US PRESIDENTIAL ELECTION

NOVEMBER 2016

National Australia Bank

Economic stress provides the backdrop to an acrimonious campaign

- Bernie Sanders and Donald Trump successfully focussed on the problems that globalisation raised for US middle class jobs and pay, providing a difficult backdrop for any candidate promoting policies like free trade or fiscal austerity where there could be clearly defined losers among blue collar and middle class voters. Instead the focus has been on tax cuts for most, the maintenance of health and welfare spending programmes and reduced immigration.
- Polls suggest a win for Mrs Clinton although the outcome remains unclear due to uncertainty around turnout and voter reluctance to reveal their voting intentions to pollsters. Reluctance to compromise, politicisation across many areas of economic policy and the political risk of shifting from pre-election positions suggests that there could be continued grid-lock in US policy unless one party controls both the Presidency and the Congress.
- For markets, a surprise Trump victory would create volatility but we expect the US dollar to strengthen whoever wins. We do not expect the US election outcome to be a game changer for bonds but the emphasis on more government spending by both candidates suggests a shift away from monetary stimulus towards fiscal policy. This would help sustain the trend to higher yields and a steeper yield curve in US financial markets.

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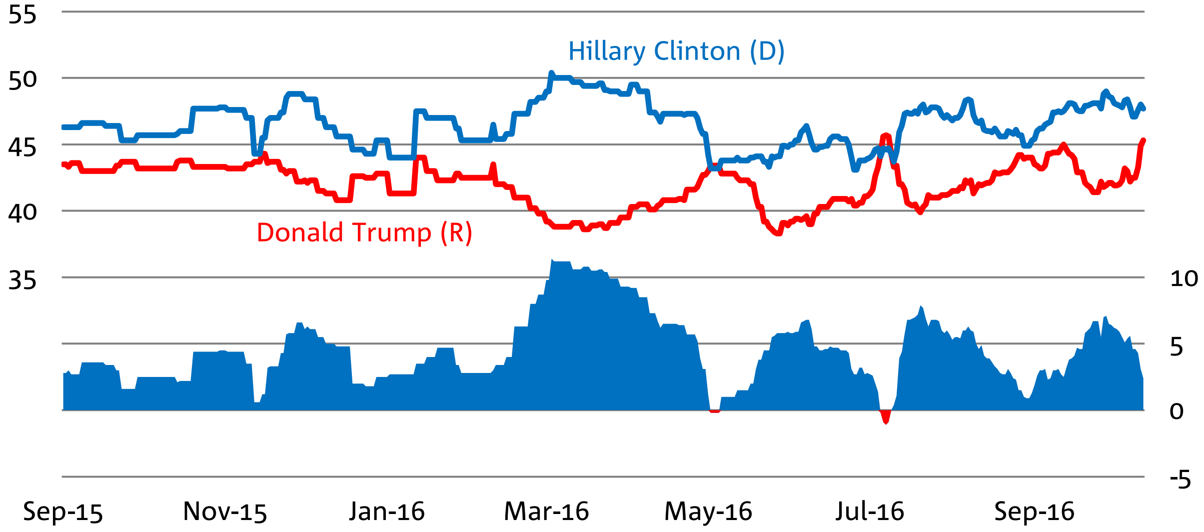
HOW DID WE GET HERE?

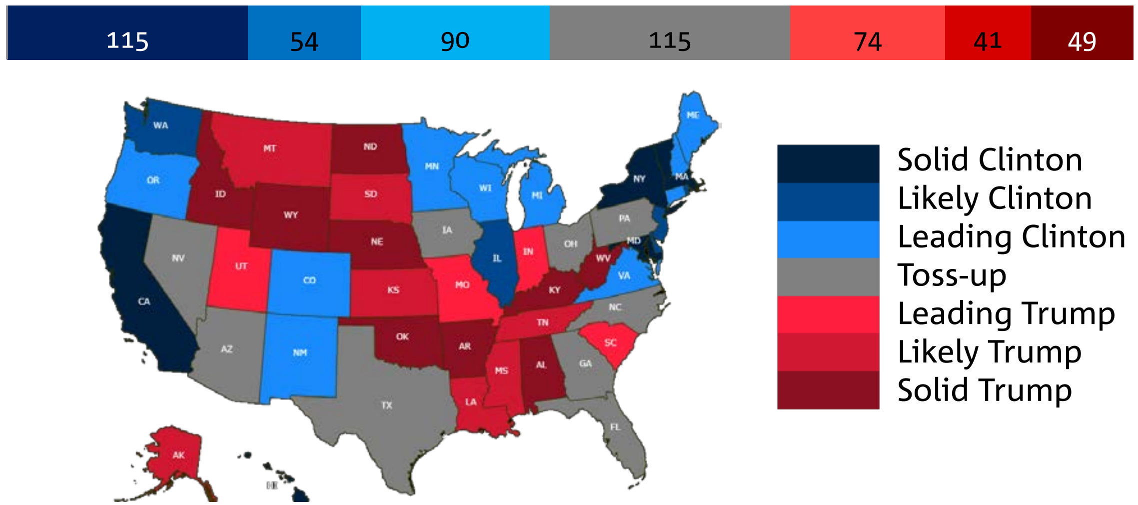
WHAT DOES THE POLLING TELL US?

