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Pence Perspectives April 2017

Bottom Line Up Front:

Policy matters. For almost a decade, the economy and markets have been driven by the Federal Reserve's (Fed) monetary policy. That process has run its course, although longer than expected. Now, fiscal policies of the federal government need to take over. In the first year of the Trump administration, it is all about policy **expectations**, **implementation**, and **effectiveness**. The objective is to move the economy from an anemic 2% gross domestic product (GDP) growth rate to a more meaningful 3% or higher growth rate.[1]

After the election, President Trump and Republicans controlled both the White House and Congress. "Expectations" for fiscal stimulus have become high, and the stock market has rallied about 10% as a result. We are now in the "implementation" phase. The big question is "will there be gridlock again" or will the policies necessary to stimulate the economy become laws? By executive orders, President Trump has carried out certain key objectives but the heavy lifting must be done by Congress.

In order for fiscal policies to become a long-term success, gridlock must not interfere. We need laws that can lead to tangible "effective" results in the form of GDP growth, job creation, wage growth, and corporate earnings before the midterm election in less than 20 months. If it works, everybody wins.

[1] Private sector GDP growth (3%) has been significantly faster than headline GDP (2.1%) in this recovery as government expenditure has been a significant and enduring drag, shrinking -2.2% until 2014.

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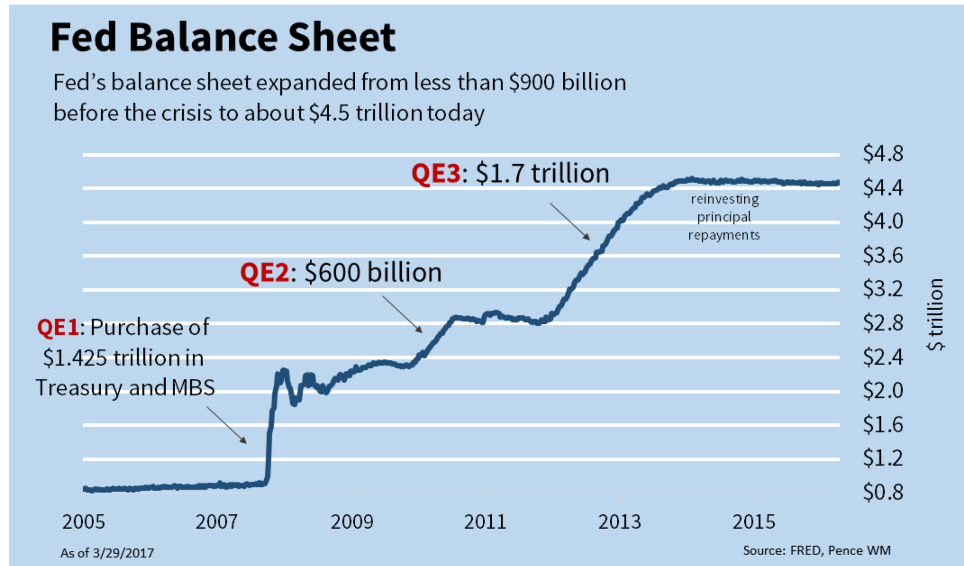
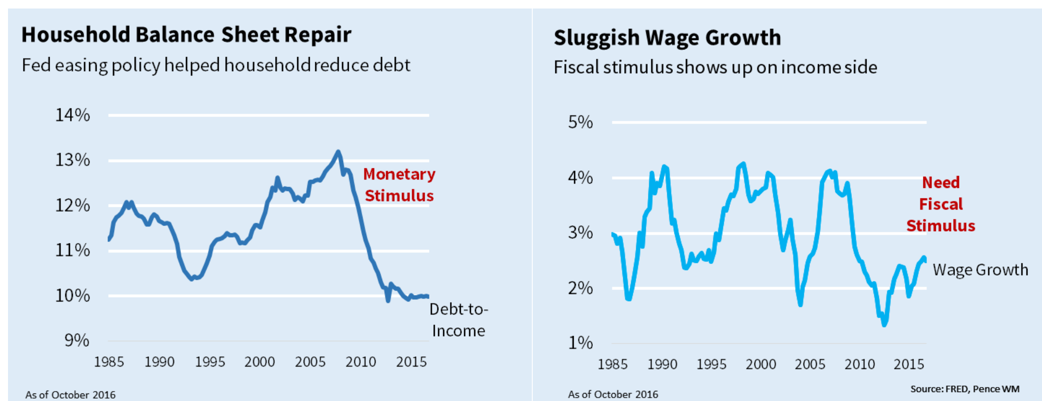
Monetary Policy Has Run Its Course

To help stabilize the financial system and promote economic recovery, starting in late 2008, the Fed injected massive amounts of cash into the economy by buying bonds (US Treasury and mortgage-backed securities), which is the policy of the so-called quantitative easing (QE). Over the last 8 years, the Fed's balance sheet expanded from less than $900 billion before the crisis to about $4.5 trillion today (see chart below). Currently, the Fed holds roughly $2.5 trillion in US Treasuries, more than Japan and China, combined.[2]



In order to achieve escape velocity – the ability to reach a sustainable 3% GDP growth or higher from slow-moving state of 2% growth, the fiscal stimulus from the federal government needs to be "effective". Frequently, monetary stimulus shows up on a household's balance sheet by **lowering the expense of debt**, whereas fiscal stimulus affects the **income-side**. The Fed easing policy did its job: Household debt-to-income ratio has improved significantly since the Great Recession. On the other hand, falling unemployment has not yet translated into faster wage growth, which is still below the 3% long-term average (see chart below).



