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Pence Perspectives December 2016

US Election: Clinton Lost, Less Gridlock in Washington

On November 9th, Donald J. Trump was elected as the 45th president of the United States. He will be the first president with no government or military experience. Unofficial election results indicate that Hillary Clinton got 5 million fewer votes than Obama did eight years ago, the voter turnout in this election was lower than the previous two. This means that the new administration will need to move extra fast to make its mark if it wishes to have long term success.

Past experiences show that getting the "big stuff" done in the first 100 days of a new presidency is often the best rapid action strategy because the opposition is still stunned and disorganized. With a Republican majority in both houses of Congress, President-elect Trump will want to take action very quickly before the 2018 mid-term elections, when Democrats will try to regain some seats in Congress. We believe the net outcome of the 2016 election is less gridlock, at least over the next two years.

Years	Republican Votes		Democrat Votes		Total Votes	Total Vote Casted	Total Citizen Population	Turnout
	Candidate	Votes	Candidate	Votes				
2008	McCain	59,934,814	Obama	69,456,897	129,391,711	**131,257,328**	206,072,000	63.7%
2012	Romney	60,932,152	Obama	65,899,660	126,831,812	**129,067,662**	215,081,000	60.0%
2016	Trump	62,248,428	Clinton	64,243,397	126,491,825	**132,302,156**	227,019,486	58.3%

Source: US Census, UC Santa Barbara *(as of Nov 28 2016)*

Bottom Line Up Front:

First, President-elect Trump has a very ambitious agenda that he wants to accomplish immediately by the stroke of a pen, via Presidential Executive Order.[1] He has already outlined 6 items. He wants to withdraw from negotiations on the Trans-Pacific Partnership (TPP) trade deal, cancel many environmental restrictions put in place by President Barack Obama, ask his national security team to buttress against infrastructure attacks, have the Labor Department investigate federal worker visas and impose broad new bans on lobbying by government employees.

Second, he is going to try to move through Congress measures he can achieve quickly such as tax-reform, infrastructure spending, and increasing the military budget. For the markets, his policies would affect specific sectors. For example, Trump wants to lower taxes and increase government spending which will likely raise government debt, this in turn means higher expected inflation and higher interest rates. Higher interest rates are good for bank stocks and the financial sector. His military and infrastructure spending will mean higher earnings for major defense contractors as well as companies in the industrial, general construction, and construction materials sectors. Furthermore, he will disregard regulations advocated by Hillary Clinton, which may help take pressure off of the healthcare sector, which has been underperforming year to date. His Proposed corporate tax reforms could boost corporate profits. President-elect Trump's proposal to lower individual federal income tax rates will most likely increase households' disposable income which means more discretionary spending. Usually this is positive for companies in the consumer discretionary sector. For the bond market, we will see continued volatility as interest rates rise.

Trump's Economic Plan

President-elect Trump wants to grow the economy at 4% per year and add 25 million new jobs over the next decade. The first six items of his action plan should go into effect shortly after January 20th, 2017. Items such as building a wall or fence along

1 For more information: https://assets.donaldjtrump.com/_landings/contract/O-TRU-102316-Contractv02.pdf

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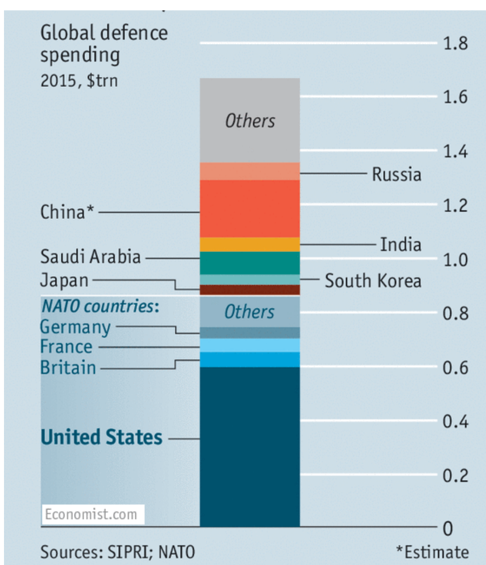
the Mexican border, placing new restrictions on immigration, repealing Obamacare, tax reform, and spending $1 trillion on infrastructure will require the approval of Congress and are likely to take significantly more time and work.