Clinton still ahead, but Trump gaining quickly

REAL CLEAR POLITICS POLL AVERAGE



REAL CLEAR POLITICS ELECTORAL MAP



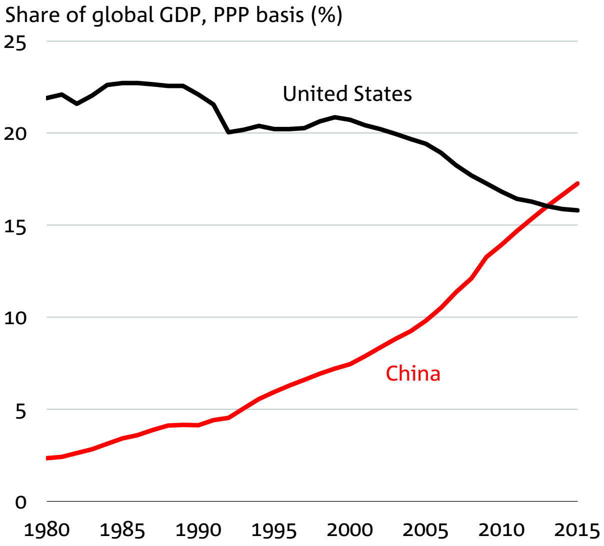
- This election has seen considerable volatility in polling but the Real Clear Politics polling average has shown Mrs Clinton ahead for almost the entire campaign, save for brief periods in May and July this year.
- The latest polls show a considerable uptick in Mr Trump's support, reflecting gains among undecided and third party supporters, while Mrs Clinton's support has held reasonably steady. Real Clear Politics places Mrs Clinton only 2.2 points ahead, while Fivethirtyeight gives Mrs Clinton a 3.8 point lead, with a 71% chance of winning based on polling alone.
- Although the national polls favour Mrs Clinton, there is no single national vote for President per se, rather voters in individual states vote for electors who then go on to vote for their candidate in the Electoral College. More populous states have more Electoral College votes, making them more important. All states except Maine and Nebraska are "winner take all" states, in which the candidate with the most votes claims all electors for a given state.
- The Electoral College remains favourable for Mrs Clinton, although this could change if Mr Trump were to have a late surge in support. Recent Real Clear Politics state polling data showed the sum of states where her position was solid, likely or leading was only 11 votes short of the 270 needed to win. If she were to win all solid, likely and leading states, Mr Trump would need to win most toss up states to claim victory. While this seems unlikely on current polling, some states have seen little good quality polling recently, which adds uncertainty to the outcome.
- Despite most polls showing Mrs Clinton likely to win, there has been a great deal of speculation that the polls might be wrong. The polls could be systematically wrong for two reasons - uncertainty around turnout and the "shy tory effect" where voters are unwilling to admit their conservative views to polling companies. However, it seems unlikely that either factor would be sufficient on its own to hand Mr Trump victory given the very large number of polls and the lack for evidence for Mr Trump outperforming poll predictions during the primaries.
- The election has shown a deep, widespread disillusionment across a large part of the US electorate and the factors producing this mood appear unlikely to suddenly vanish after the vote. This raises the distinct prospect that the anti-globalisation populist mood that Mr Trump and Mr Sanders tapped into could still be around to shape the political agenda through the term of the next President, the 2018 mid-term elections and into the 2020 Presidential election.

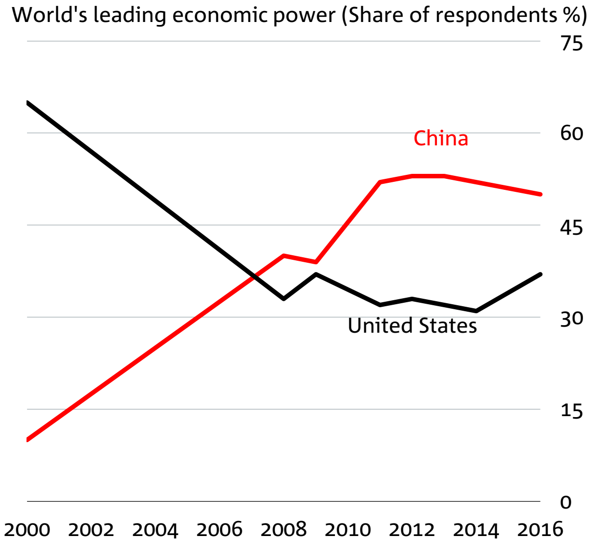
Sources: Realclearpolitics, Bloomberg, Fivethirtyeight, Huffpost Pollster, NAB Economics

WHAT UNDERPINS US VOTER MOOD

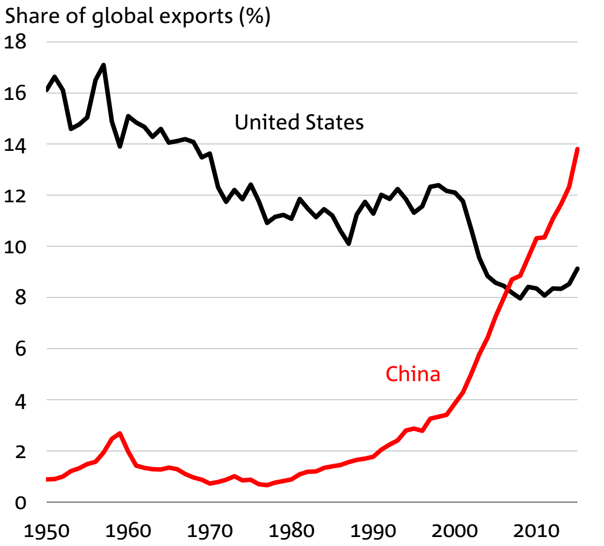
China outstrips US as world's biggest economy – focuses globalisation concerns

