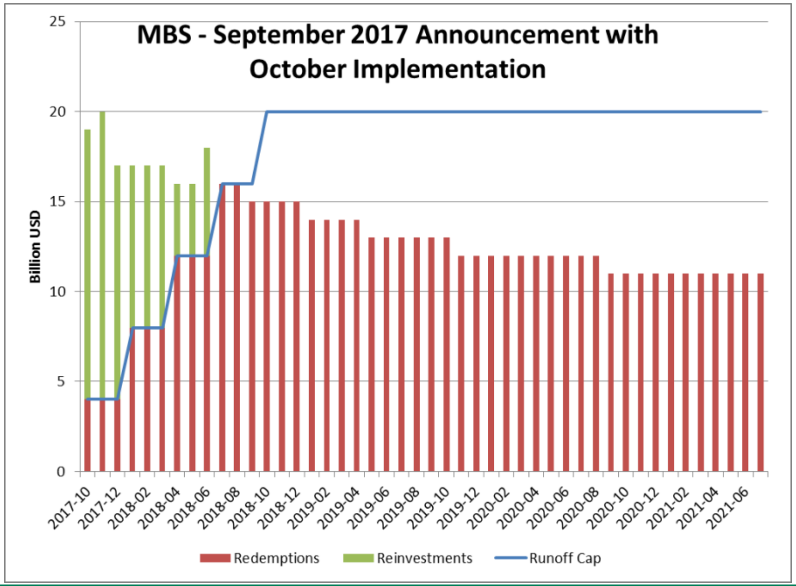


Source: June 2017 FOMC Summary of Economic Projections, CNE Group, Crédit Agricole CIB. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.

Fed balance sheet normalization

- Fed policymakers anticipate beginning their balance sheet reduction “relatively soon.” We look for the FOMC to announce the change in its portfolio reinvestment policy in September.
- The Fed’s balance sheet currently contains about \$2.3trn of Treasuries and \$1.8trn of agency MBS.
- The Fed plans to gradually reduce the size of its securities holdings by decreasing reinvestment of principal payments from those securities with increasingly larger caps on the dollar amounts of securities that will be allowed to roll off each month.
- The cap for Treasury securities has been set at \$6 billion per month, increasing by \$6 billion every three months until reaching \$30 billion per month.
- The cap for agency debt and mortgage-backed securities will be \$4 billion per month initially, increasing by \$4 billion every three months until reaching \$20 billion per month.
- Other Central Banks are also beginning to adopt less monetary accommodation. BoC hike, ECB QE taper.





Source: FRBNY, Crédit Agricole CIB

Fiscal policy prospects

Is fiscal stimulus needed?

The Fed sees the economy’s potential growth rate slightly below 2%.

If fiscal policies were to significantly boost aggregate demand growth (with the economy near full employment) without any corresponding increase in aggregate supply (via productivity growth) then higher inflation would be likely.

This would lead the Fed to hike rates more aggressively, slowing growth.

Pro-growth fiscal policies

- **A "pro-business" Trump Administration (less regulation, lower health care insurance costs, lower taxes on profits and increased infrastructure spending) could fire up business leaders' 'animal spirits'. But…**businesses will likely wait for more clarity on fiscal programs before ramping up investment and the news so far has not been supportive. Little interest in Congress for "paying for" trillion-dollar infrastructure investments. **The Trump "reflation trade" is no longer priced into financial markets**.

- **Lack of consensus in DC on appropriate fiscal policy but significant political pressure on Republicans to lower taxes.**
  - *"The goal is a plan that reduces tax rates as much as possible, allows unprecedented capital expensing, places a priority on permanence, and creates a system that encourages American companies to bring back jobs and profits trapped overseas… without transitioning to a new domestic consumption-based tax system."*
  - Congressional Republicans want smaller government and reduced deficit:
    - Ideology and legislative constraints of reconciliation (Byrd Rule)
  - The White House less concerned about near-term deficit and predicts 3% growth to balance the budget at end of 10 years. CBO sees growth assumptions as unrealistic.
  - Significant tax reform is very difficult and without bipartisan agreement it is extremely difficult. → Tax cuts likely temporary or mix of temporary and permanent.

Tax cuts/reforms: deficit neutral? Winners and losers

House plan proposes reducing the statutory corporate from 35% to 20%.

- The proposal includes full expensing of business capital investment, no net interest deduction and limits on net operating losses.
- The proposed tax reforms would favor firms with more capital investment. Firms with more debt in their capital structure would fare worse.

Border Adjustment Tax (BAT) no longer considered viable.

- The BAT and a territorial tax system was expected to raise revenues to pay for corporate tax rate deduction and discourage firms keeping profits off shore. How to replace the lost revenues to “pay” for the tax cut?
- Tax base broadening measures are politically difficult. (VAT, carbon tax) and no Republican consensus has been built.

Personal tax cut implications

- Consolidates 7 brackets to 3. Top rate 33%
- Lion’s share of the tax cuts go to wealthy, high income taxpayers.
- Standard deduction rises; itemized deductions for mortgage interest and charities less valuable
- State and local tax deduction?

