
Quant Macro Series – Trumponomics November 15, 2016

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- **A Trump victory has taken markets by surprise with many of us still trying to understand the implications of a Trump presidency.**
- **In this note, we look to shed some light on the macro and market implications of his proposed policies. Although there remains a considerable amount of uncertainty around details and implementation, we try to reconcile market reactions with the policies detailed in his ‘100 Day Plan to Make America Great Again’ and draw tentative conclusions.**
- **We find that Trump’s policies can be described as supply-side protectionism which we conveniently call Trumponomics.**
- **As importantly, since there is no apparent historical analogue for his set of proposed policies, we face somewhat of a problem of induction. This means relying on deductive reasoning almost exclusively to draw conclusions.**
- **We conclude that Trumponomics (or the combination of supply-side and protectionist policies) is likely to represent a major structural change for the term structure of U.S. interest rates. An increase in domestic investment relative to national savings along with an increase in trade protectionism are likely to require more domestic funding which can only take place at much higher interest rates (i.e. the desired investment/savings balance).**
- **We find the most compelling trade opportunity to be relative U.S. vs. DM yield curve steepening, or more specifically a USD vs. SEK 5s10s steepener.**

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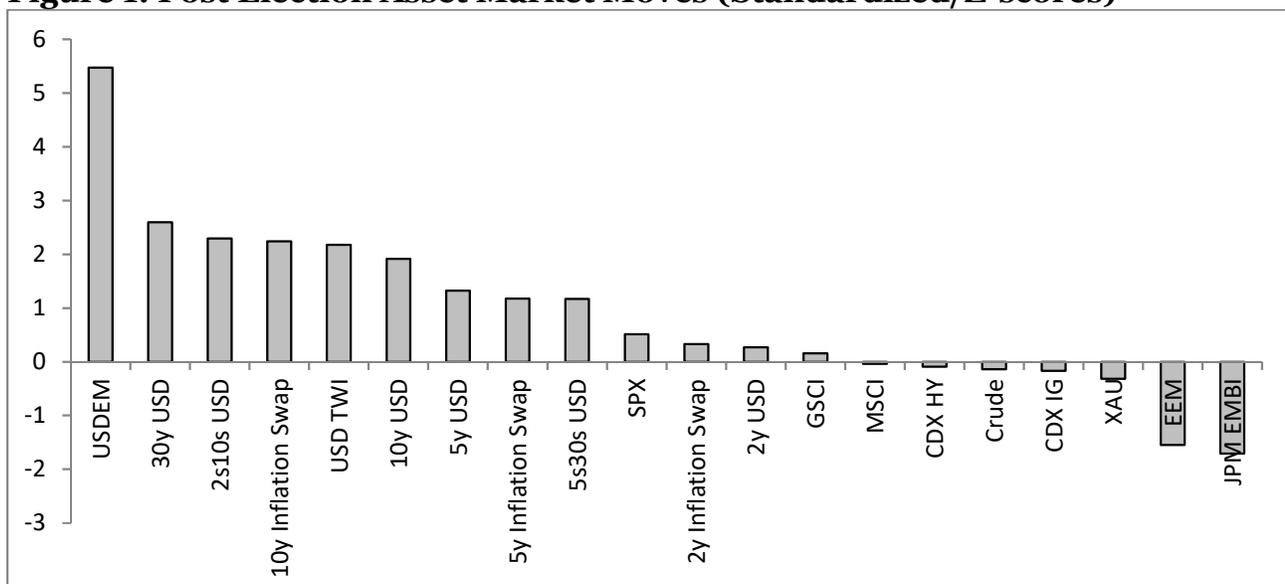
In this note, we look to shed some light on the macro and market implications of his proposed policies. Although there remains a considerable amount of uncertainty around the details and implementation, we try to reconcile market reactions with the policies detailed in his ‘100 Day Plan to Make America Great Again’ and draw tentative conclusions (contingent on implementation of course).

First, let’s start by assessing how markets have reacted to the Trump election news and what they seem to be telling us.

Market Reaction:

Figure 1 shows the change in major asset markets adjusted for volatility since Wednesday. This standardized measure allows us to compare markets with different volatilities on an apples to apples basis.