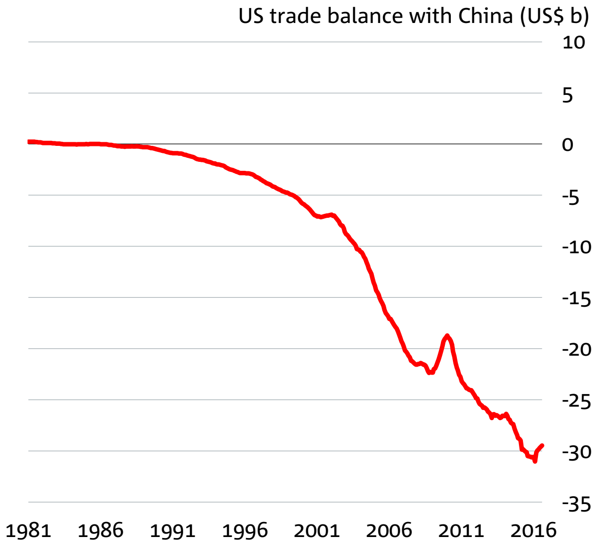
UNITED STATES NO LONGER THE BIGGEST ECONOMY





CHINA REPLACES US AS TOP GLOBAL TRADER AS US TRADE DEFICIT WIDENS





- Mr Trump's election slogan "Making America Great Again" ties into voter concerns on many levels - some relate to domestic concerns, others refer to a worry that the US is no longer the world's economic superpower.
- The US overtook the UK to become the world's biggest economy in the 1870s and kept that position until a few years ago when China took the number one spot. At its peak in the 1950s the US had almost 30% of global output and its share was still 22% in the early 1980s. Back then China accounted for only 2% of global output but its growth has been so rapid that its GDP overtook the US in 2014. Currently China has almost 18% of global output while the US has 15½%. With Chinese annual output growth running almost 7% as opposed to the US's 2%, the IMF expect China's share of global output to steadily outstrip that of the US.
- China has also displaced the US in the ranks of global exporters, becoming the world's biggest goods exporter in 2009 and currently accounting for around 14% of global exports, as opposed to the US share of under 10%. Merchandise trade between the US and China has swung from balance to a $US30 billion annual deficit since 1985.
- This shift in the geographical distribution of output and trade is reflected in many of the US opinion polls. Back in 2000 only 10% of Americans polled by Gallup saw China as the world's leading economic power, 65% felt it was the US. China overtook the US in the poll around the time of the global financial crisis and since 2011 50% or more of Americans have viewed China as the leading global economic power while the proportion still thinking it is the US has fallen to under 40%.
- Pew Research Center surveying shows 75% of Chinese people polled in 2016 thought that China played a more important role in the world than it did 10 years ago, 60% felt involvement in the global economy was good and over 80% thought their children would be better off financially than their parents. By contrast, only 21% of the US people Pew surveyed thought the US played a more important role than a decade previously, only 44% thought involvement in the global economy was good and around 60% thought children would be worse off than their parents, twice as many as felt the children would be better off.
- These global economic trends and sentiment have played a role in voter attitudes toward key electoral issues like free trade and globalisation. Criticism of trade liberalisation and unfair trade has been an important feature of the campaign, reflecting widespread voter concern about economic prospects and suggesting that political support for globalisation has peaked.

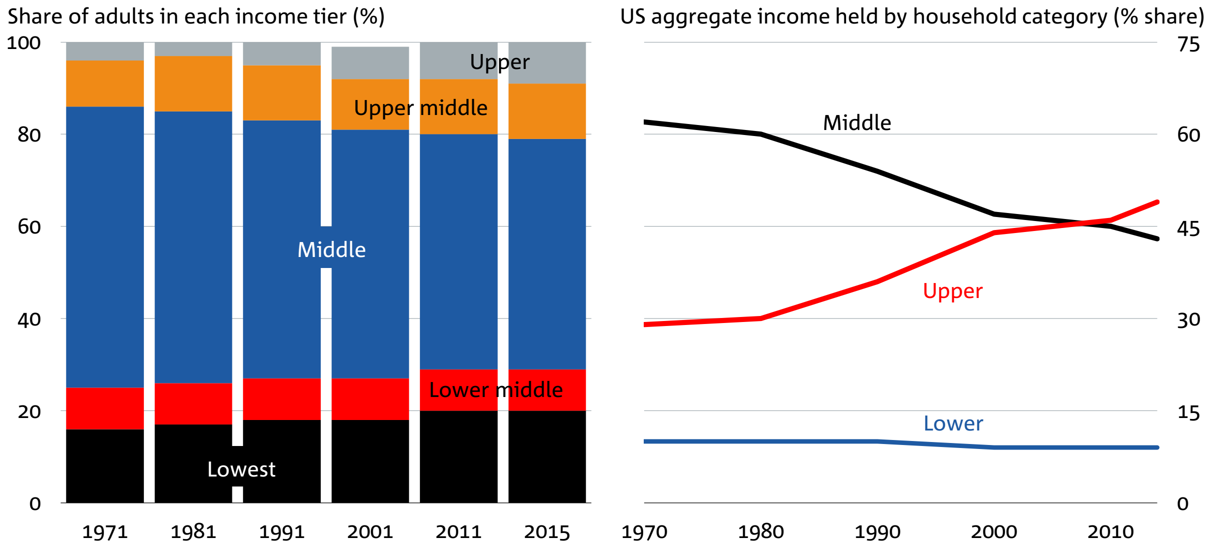
Sources: IMF, Gallup, WTO, US Census Bureau, NAB Economics

