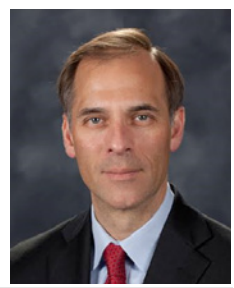
2017 Economic Forecast



Trump Presidency Promises to Push Strong Economy in Different Direction

By Mark Zandi

The economic outlook has meaningfully changed due to the election of Donald Trump as president of the United States. Significant changes are likely in tax law and government spending, trade and immigration policies, and regulation. ■ Precisely what economic policies President Trump implements and when are highly uncertain, and it will take time to nail things down as he works to assemble his government. Once he does, he will be able to move quickly, given the president's substantial authority. He can make many decisions unilaterally, and while they will almost certainly be challenged in the courts, it will all take years to sort out. ■ A Republican-controlled House and Senate will also smooth the way for more policy becoming law, particularly since the Senate filibuster is no longer the legislative handcuff it used to be.

Financial markets are already discounting the coming policy changes. Stock prices were up over 5% since Election Day to a record high, with the biggest gains in the shares of financial institutions, and energy and industrial companies. Long-term Treasury yields have also risen sharply, with 10-year yields up almost 80 basis points to near 2.6%. This has pushed fixed mortgage rates back up to well over 4%. Corporate credit spreads have narrowed, thus borrowing costs for businesses have not risen nearly as much.

The value of the U.S. dollar has also appreciated, particularly vis-à-vis the Japanese yen and the euro. The euro/$ is near parity. On a broad trade-weighted basis, the dollar is as strong as it has been since Y2K. Oil and metals prices are also up since the election, although this may also reflect other factors, such as the recent OPEC deal to rein in its production.

CORPORATE TAX REFORM

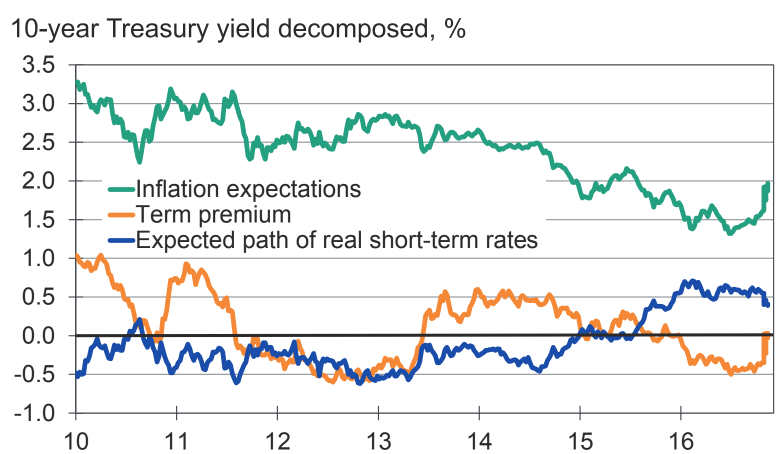
Consistent with the higher stock prices and narrower credit spreads are investor expectations of corporate tax reform. Trump has proposed a 15% top marginal corporate rate, down from its current 35%, and the adoption of a territorial taxation system with a one-time 10% rate on repatriated foreign earnings. His strong support of deregulation has also cheered investors. Financial stocks have gotten a pop in anticipation of changes to Dodd-Frank, as have health-care stocks given the likely repeal of the Affordable Care Act. Energy and environmental deregulation seem near certain, which is a plus for energy producers and related industries.

Investors also appear to be anticipating fiscal stimulus–deficit financed tax cuts and increases in government spending. This is clearest in the rise in long-term Treasury yields, which can be traced to increases in inflation expectations, expected real short-term rates which reflect anticipated future monetary policy, and the term premium, or the yield compensation that investors require for the risk of investing in a long-term security. (See Chart 1.)