Figure 1: Post Election Asset Market Moves (Standardized/Z-scores)



The key market themes which emerge are:

- 1) EM: EM currencies were the largest losers followed by EM bonds and equities. Losses over the last 2 days exceeded 1.5 standard deviations in all cases.
- 2) Yield curve: the sell-off in 30y rates along with a sharp steepening in 2s10s and rise in inflation BEs/swaps.
- 3) USD: although the USD has rallied significantly vs. EM, it has also gained against other G10 currencies.
- 4) U.S. equities and Credit: although much more moderate, we've seen a rally in both equities and credit in the U.S.
- 5) Commodities: the market reactions here were also more muted with moderate sell-offs in both gold and crude oil.

As we will see, these market themes are for the most part consistent with Trump's proposed policies.

100 Day Action Plan to Make America Great Again:

At the end of October, Donald Trump laid out a plan for his first 100 days in office. The plan outlines his policies across areas of immigration, healthcare, foreign policy, economics and many others.

The full plan can be found here: <https://assets.donaldjtrump.com/landings/contract/O-TRU-102316-Contractv02.pdf>

We summarize the key economic policies of this plan below.

- 1) Reducing government size and regulations: 1) a hiring freeze on all federal employees and 2) a requirement that for every new federal regulation, two existing regulations must be eliminated, 3) lift the restrictions on the production of \$50 trillion dollars' worth of job-producing American energy reserves, including shale, oil, natural gas and clean coal and 4) lift the Obama-Clinton roadblocks and allow vital energy infrastructure projects, like the Keystone Pipeline, to move forward, 5) fully repeal Obamacare and replace it with Health Savings Accounts, the ability to purchase health insurance across state lines and let states manage Medicaid funds.
- 2) Immigration reform: 1) visa reform and ending illegal immigration.
- 3) Taxes: 1) a middle-class family with two children will get a 35% tax cut, 2) the current number of brackets will be reduced from seven to three, and tax forms will likewise be greatly simplified, 3) the business rate will be lowered from 35% to 15%, and 4) the trillions of dollars of American corporate money overseas can now be brought back at a 10% rate.
- 4) Trade: 1) direct the Secretary of Commerce and U.S. Trade Representative to identify all foreign trading abuses that unfairly impact American workers and direct them to use every tool under American and international law to end those abuses immediately, 2) establish tariffs to discourage companies from laying off their workers in order to relocate in other countries and ship their products back to the U.S. tax-free.
- 5) Fiscal stimulus: 1) an economic plan designed to grow the economy 4% per year and create at least 25 million new jobs through massive tax reduction and simplification, in combination with trade reform, regulatory relief and lifting the restrictions on American energy, 2) Leverages public-private partnerships, and private investments through tax incentives, to spur \$1 trillion (~ 6% of GDP) in infrastructure investment over ten years (revenue neutral).

So what can we conclude from this first 100 days action plan?

Although Trump has not been explicitly called a supply-sider, one can argue that this is exactly what typical supply-side economic policies looks like: 1) lower marginal tax rates, 2) a reduction in the size of government and 3) increased incentives for private sector investment and employment. The one big difference would be his stance on trade policy which supply-siders would oppose as free-trade advocates.

Table 1 summarizes the likely impact of Trump’s proposed policies on the internal and external sectors as well as prices.

Table 1: Macro Impact of Proposed Trump Policies

<i>Internal</i>	
Consumption	+
After-tax income	+
Private sector employment	+
Government	+
Infrastructure spending & defense	+
Gov’t employment	-
Tax revenue	-
Private Investment	+
Infrastructure projects	+
Energy projects	+
Net Trade	+
Imports (tariffs)	-
GDP Growth	+
<i>External</i>	
Gross national saving	-
Gross domestic investment	+
Private sector balance	-
Gov’t sector balance	-
External balance	-
<i>Prices</i>	
Energy	-
Wages/slack	+
Imports	+
Inflation	+

In many cases, the macro impact of these policies is reasonably straight forward. In others, it is much less so.

Internal Sector: Growth & Inflation

The impact on growth seems unambiguously positive for each of the 4 components of GDP (consumption, government spending, investment and net trade).

Furthermore, although a rise in energy investment projects would likely increase the supply of energy and lower its cost over time, the initial impact of tax cuts and higher investment spending would be a reduction in labor market slack and a rise in wages. Trade tariffs would further contribute to inflation pressures by raising the price of foreign goods/imports.