At first, his jobs goal may seem too ambitious, considering the economy has created a total of 15 million jobs since 2010 after losing 8.7 million jobs during the Great Recession. But his plan hopes to re-engage most of the 14 million people who left the labor force over the past seven years. He believes that for each additional one percentage point rise in gross domestic product (GDP), the economy could add each year an additional 1.2 million jobs.[2]

In his **tax plan**, he is proposing to reduce the corporate tax rate to 15% from 35%, while collapsing the current seven personal income tax brackets to three brackets: 12%, 25%, and 33%. His tax reform plan also caps individual federal tax rate at 33% instead of 39.6% for households whose adjusted gross income (AGI) exceeds $225,000, while increasing the standard deduction for joint filers to $30,000 from $12,600 (for single filers to $15,000 from $6,300). He also wants carried interest to be taxed as ordinary income instead of long-term capital gains. Tax rates on capital gains would be capped at the current rate of 20% and itemized deductions are capped at $200,000 for joint filers or $100,000 for single filers. He's also proposing eliminating the estate tax, a favorite proposal of small-business owners and farmers who want to pass on their success to their heirs. In order to finance some of his spending, he is proposing a one-time 10% tax on the repatriation of retained earnings stashed overseas by corporations, estimated to be as high as $2.5 trillion. .

The President-elect proposes an infrastructure rebuilding plan offering $137 billion in federal tax credits to private investors to unleash up to $1 trillion worth of **infrastructure investment** over 10 years through revenue-producing public-private partnerships rather than sole government spending. According to the McKinsey Global Institute, the US needs to boost infrastructure spending by 0.7% of GDP between now and 2030 to meet the demands of a growing economy. That equals an additional $130 billion per year over the $416 billion spent by federal, state, and local governments on transportation and water infrastructure in 2014.

The President-elect proposes to eliminate the **defense spending** cuts under sequestration and submit a new budget to rebuild the US military. In his campaign, Mr. Trump called for 90,000 more active Army soldiers, a total of 350-ship Navy, nearly 100 more fighter aircraft, and strengthened nuclear and missile defenses. According to Mr. Trump's senior campaign aide, eliminating the sequester would amount to roughly a $50 billion a year increase in defense spending or a $500 billion reinvestment over 10 years. In 2015, the US spent over $600 billion, which is twice the amount spent by all the other 27 NATO countries combined. In order to offset some of the additional cost, Mr. Trump may seek additional payments from countries where the U.S. has military bases, including Germany, Saudi Arabia and Japan or ask NATO-countries to pay their fair share. The United States accounts for one-third of global defense spending. In fact, we spend more money on the military than the next seven countries combined as shown in chart below.



2 Increasing GDP growth by 1.5% over the current 2% could result in 18 million jobs over 10 years (1.5 X 1.2 million X 10 years) above the projected current estimates of 7 million, generating a total of 25 million new jobs for the American economy.

When it comes to **trade**, Mr. Trump wants to focus on the two countries that matter: China and Mexico. The chart below depicts that these two countries account for more than half the US trade deficit in recent years. Mr. Trump wants them to come to the table. With China, he has said he would impose 45% tariff on Chinese imports and declare Beijing a currency manipulator *if China doesn't change its trade practices*. With Mexico, he threatened to leave the NAFTA and impose a 35% tariff on imports from Mexico *if Mexico doesn't agree to renegotiate the pact*. The truth is these two countries need the US more than the US needs them. In 2015, the US accounted for 80% of Mexico's exports and 20% of China's exports, whereas Mexico and China accounted nearly 15% and 8% of US exports, respectively. Negotiating from a stronger position with just these two countries can significantly reduce the US trade deficit.