WHAT UNDERPINS US VOTER MOOD

The squeezed middle class

REAL INCOME STAGNATES FOR MANY AMERICANS

MIDDLE CLASS SHARE OF HOUSEHOLDS AND INCOME IS FALLING



Sources: US Census Bureau, BLS, Pew Research Center, NAB Economics

- Although the US has performed well recently in terms of economic growth and cutting unemployment, financial pressures on the American middle class and the disappearance of stable blue collar manufacturing jobs have been central issues in both the Democrat and Republican campaigns. The "hollowing out" of the middle class is a concern in OECD countries with very different characteristics and it has been blamed on such trends as globalisation, the erosion of union power, technological change demanding high skilled workers and "winner take all" pay systems. These concerns will not disappear post-election.

- The focus on the US "middle class squeeze" follows years of attention on the stagnation of real earnings. While the details vary depending on which measure is used, the overall story is one where average and median real earnings both fail to grow much at all and in line with labour productivity. In fact, one often quoted measure – the inflation adjusted average hourly wages of non-managerial private sector staff – was about the same in 2015 as it was in the late 1970s. Even after a 5% jump in 2015, the more comprehensive measure of median household real income has only just got back to the levels seen in the late 1990s.

- How middle class earnings are faring has had lots of attention. The Pew Research Center finds that the upper end of the income distribution has done best with the middle class faring less well. The share of US adults with real incomes that would put them in the middle class fell from 61% to 50% between 1971 and 2015 but their share of total US household income fell by much more – from 62% to 43%, a drop of 19ppts. The growth has come in the upper income groups whose share of the adult population rose from 14% to 21% and whose share of total household income grew from 29% to 49%, up by 20 ppts. Faster earnings growth in upper income groups explains much of their rising share of incomes.

- The replacement of middle income by upper income households is hardly a problem but Pew finds big problems in particular regions – especially US manufacturing cities where many middle class occupants have gone down rather than up the income scales. This highlights the issue of low social mobility in the US as it appears harder to move up the social ladder there than in many other countries, leaving many people feeling locked into their current rung of the ladder.

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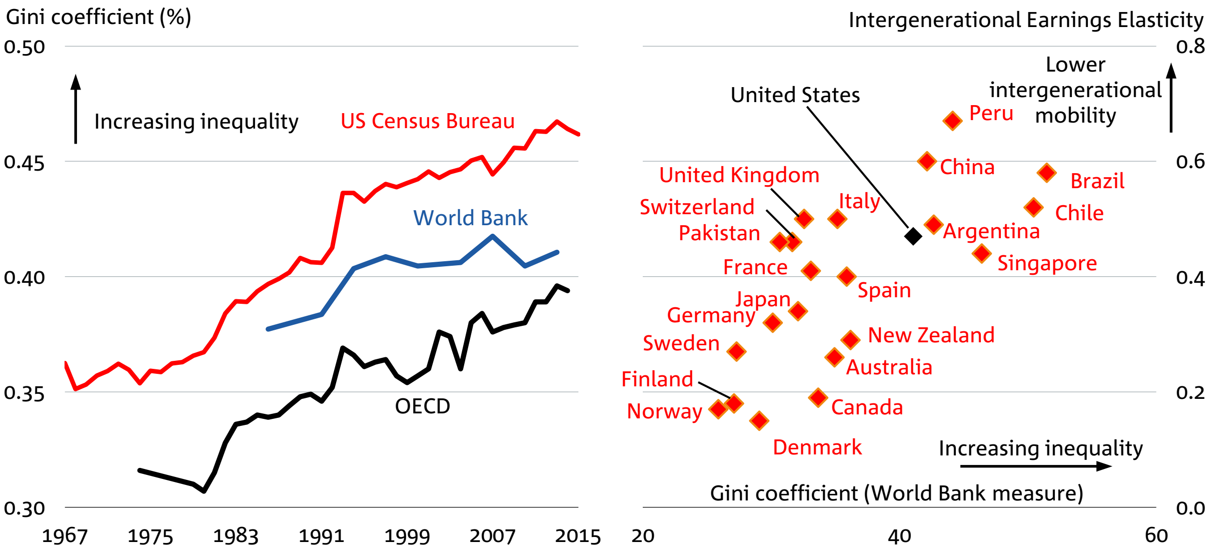
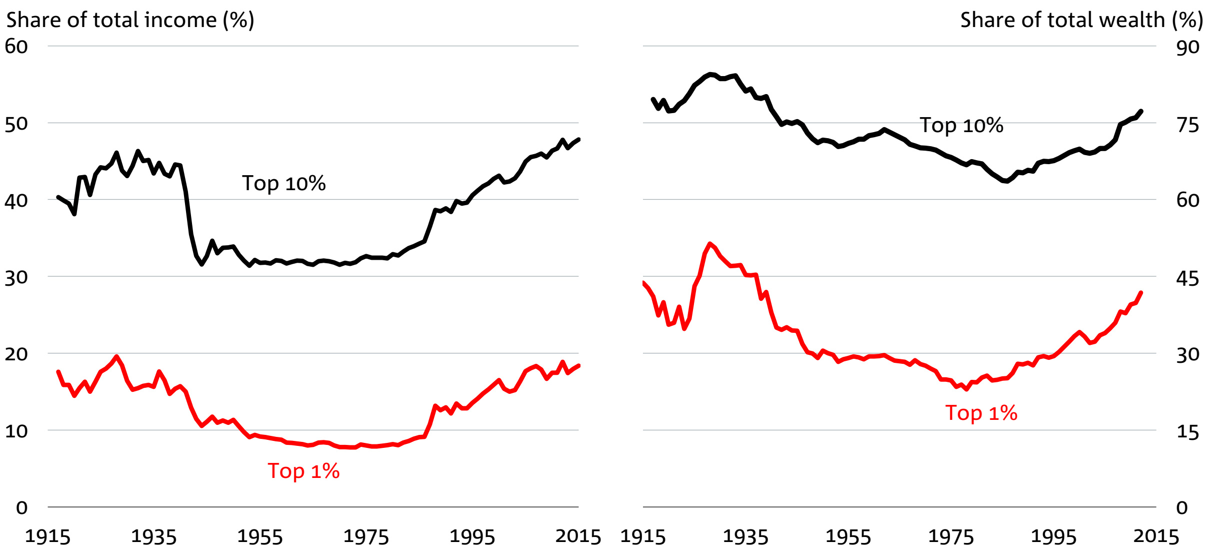
WHAT UNDERPINS US VOTER MOOD