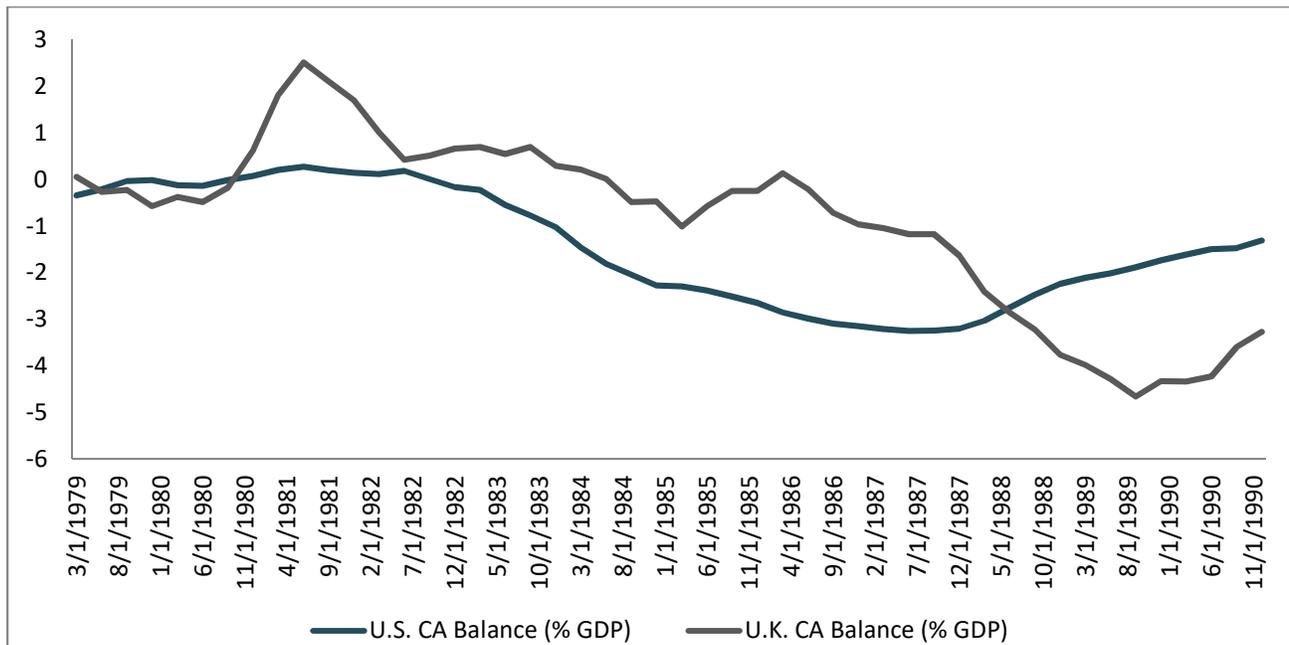
Hence, we see the likely impact of Trump policies as both pro-growth and inflationary.

External Sector: the Reagan/Thatcher Analogue

For other macro variables such as the government budget balance and the external balance, both the sign and magnitude of the impact of proposed policies are much less clear. For example, the impact of tax reform on the budget balance will depend on how much government revenue is lost from lowering tax rates vs. additional revenue gained by any increase in income growth or broadening in the tax base. Empirical evidence suggests that unless tax rates are already on the high side and stifling an economy, revenues lost from tax cuts generally dominate the increase in revenue from higher growth in determining the budget balance (aka the Laffer curve).

In addition, supply-side economic policies have historically been external balance negative as the Reagan/Thatcher era shows (figure 2). By accounting identity, since the current account balance can be defined as the difference between gross national savings and gross domestic investment, an increase in investment relative to national savings implies a decline in the current account balance.

Figure 2: Current Account Balance – Reagan and Thatcher Era (1980-1990)



Or if one prefers, the same accounting identify implies that as both the government and private sector balances decline, so should the current account balance. This identify is described below:

$$CA = (\text{private sector balance}) + (\text{public sector balance}) = (\text{savings} - \text{investment}) + (\text{tax revenues} - \text{government spending})$$

Since the private sector balance tends to be highly countercyclical (figure 3), any increase in growth from fiscal stimulus at this stage in the cycle is likely to also lead to a further decline in the current account balance.