Challenges

According to the Tax Foundation's Taxes and Growth Model, President-elect Trump's **tax plan** would add around 0.5% to economic growth each year. Depending on the nature of key policy provisions, the plan would also reduce tax revenues to between $2.6 and $3.9 trillion, after accounting for the larger economy and the broader tax base. The plan may increase our national debt, which stands at $19.8 trillion today. This means we should expect meaningful debates on budget deficits moving forward.

On his **plan to repatriate money**, a similar temporary rate cut to 5.25% under President George W. Bush in 2004 prompted companies to bring back $312 billion. Studies of the 2004 Bush-era repatriation tax break; however, found that almost all of the money was used to fund stock buybacks and executive compensation. Little was used to hire more workers or acquire capital equipment.[3] This is why we are not sure how the repatriation tax break will affect hiring and capital spending during Mr. Trump's presidency. For this reason we can expect more conditions on repatriation than just taxation alone.

On his **infrastructure spending**, we believe there are limits to how much can be done with private financing because privately funded projects need to turn a profit. They are better suited for major projects such as toll roads and airports and less appropriate for routine maintenance such as repaving a public street or repairing a decaying public bridge. An important question regarding his plan is to know how much of the infrastructure investment would be incremental and how much would simply replace existing municipal debt-financed investment. This means we can expect debates on which projects get funded.

On his **defense spending**, given the current state of their economies, we can expect other NATO countries to resist spending more on their defense. NATO's official guidelines say member states should spend at least 2% of their GDP on defense. Of the 28 countries in the alliance, only five -- the U.S., Greece, Poland, Estonia and the U.K. -- meet the target. The median spending in 2015 was just 1.2% of GDP, compared to 3.7% for the United States. NATO is pushing hard for the 2% guideline to be taken more seriously. In 2014, all member countries that fell below the threshold have committed to gradually ramp up military

3 In fact, the 15 companies that brought back the most cash reduced the size of their workforce in total and decreased spending on research and development, according to a 2011 Congressional investigation.

spending to reach the target within the next decade. This means we can expect a push for a more aggressive time table.

On his **trade plan**, trade experts argue that tariffs won't guarantee to bring jobs back. In fact, higher tariffs may make things more expensive. For example, imposing the maximum proposed tariff on China and Mexico would raise the average effective US tariff rate by roughly 11-12 percentage points from 1.5% to roughly 13%, a level not seen since WWII, according to Goldman Sachs. This may mean higher input costs and higher inflation. The Peterson Institute simulated a scenario on Trump's tariff threat. It calculated that the US would enter a recession and lose close to 4.8 million private sector jobs *if both China & Mexico responded in kind with identical tariffs*. The Peterson Institute report shows that the Rust Belt, the Southwest, and California could be hit particularly hard. This means we can expect more vigorous debate on these issues which may slow down major changes.

Long Term Effects

There is a consensus view that Mr. Trump's proposals may boost the economy in the short run. The long term consequences of his policies; however, still remain unclear. The markets are already pricing in Trump's policies. Investors believe a Trump presidency will mean higher growth, higher inflation, and higher interest rates. The yield on 10-year US Treasury bond has jumped from 1.8% to 2.4% within days of Trump's election victory, the fastest move in history. One thing we believe is that monetary policy has run its course. It alone cannot create sustainable economic growth over a long period. The Federal Reserve (Fed) poured money into the system through quantitative easing (QE), starting from November 2008 (QE1), then November 2010 (QE2), and finally September 2012 (QE3) which helped move us through the Great Recession at an anemic 2% economic growth, the slowest recovery in history. It is time; however, to move forward with fiscal policy where policy makers have a willingness to work together to move the country forward. Should this happen, we can expect the economy and markets to react favorably and look forward to a brighter 2017.

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

All the best, ❖

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