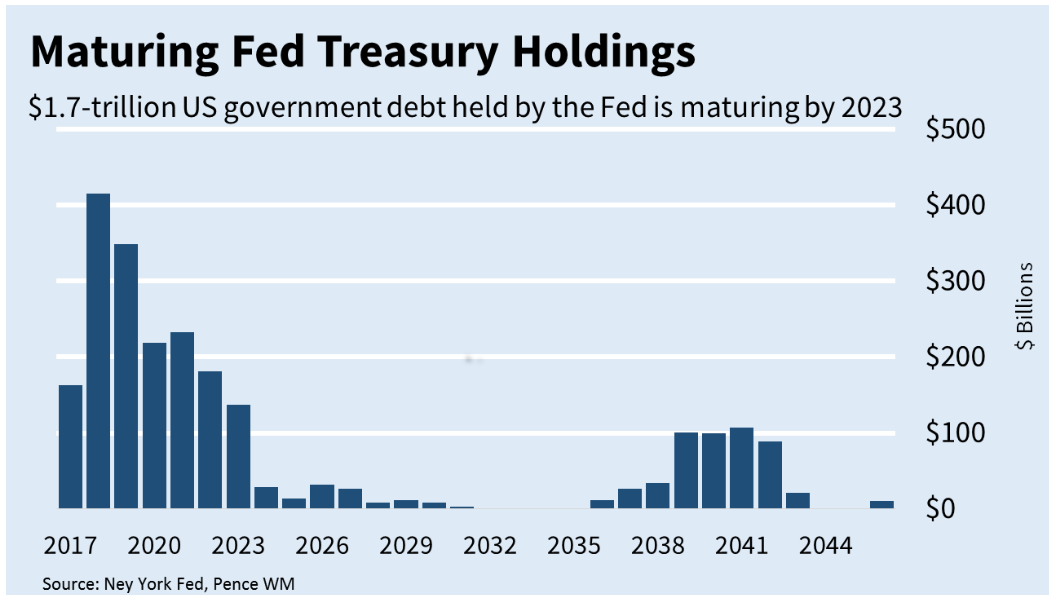
[2] As of Jan 2017, Japan holds $1.10 trillion and China holds $1.05 trillion worth of US Treasury securities

Trimming the Fed's $4.5 Trillion Balance Sheet Remains a Challenge

In March, Fed officials raised fed funds rates for only the third time since it began its tightening policy in December 2015, to a range between 0.75% and 1%. That was the second increase in three months. Depending heavily on US economic data to determine labor market conditions, Fed officials are signaling two more rate hikes this year once in June and another time in September or December. There could possibly be three hikes if inflation picks up and the economy tops expectations later in the year.

Since October 2014, the Fed has maintained the size of its balance sheet by reinvesting proceeds of maturing securities into new mortgage and Treasury bonds. Ceasing reinvestments would cause its balance sheet to shrink. The Fed has been clear that it will not begin reducing it until "normalization of the level of the federal funds rate is well under way." In short: rate increases first, balance sheet reduction later. A total of three rate hikes so far may not justify normalization is "well under way", but some Fed officials recently stated that the Fed could begin shrinking it as soon as this year.[3] Trimming balance sheet works in the same direction of rate hikes, as a **substitute**. The plan is to let the bonds naturally mature without replacing them or partially replacing them. We think it is possible for the Fed to **pause** (not stop) rate hikes in 2018 and start reducing the size of its balance sheet. We expect a balance sheet target between $2 trillion and $3 trillion in 5 years, which is substantially higher than the $900 billion level of the balance sheet in 2007 before the financial crisis began. Former Fed Chair Ben Bernanke explains that the Fed now needs a larger balance sheet simply to accommodate the public's higher demand for our currency in circulation.[4]

We are confident of the Fed's ability to figure out whether there is an **optimal speed** at which its size could be drawn down without causing a market panic. Any missteps such as tightening too-fast, too-soon can hurt the recovery process given the fact that between 2017 and 2023, $1.7-trillion worth US government debt held by the Fed is maturing (see chart below).[5] So we see interest rates continuing to rise at a modest pace though a combination of a small increase in rates and a gradual reduction in the balance sheet.



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[3] http://www.reuters.com/article/us-usa-fed-dudley-idUSKBN1721SZ

[4] https://www.brookings.edu/blog/ben-bernanke/2017/01/26/shrinking-the-feds-balance-sheet/

[5] Between October 2014 and February 2017, US Treasury issued $637 billion worth of bills/notes/bonds on a monthly basis. It represents about 3% - 5% debt issuance by the US Treasury. $415 billion is maturing in 2018 alone.