Figure 4 and 5 show the government budget balance and current account balance vs. the unemployment rate.

Figure 3: Private Sector Balance vs. Unemployment Rate

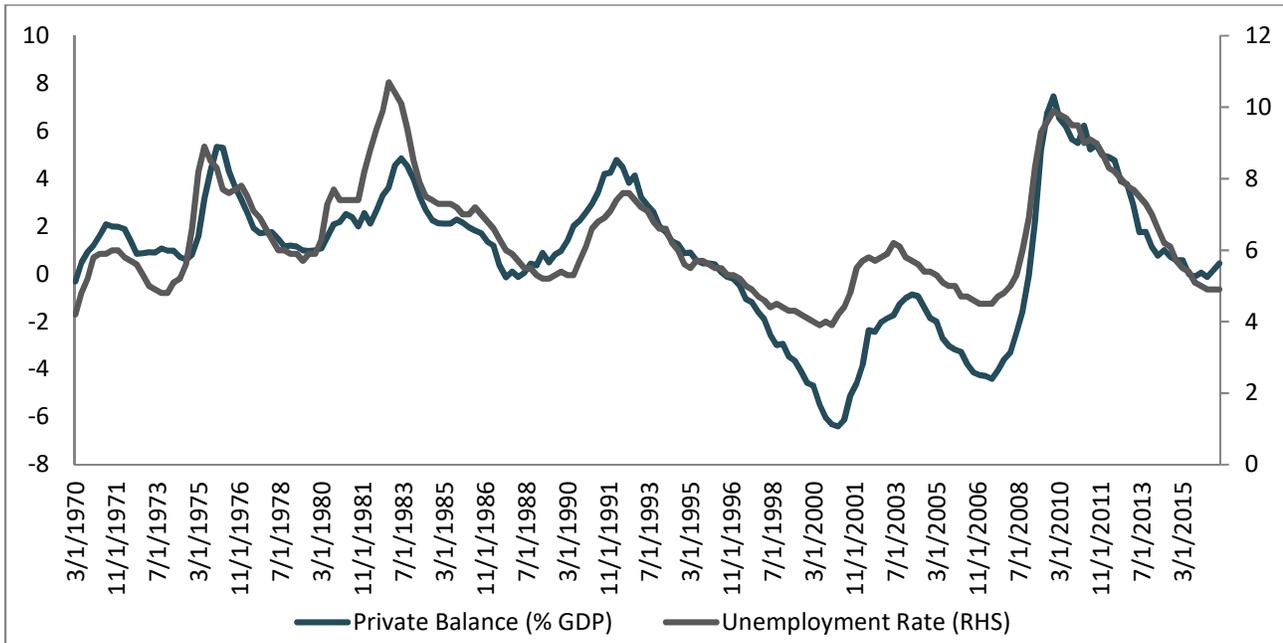


Figure 4: Gov't Budget Balance vs. Unemployment Rate

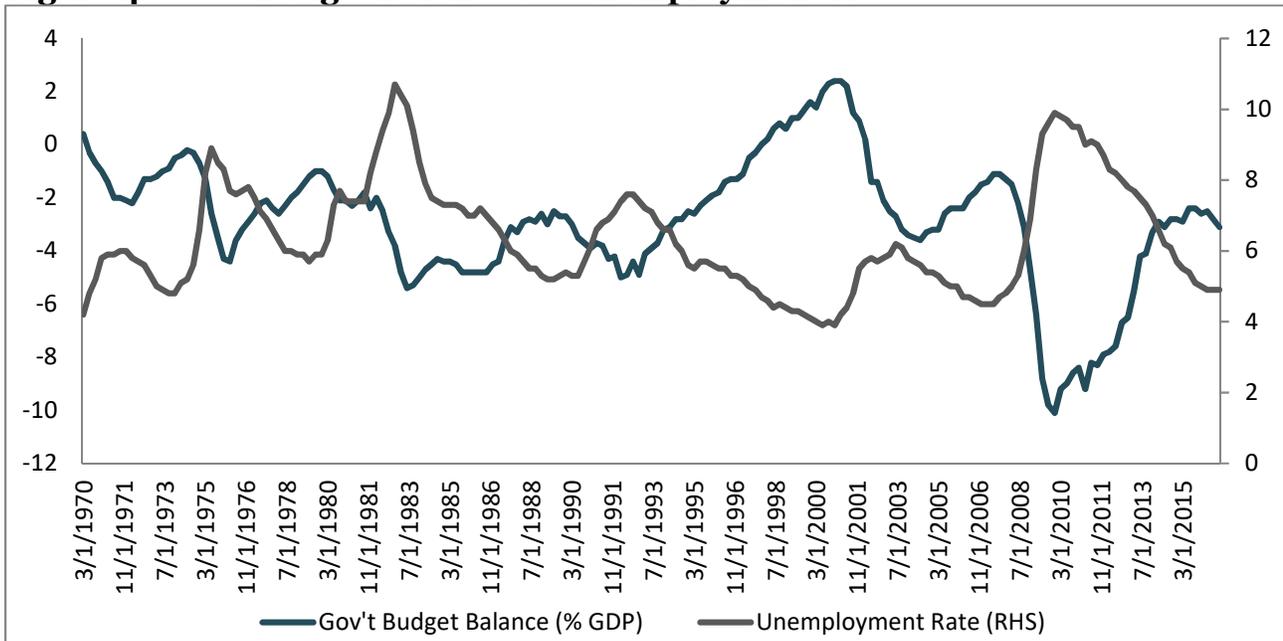
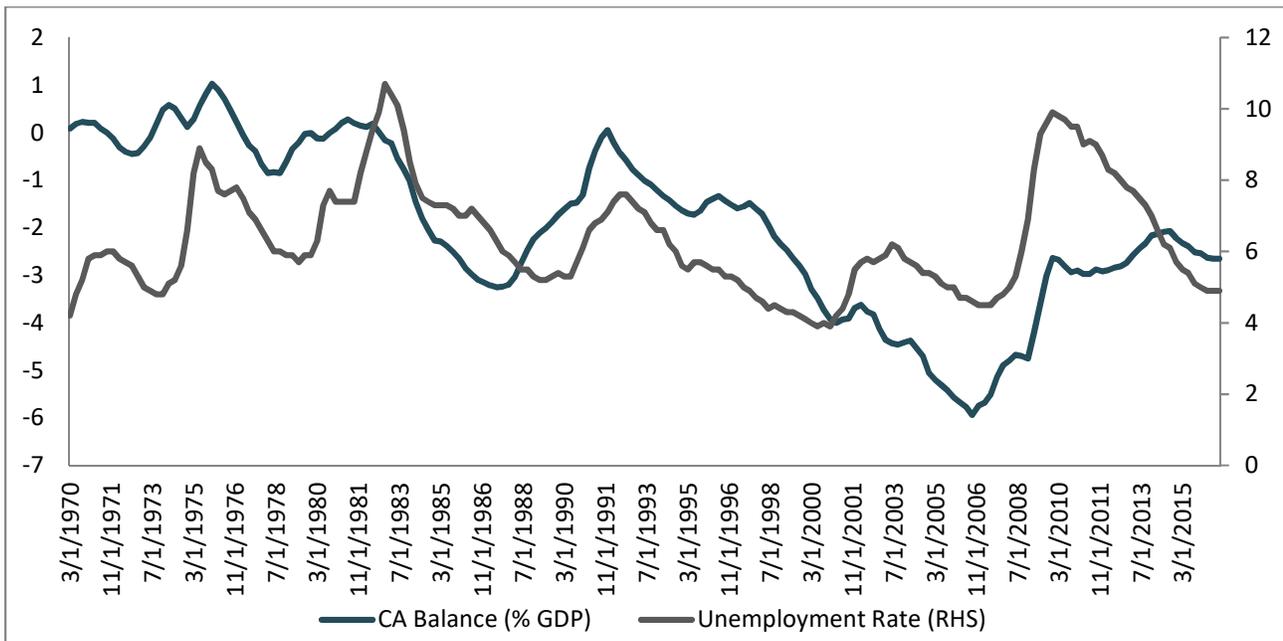


Figure 5: Current Account Balance vs. Unemployment Rate



Trumponomics: When Supply-Side Meets Trade Protectionism

So what happens when the demand for both private and public sector investment increases relative to the domestic supply of savings just as trade policies turn increasingly protectionist?