Investors understand that stimulus applied to a full-employment economy–an apt description of the economy in 2017–will result in more wage and price pressures and a faster normalization of monetary policy. The big swing from negative to positive since the election in the term premium–which is sensitive to expectations regarding the government's future fiscal situation–says investors also appear to believe Trump's policies will add to future budget deficits.

"Consistent with the higher stock prices and narrower credit spreads are investor expectations of corporate tax

CHART 1 **MARKETS ANTICIPATE TRUMP FISCAL STIMULUS**



Sources: Federal Reserve, Moody's Analytics

TIGHTER FINANCIAL CONDITIONS

Financial markets' strong reaction to the election net out to a tightening in financial conditions, which if sustained as anticipated will ding economic growth next year. (See Chart 2.) It will still be a very good year, as President Trump will inherit an economy that is fundamentally strong. Job creation is robust, the economy is near full employment, and wage growth is accelerating. With a record number of open job positions and few layoffs, it would take a severe shock to derail the economy. But it won't be quite as good a year.

Higher stock prices are a clear plus for growth, primarily via the wealth effect on consumer spending. Household stock holdings are worth about $1 trillion more since the election. If sustained, that should prompt more spending and be a meaningful add to growth in 2017. But this will be largely washed out by the stronger U.S. dollar and the resulting widening in the trade deficit. The higher interest rates will also bite.

With fixed mortgage rates back over 4%, refinancing activity has already been curtailed, since the average coupon on outstanding mortgages is close to 4%. Home sales and house prices will also feel it, as more trade-up buyers will have to pay a higher rate on their new mortgage than on their old one. This is a big change, since homebuyers have enjoyed more-or-less declining mortgage rates since the early 1980s.

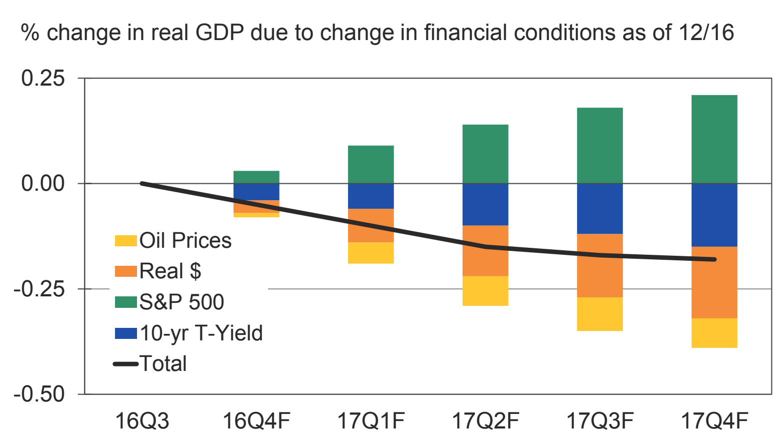
Other potential near-term fallout from the election includes heightened policy uncertainty as the new administration struggles to articulate its policies. This could cause businesses to delay investment and perhaps hiring decisions, and consumers will pause at least for a while to see how things are proceeding. However, consumer and business confidence may get a lift given the prospects for change. Judging from recently stronger sentiment surveys, frustration over gridlock in Washington may have been weighing on confidence. It is hard to know the upshot of all this, but it is likely these crosscurrents eventually cancel out.

MORE CYCLICAL ECONOMY

Like financial markets, we expect President Trump to implement an expansionary fiscal policy of deficit-financed tax cuts and greater government spending. This will result in stronger growth over the next 2-3 years as the stimulus ramps up, but weaker growth by the end of his term when the stimu-

"Like financial markets, we expect President Trump to implement an expansionary fiscal policy of deficit-financed tax cuts and greater government spending."

CHART 2 FINANCIAL CONDITIONS TIGHTEN



Source: Moody's Analytics

lus fades. There will thus be bigger ups and downs in the business cycle. (See Chart 3.)