Growing inequality and lack of social mobility questions the American Dream

INCOME INEQUALITY RISES, LOW SOCIAL MOBILITY BY OECD STANDARDS



SHARE OF INCOME AND WEALTH OF THE RICH IS RISING



Sources: OECD, US Census Bureau, World Bank, Institute for the Study of Labor, Saez & Zucman, NAB Economics

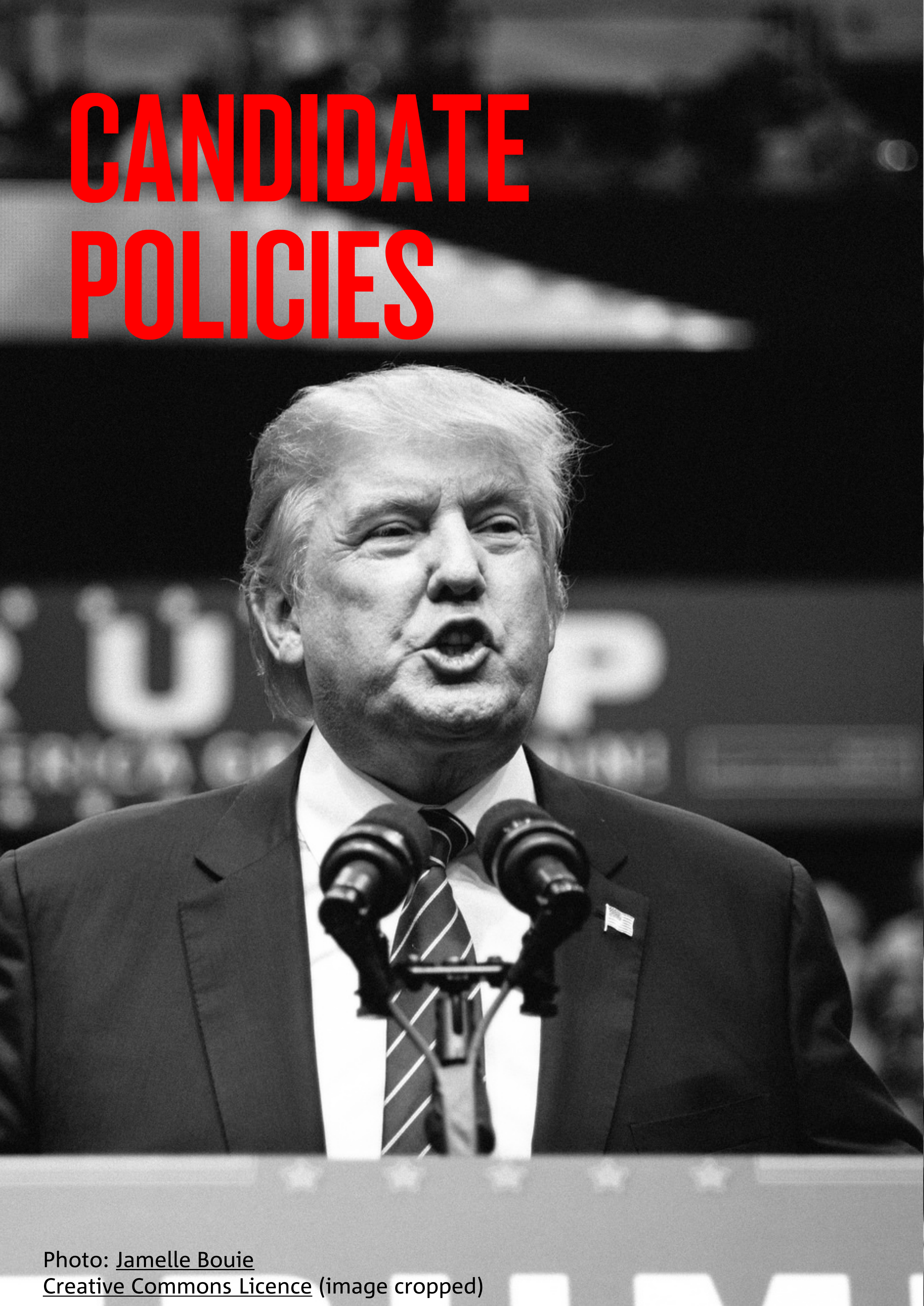
- Inequality has also been a big issue in the campaign, especially among Democrats. The top 20% of households have lifted their share of US household income from 43% to 51% since the late 1960s with the top 5% share rising from 17% to 22%. Middle income categories share of the cake has shrunk – from 10.8% to 8.2% for the 21st to 40th percentiles and from 17.3% to 14.3% for the 41st to 60th percentiles. Growing inequality of US household incomes was shown by the upward trend in the Gini co-efficient to 2011 but since then it has levelled out (US Census data).