Typically, an increase in domestic funding requirements can be financed externally without much impact on interest rates especially when there is a glut of global savings. This was largely the case during the pre-crisis cycle when the U.S. economy expanded, gross domestic investment increased relative to gross national savings (and by identity the U.S. current account deficit widened to 6%) yet long-term interest rates remained mostly stable in what Alan Greenspan called the ‘bond conundrum’.

However, a move towards protectionism implies a closing of the economy to both trade and (by definition the flipside of trade) capital flows. In such a case, the increase in desired investment relative to desired savings which cannot be fully financed externally has to be financed domestically. However, without a surplus of global savings to fund the domestic investment at the current interest rate, the price of loanable funds must increase relative to the rest of the world to balance desired savings and investment.

In other words, an increase in financing needs combined with protectionist policies is highly likely to put substantial upward pressure on interest rates in the U.S. Rather than a simple

position unwind, the repricing of the U.S. yield curve over the last 2 days is signaling that we may be at the initial stages of a major structural change.

Bottom line, the combination of policies which lead to an increase in domestic investment relative to national savings and an increase in trade protectionism cannot be achieved simultaneously without a significant rise in interest rates.

The Perfect Storm:

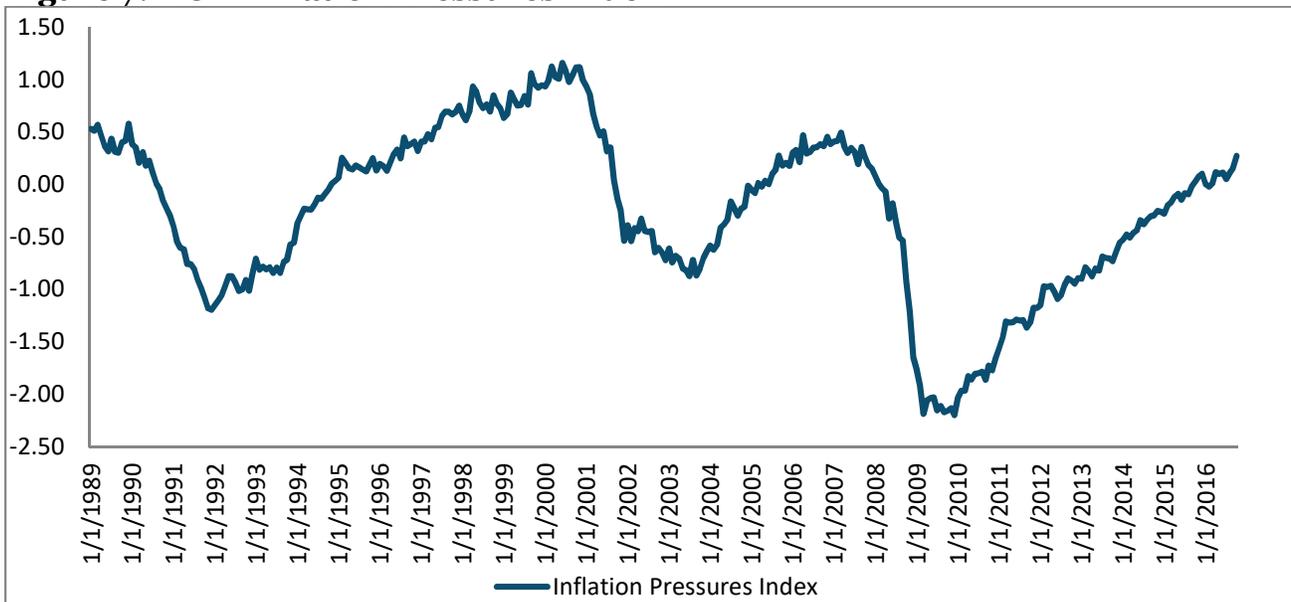
Although one can make a strong case for a higher USD, EM weakness or even equities, the U.S. yield curve could be facing a perfect storm on the horizon:

- 1) A term premium which is at historic lows effectively offering negative compensation for inflation risk (figure 6).
- 2) Labor market slack which has been significantly reduced (across both broad and narrow measures of slack) with wages showing recent signs of acceleration (figure 7).
- 3) Fiscal policies which are likely to increase domestic investment relative to national savings.
- 4) Protectionist policies which would make funding the external deficit at current interest rates much more difficult.
- 5) Investment in productive capacity which is likely to increase the equilibrium/neutral rate.
- 6) Easier fiscal policy is which likely to provide an impetus for the Fed to move further way from the zero bound in nominal rates.