The expected tax cuts will not be nearly as large as Trump proposed during the campaign, but the price tag is still expected to be sizable at close to $1 trillion over the next decade. This includes cuts to both personal and corporate income taxes. Government spending also seems set to increase substantially, by at least $500 billion over the next decade. This will include more government spending on veterans' benefits and the military. And while more infrastructure spending is not as sure, given skepticism among some congressional Republicans around the costs, Trump appears all-in on it.

Economic growth should peak by mid-2018, when the tax cutting and spending increases are in full swing. Negating the economic benefit of the Trump stimulus is the full-employment economy. The tax and spending multipliers—the growth due to the stimulus—are much smaller than they would be if the economy was struggling with high unemployment, as it was in the Great Recession when the highly effective 2009 Recovery Act was implemented.

Indeed, in a full-employment economy, the expansionary fiscal policy is quickly crowded out by a less accommodative Federal Reserve and global investors, so-called bond vigilantes, who push up long-term interest rates in anticipation of more inflation and bigger deficits. Higher inflation and interest rates are indeed part of our baseline scenario, with core consumer price inflation breaching 3% on a sustained basis, well above the Fed's inflation target. (See Chart 4.) The Fed responds by increasing the federal funds rate to nearly 4% by early 2020, and the vigilantes push the 10-year Treasury yield to as high as 4.5%.

These are the classic symptoms of an overheating economy, which have historically ended in recession. We do not expect a recession, but the economy comes unnervingly close by the end of President Trump's term.

> "With fixed mortgage rates back over 4%, refinancing activity has already been curtailed, since the average coupon on outstanding mortgages is close to 4%. Home sales and house prices will also feel it, as more trade-up buyers will have to pay a higher rate on their new mortgage than on their old one."

CHART 3 A MORE CYLICAL ECONOMY

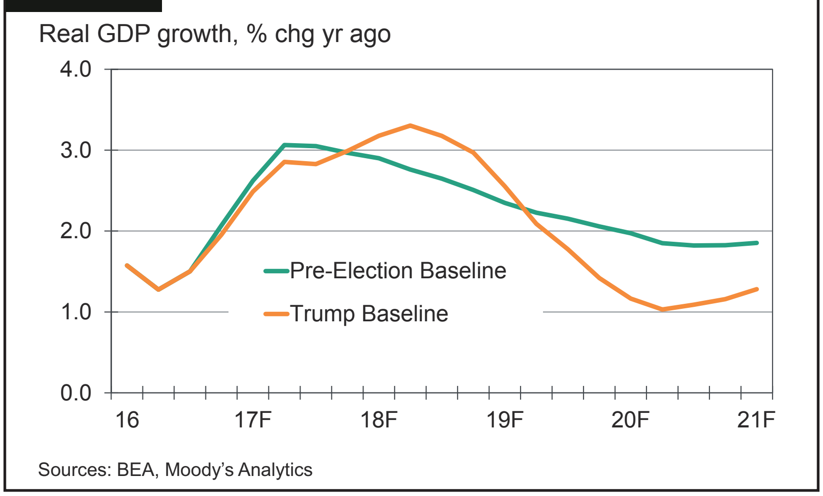
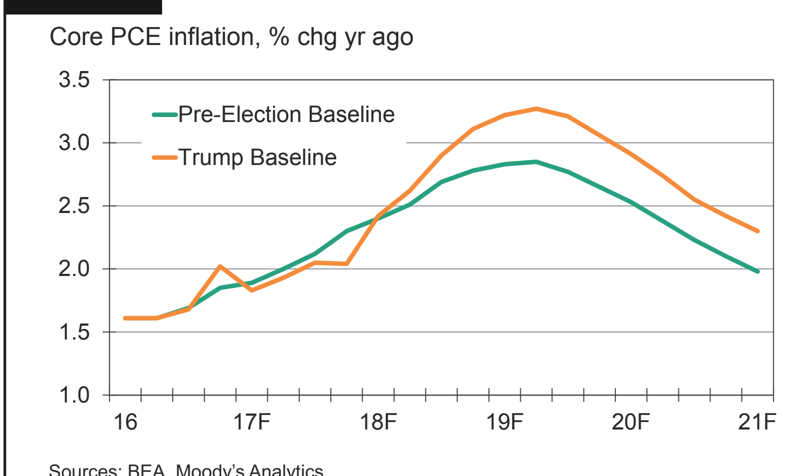