- Income growth has been concentrated at the very top of the distribution. The top 10%'s share of household income rose from 32% to 48% between 1979 and 2015 but two-thirds of this extra income went to the 1% best paid households. The same happened with wealth where the richest groups shares are the highest since the 1920s. The top 0.1% of US households held 22% of all wealth in 2012, up from 7% in the late 1970s.

- Inequalities in income and wealth pose a particular problem in the US as they can limit social mobility, when those at the top lock in advantages through the use of money and networks to support the position of their children. The US has low levels of social mobility compared to many other OECD countries and its level of social mobility has declined since the 1980s, especially for middle class workers who are finding it harder to get into the upper income groups, helping polarize the workforce.

- Opinion polls show a sizeable percentage of US public opinion worries about growing inequality and how hard it is to get ahead. A regular CBS/NYT poll finds over two-thirds of people believe the gap between rich and poor is widening in the US and more than half think the government should be doing something to lessen it. A February 2016 CNN poll found 71% of respondents felt the US economic system favours the wealthy. An August 2015 CBS poll found 63% of people surveyed felt that money and wealth should be more evenly distributed. A May 2015 CBS poll found that 61% of respondents felt that just a few people had the chance to rise to the top in the US now, only 35% felt everyone had the opportunity. These sentiments are mainly found in Democrat rather than Republican supporters – a split seen in election polling where 70% of Clinton supporters see the gap between the rich and poor as a very big problem whereas only 31% of Trump supporters agree.

CANDIDATE POLICIES



FOREIGN TRADE

Neither candidate seems keen on more free trade

Trump

- Long standing supporter of very active use of US trade policy to curb “unfair” trade and support the US manufacturing sector.
- Particular focus on China, arguing it is not complying with the WTO rules that govern global trade (e.g. subsidising its exports, pirating US intellectual property) and bringing trade cases against China in the WTO.
- Declare China to be a “currency manipulator” “on day one” and suggests using tariffs and taxes against countries under-valuing their currencies, mentioning a 45% tariff on US imports of Chinese goods.
- Use unilateral trade measures against Chinese exports to the US if China does not stop alleged breaches of WTO trade rules. US law gives the President several avenues to impose tariffs and duties on imports.
- Would demand re-negotiation of North American Free Trade Agreement (NAFTA) with Canada and Mexico or US withdraws from the deal
- Opposes US ratifying Trans-Pacific trade deal (TPP) – a 12 nation economic pact that includes Australia and New Zealand.