Figure 6: Kim-Wright 10y Term Premium



Figure 7: DGA Inflation Pressures Index



Fed Response and the Yield Curve:

All this makes one wonder whether there's still room to play for a further rise in interest rates or whether this rise will become self-limiting as we've seen so many times over the course of the current recovery. It may be too early to answer this question just yet.

Firstly, we have yet to get the details on the proposed Trump policies. Were some of these proposed policies simply populist rhetoric meant to win over the electorate or serious proposals?

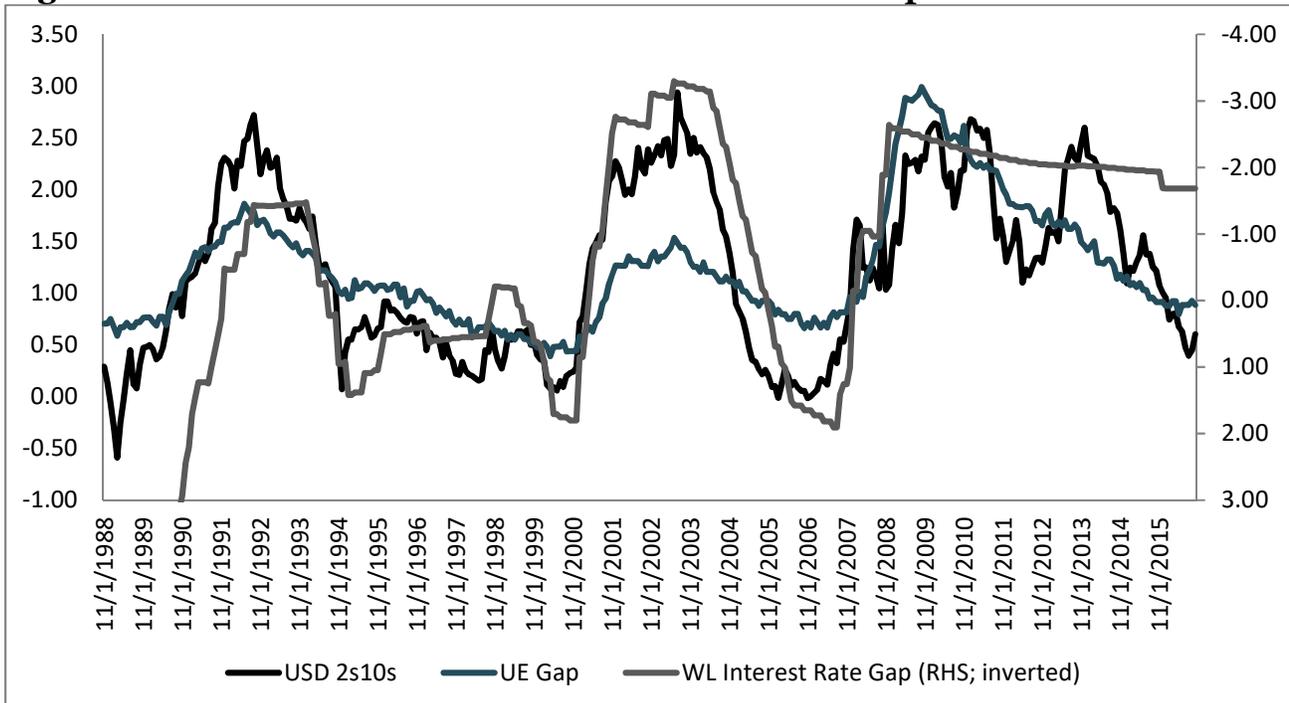
Secondly, assuming these policies are enacted, how will the other policy levers change? Specifically, how will the Fed alter its forecast for the path of growth, inflation and the policy rate?

This last question will be particularly important since the Fed’s response to a growth and inflation impulse will largely determine the impact on both the yield curve and the USD.