Time for Fiscal Stimulus

For the first time in a decade, American politics significantly affects the course of US equity markets. Government can stimulate the economy through aggregate demand by cutting **taxes** and increasing government **spending**. Expectations that expansionary fiscal policy will boost economic growth and boost inflation are part of the reason stocks have rallied since the election.

Trump wants to grow the economy at a higher than current rate by lowering taxes, lifting regulations, and boosting spending. If everything goes according to the plan, everybody wins.

Congress will be in Easter recess for 2-1/2 weeks (April 7-24). After the recess, it will have four business days between April 25 and April 28 to approve new government spending and increase the debt ceiling in order to avoid a **government shutdown**.

After the healthcare bill failure, Trump wants to advance **tax reform** alongside an infrastructure investment package as quickly as possible. An ambitious plan would be to pass both bills with bipartisan support before Congress' August recess (July 31 - September 4), but it seems unlikely given that Republicans aren't entirely on the same page about infrastructure funding and a border adjustment tax and Democrats are unlikely to get on board with steep tax cuts. Such a massive legislative effort may present plenty of opportunities to make everybody happy, but also sets up the possibility of long debates, which may prolong the effectiveness of those reforms.

We think Trump will wait until he is certain he has the votes needed in Congress to pass the tax reform. The House of Representatives tax committee has been working on a plan since mid-2016 that would cut the corporate tax rate from 35% to 20%, lower taxes on profits repatriated from overseas, and cut other tax rates for businesses and investors. For an income tax bill, Trump wants to reduce personal income tax rates from 7 to 3 brackets, namely:

Proposed Tax Brackets	***Income: Single Tax Filer***	***Income: Joint Tax Filer***	***Long-Term Capital Gains Tax Rate***
12%	$0-$37,500	$0-$75,000	0%
25%	$37,500-$112,500	$75,000-$225,000	15%
33%	$112,500 and above	$225,000 and above	20%

The US tax code is riddled with narrow subsidies and loopholes, many of them deeply embedded in the economy and defended by the interests they benefit. There is a possibility for a scenario of a fast-tracked tax reform bill that would yield quick action by the August recess but that would limit how aggressively they can cut corporate and individual rates.

The fifty-four billion dollars in additional **defense** spending has already been included in the 2018 budget. On **infrastructure** spending, we expect President Trump to accelerate the introduction of his $1 trillion infrastructure bill. He described the infrastructure package as very popular and a high-value legislative sweetener that he could use for another bill such as a revived Affordable Care Act repeal bill or tax code overhaul to attract bipartisan support. On March 27, labor unions representing construction workers have already sent an infrastructure priority list to Trump at his request, as he is ready to give a greenlight to those projects that require little, if any, federal funding. More than half of the projects on the list given to Trump are privately financed and could use the Trump administration's help in the form of regulatory relief.

What Do Fiscal Policies Mean for Markets, Sectors, and Earnings

Hopes for tax reform, government spending, and deregulation helped drive up stocks 10% since the election. Remarkably, since then volatility has remained low. Until the close of trading March 21, 2017, the index had gone 110 consecutive trading days without suffering at least a 1% decline over any single trading day. That was the longest span in history, breaking the record of 105 days it had more than 21 years ago.

Corporate profits have been weak in recent years, mostly due to the energy sector. The price of oil around $50 takes the edge off many energy companies. Analysts are currently projecting earnings growth of 10% and revenue growth of 5% for the year if nothing gets done in Washington this year.

Markets will likely react positively to the news of the tax bill long before other developments. With Trump's tax plan, we could see a boost to markets in 2017 if Congress passes and makes it effective this year, as it will show in this year's earnings. Some analysts believe a reduction in the corporate tax rate to 15% or 20% could add $10 to $15 in earnings per share (EPS) to the S&P 500 index. That is equivalent of an additional 10% increase in earnings or an additional $2 trillion increase in market value, calculated in current multiples. Having said that, the effects of the tax bill may take a little while to work through the real economy. We may have to wait until 2018 before it shows up in consumers' balance sheets.

If successfully implemented, we think sectors such as financials and information technology along with industries such as major defense contractors and construction materials will do well under proposed policies. Additionally, we favor companies in the consumer discretionary sector as lower tax bills should boost consumer discretionary spending. Sectors such as utilities, energy, and consumer staples have been favored during a low interest rate environment as income substitutes. Once the rates start rising, we think these sectors will fall out of favor and investors will look elsewhere for yield with better risk-adjusted returns.

Conclusion

On a bright side, both earnings and revenue are expected to grow in 2017 and 2018 along with minimum 2% or higher economic growth. We believe this should support the current equity rally for the rest of the year and into the next year if everything goes according to expectations. If the political conflict remains elevated in Washington and the "implementation phase" takes longer than many of us have been hoping for, the delay in results could lead to some volatility in stocks. Going forward, we think the conventional wisdom tells us to remain cautiously optimistic. Sector picking will be a key factor, alongside building portfolios to manage the bouts of volatility and pullbacks.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

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