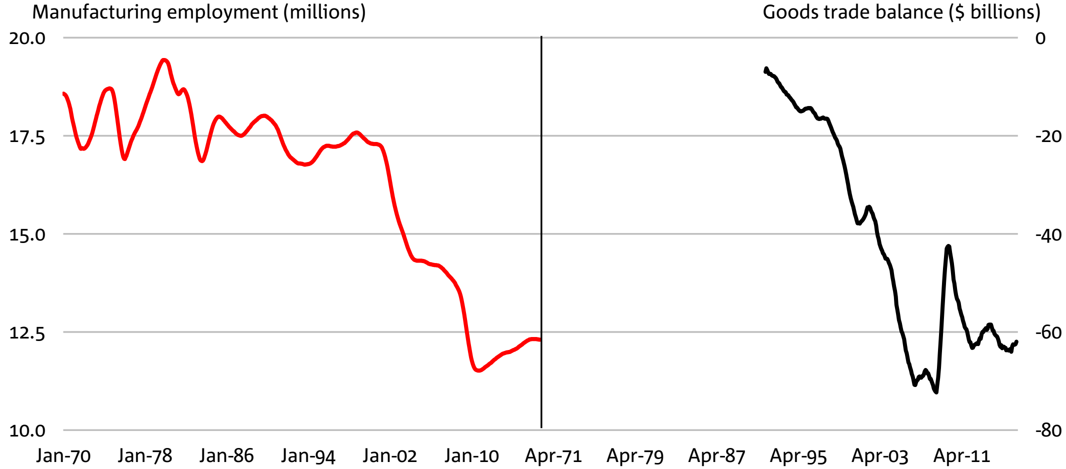
Clinton

- A less vocal critic of the alleged failure of the WTO rules-based system to counter unfair trade practices but she still supports measures aimed at currency manipulators or suppliers not meeting internationally agreed labour standards.
- Opposes the TPP as it does not meet the “high bar” she sets – it needs to raise US wages, create well paying jobs and enhance US national security.
- Willing to use duties and tariffs to punish unfair traders.
- Specifically mentioned China as using “unfair and underhanded trade practices to tilt the playing field against American workers and businesses” and “our middle class pays the price”.
- Do not let the Chinese get “market economy status” for trade rules as that would make it harder to impose anti-dumping duties on Chinese goods. US trade officials have now told the Chinese they will oppose that trade status.
- Put more resources into trade enforcement and apply the rules more vigorously, stopping unfair trade hurting US.

The Bottom line

- Neither candidate expresses support for more free trade or further moves toward globalisation and we may be past its high point of political support.
- Opinion polls show a sizeable percentage of US voters question whether globalization has benefitted the US economy and a majority think it has cost jobs and led to lower wages. The fall in industrial jobs and the widening trade deficit are shown opposite.
- More people surveyed thought the NAFTA deal was bad for the US economy than believed it was of benefit and opinion is fairly evenly split on the TPP.
- Clinton, who now opposes the TPP, called it the “gold standard in trade agreements” in 2012, leading Trump to claim she will negotiate minor changes in the deal if elected and then change position to support it.
- Clinton also told an audience of Brazilian bankers in 2013 that her dream was an American wide common market but then said she only meant for the energy sector.
- The Democrats Vice Presidential candidate has said they would not “close the door” on big trade deals – provided they met his strict tests and are good for American workers and the economy. The door is not closed to more free trade but progress looks very hard in this political climate.

INDUSTRY HAS SHED JOBS AS TRADE BALANCE WORSENS



Sources: Bureau of Labor Statistics, Census Bureau. Data are 12 month moving averages.

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TAXATION

Reforms to US business tax likely and will impact on Australia

Trump

- Significant cuts in personal income tax rates across the entire income distribution with the largest percentage gains for the upper income groups.
- Big increases in standard tax deductions for US households and index them to inflation after 2016, further boosting personal post-tax revenue.
- Some of the tax revenue lost from tax rate cuts and higher standard deductions is clawed back by removing personal exemptions and capping itemized tax deductions.
- The corporate tax rate would be cut from 35% to 15%, giving an incentive to workers to shift from higher personal to lower rates of business taxation.
- US corporate profits kept offshore can be brought back into the US at a 10% tax rate, well below the usual 35% that would be levied on their return.
- US firms may not be allowed to defer paying tax to the US authorities by keeping their profits outside the country, rather they may be taxed by the US authorities at 10% as they earn profits abroad.

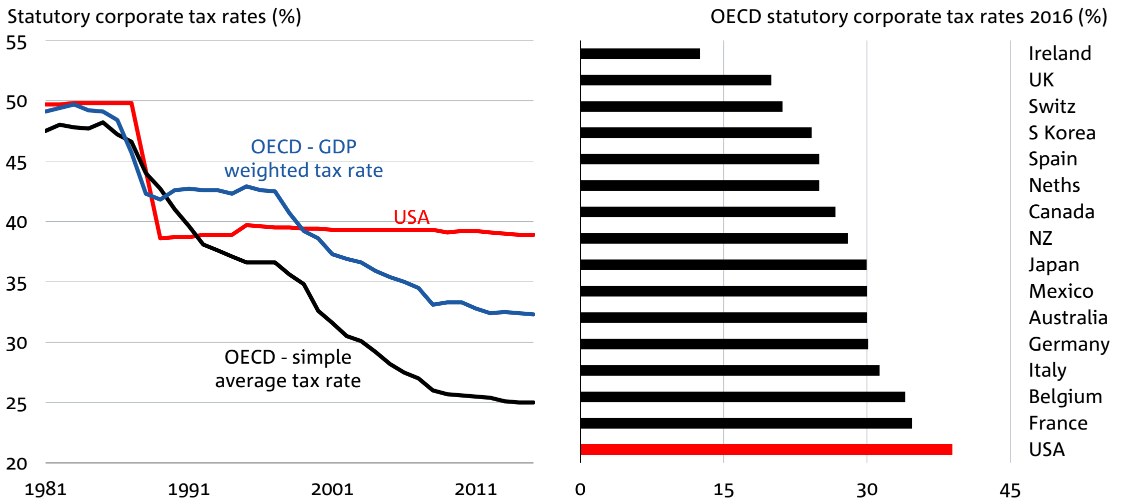
Clinton

- Higher taxes on high income households – a 4% surcharge on those earning over $5 million, a minimum income tax of 30% phasing in between $1 million and $2 million and a limit on the benefits of tax deductions.
- No mention of changes in corporate taxes but Bill Clinton has said that the 35% US corporate tax rate looks out of line with current global rates and we expect the company tax system to be reviewed if the Democrats win.
- No mention of a concessional tax rate to encourage US corporates to bring back profits held overseas but clear interest in this idea in Democratic party.
- Measures aimed at making it harder for US corporates to lower their tax bills by shifting their legal control to lower tax foreign countries ("inversions"), prevent US corporates from "stripping" their domestic earnings by shifting them as interest payments rather than dividends to a parent company located in a tax haven and imposing an "exit tax" on US firms becoming foreign residents to get tax benefits via inversions.