CHART 4 ... WITH HIGHER INFLATION



2 PERCENT GROWTH, NOT 4 PERCENT

While the election of President Trump will mean big changes for the economy, his policies aren't expected to materially change long-term growth prospects. Prior to the election, long-run potential real GDP growth—that rate of growth consistent with stable unemployment—was projected to be 2% per annum. Post-election, our estimate of the economy's potential has not changed.

To be sure, long overdue corporate tax reform should provide a meaningful boost to the economy's potential. Lower marginal rates and the adoption of a territorial tax system will lower the cost of capital for businesses and prompt greater investment. More investment and a larger capital stock will lift labor productivity growth and the economy's growth potential. But this boost will need time to develop, much longer than Trump's term as president, and although it will be a meaningful addition to growth in the long run, it is not the game changer that the new president is hoping for. The economy's growth potential may increase from 2% to 2.25%, not Trump's stated 4% goal.

Moreover, Trump's anti-globalization stance will eventually catch up to the economy. It will lead to a smaller workforce as some undocumented workers leave the country and fewer legal immigrants come. Global trade also suffers as the nation pulls away from trade deals and skepticism increases around our trading relationships, all of which impedes competition and productivity growth.

Economic policy during the Trump presidency can take many alternative paths, and Moody's Analytics will consider many of them. However, under most scenarios the economy is more cyclical and its long-run growth potential is unchanged.

Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of eco omic research, data and analytical tools. Dr. Zandi is a co-founder of Economy.com, which Moody's purchased in 2005. Zandi's recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy.

ABOUT MOODY'S ANALYTICS

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. With its team of economists, the company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research, and financial risk management. By offering leading-edge software and advisory services, as well as the proprietary credit research produced by Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges.

Concise and timely economic research by Moody's Analytics supports firms and policymakers in strategic planning, product and sales forecasting, credit risk and sensitivity management, and investment research. Our economic research publications provide in-depth analysis of the global economy, including the U.S. and all of its state and metropolitan areas, all European countries and their subnational areas, Asia, and the Americas. We track and forecast economic growth and cover specialized topics such as labor markets, housing, consumer spending and credit, output and income, mortgage activity, demographics, central bank behavior, and prices. We also provide real-time monitoring of macroeconomic indicators and analysis on timely topics such as monetary policy and sovereign risk. Our clients include multinational corporations, governments at all levels, central banks, financial regulators, retailers, mutual funds, financial institutions, utilities, residential and commercial real estate firms, insurance companies, and professional investors.

Moody's is an essential component of the global capital markets, providing credit ratings, research, tools and analysis that contribute to transparent and integrated financial markets. Moody's Corporation (NYSE: MCO) is the parent company of Moody's Investors Service, which provides credit ratings and research covering debt instruments and securities, and Moody's Analytics, which encompasses the growing array of Moody's non-ratings businesses, including risk management software for financial institutions, quantitative credit analysis tools, economic research and data services, data and analytical tools for the structured finance market, and training and other professional services. The corporation, which reported revenue of $3.5 billion in 2015, employs approximately 10,400 people worldwide and maintains a presence in 36 countries.

Moody's Analytics added the economic forecasting firm Economy.com to its portfolio in 2005. This unit is based in West Chester, PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com. Moody's Analytics is a subsidiary of Moody's Corporation. Further information is available at www.moodysanalytics.com.