A timely response to rising inflation pressure is likely to be met with a rise in the implied path of policy rates and most likely a bear flattening in the yield curve. A patient Fed, or one intentionally behind the curve, is likely to lead to a bear steepening in the yield curve.

However, we note that a bear steepening hasn’t occurred in the later stages of a recovery/tightening cycle in the post war era (figure 8) and would thus require a ‘this time is different’ view of the world.

Figure 8: Yield Curve 2s10s vs. UE and Interest Rate Gaps



Making America Relatively Steep Again:

Rather than position for outright curve steepening, higher front end rates or a stronger USD, what stands out to us is how flat the U.S. yield curve is relative to other DMs. This is shown in in figure 9 and 10.

This is an important feature of current market pricing for several reasons: 1) relative yield curve steepness tends to exhibit range bound/mean reverting characteristics over the longer-term making divergences attractive, 2) the relative slope of the yield curve is affected by the relative stance of monetary policy rather than the outright stance and 3) the position carries much better in most cases giving us more staying power than an outright short.

This relative flatness is especially striking relative to the SEK curve which is ~ 1.5 standard deviations steep vs. the U.S (figure 11) and continues to be the steepest curve in G10 (see *Steepness in a Flatter World*, Dec 23rd 2015).

In conclusion, we consider a USD vs. SEK 5s10s steepener to be a compelling trade opportunity as we enter a new era of Trumponomics.

Figure 9: USD vs. G10 (Equally weighted) 5s30s Yield Curve Slope



Figure 10: G10 Yield Curve Slope Ranking

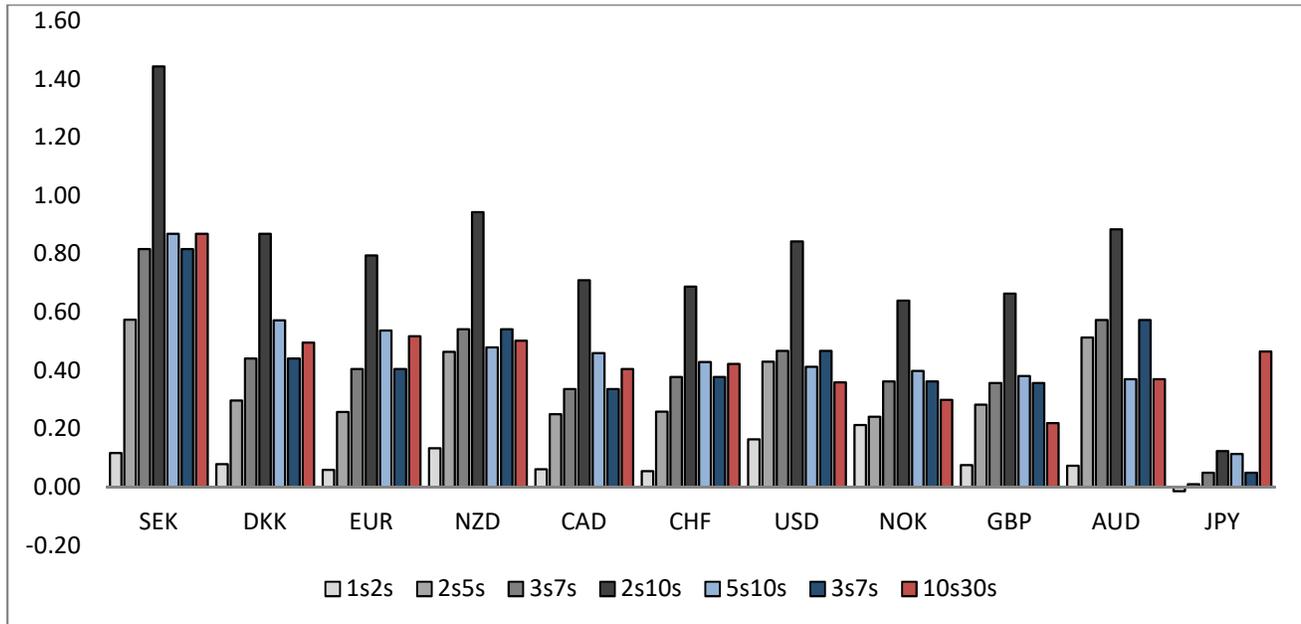


Figure 11: SEK vs. USD5s10s





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