Budget timeline: the legislative agenda

23-May	■ White House/OMB budget proposal: Aspirational!
July-Sept.	■ FY 2018 budget resolution proposal from House • To include tax reform proposals as part of budget reconciliation? • Senate tax reform proposals?
30-Sept.	■ Treasury needs debt ceiling suspension/increase before early October at the latest. ■ A continuing resolution for FY2018 budget authorization likely.
1-Oct.	■ Start of federal government's 2018 fiscal year

Policy uncertainty clouds the view

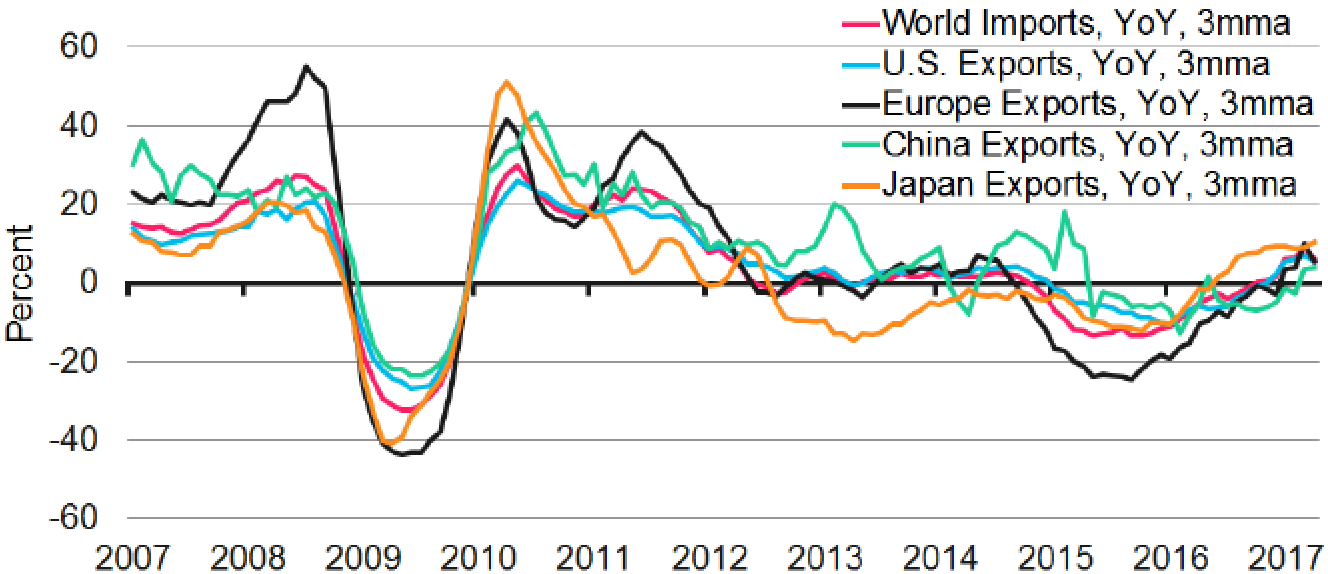
- Growth positive fiscal policies could include:
  - Targeted infrastructure spending.
  - Corporate tax reform to discourage firms keeping profits offshore.
  - Individual tax reforms targeted to middle and lower-income earners.
- The main challenge to tax reform is that someone’s ox gets gored.
  - Those adversely affected are likely to lobby hard against the change.
- The budget deficit limits what can be done.
- Partisan rancor makes the process extremely difficult and mid-term elections are not that far away.
- Conclusion: any tax reform changes or spending initiatives are likely to have a limited impact on boosting growth in 2018.

Political repercussions

Source: White House website

- **Protectionism?**
  - Reduced role of globalization
  - Less cross-border trade, immigration and foreign direct investment diminish growth prospects.
  - Trade wars?

Global Trade



Source: IMF, Bloomberg

Retreat from globalization: America First!

- **Trump's strong adversarial trade posture could increase market unease over trade wars and potentially be a destabilising factor.**
  - President Trump aggravated trade tensions with Mexico, withdrew from the TPP and will renegotiate parts of NAFTA.
  - Supply chain disruptions could lead to higher end-user prices and diminish growth prospects.
  - Currency practices treated as an unfair subsidy: US companies could bring anti-subsidy actions to Commerce Department, which could result in heavy duties. WTO compliant?
  - The Committee on Foreign Investment in the US that reviews foreign acquisitions, may get broader scope to reject deals that threaten national interests. Increased review of transfer of US technology overseas.
  - Cross-border trade and immigration will likely diminish. Immigrants play a large role in future US population growth. The Pew Research Center projects that current trends imply that future immigrants and their US-born children will account for 88% of the nation's working-age population growth between 2015 and 2065.[1]

[1]http://www.pewresearch.org/fact-tank/2017/03/08/immigration-projected-to-drive-growth-in-u-s-working-age-population-through-at-least-2035/

Key take-aways

- US economy is fundamentally solid.
- Global growth outlook is firming.
- Monetary policy is slowly tightening.

- US policy environment presents potential +/- for growth.
  - Tax reform is difficult but could be a positive.
  - Protectionism would raise downside risks.

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