The Bottom line

- The US business tax system needs reform but the Democrat's platform has little to say about the corporate tax rate or how to get US corporates to repatriate the $2½ trillion in retained profits that is supposedly held abroad. Instead, the measures would impede and penalise US firms moving offshore.
- Allowing US corporates to bring back overseas held profits at a concessional tax rate seems to interest Hilary Clinton, especially if some of that money has to be put into institutions that will be used to fund the US backlog of infrastructure investment. George Bush tried a similar move but it failed.
- Bill Clinton, who lifted the US corporate tax rate to 35% in 1993, has noted that other countries have since cut their rates and the US is now an outlier – its high statutory tax rate fuelling the retention of money offshore.
- Democratic Presidential contender Bernie Sanders was critical of loopholes that allowed US corporations to pay an effective tax rate of around 12½%, as opposed to the 35% statutory rate emphasised by Mr Trump and Bill Clinton.
- The politics of lowering US corporate taxes and allowing concessional taxation of corporate profits coming in from abroad will be politically very difficult for the Democrats – but it could well happen anyway.

US A HIGH CORPORATE TAX OUTLIER IN THE OECD



Sources: OECD, NAB Economics (note: statutory corporate taxes includes surtaxes)

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IMMIGRATION

Divergent policies target key voting demographics

Trump

- Border security and tightening enforcement of current laws is at the heart of Trump's immigration policy.
- The construction of a border wall between the United States and Mexico has been a key element of his primary and presidential campaigns.
- Enforcement of existing immigration legislation varies widely across the country. Trump proposes eliminating federal grants to so-called sanctuary cities – where police refuse to cooperate with immigration officials when they encounter suspected unauthorised immigrants.
- Proposes deportation of the estimated 11 million unauthorised immigrants and detain & deport immigrants caught crossing the border illegally.
- National implementation of E-Verify platform – which matches information from employment forms to Homeland Security data.
- Proposed pause on issuing Green Cards (providing foreign individuals with employment rights) and increase wages paid to H-1B visa holders to encourage employers to focus on local labour.

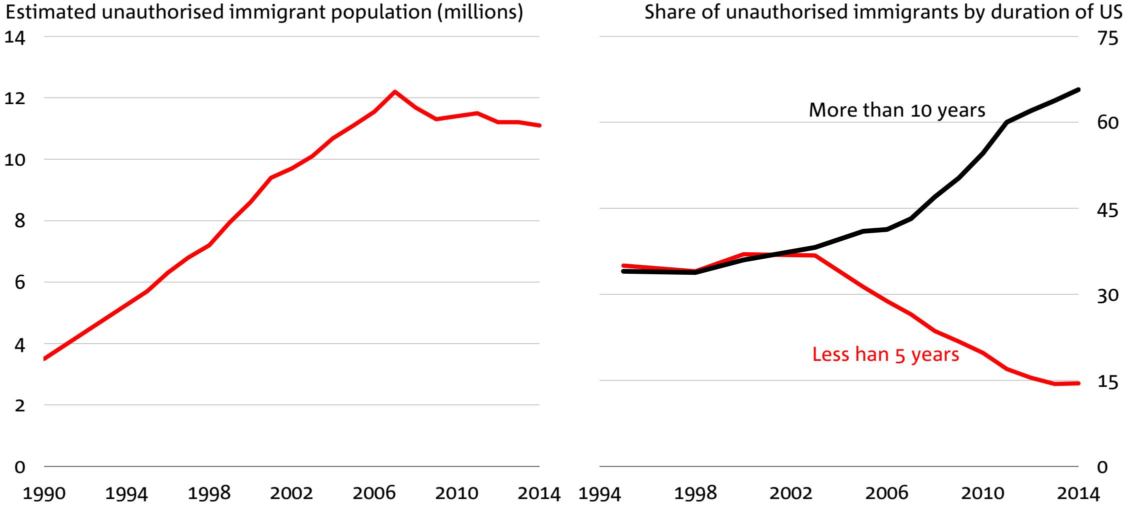
Clinton

- While Clinton's immigration policy highlights border protection and national security, its emphasis is far more on integrating immigrants into the United States (including unauthorised immigrants).
- Plans to introduce comprehensive immigration reform legislation within the first 100 days in office to provide easier pathway to citizenship
- Focus of detention & deportation efforts on unauthorised immigrants who pose 'a violent threat to public safety'.
- Supports Obama Administration executive orders that defer deportation of the undocumented parents of US citizens and adults brought to the US as children (known as DAPA and DACA). Proposes providing work permits to undocumented immigrants who qualify under DAPA and DACA requirements.
- Reduce costs to citizenship process with expanded fee waivers and support integration by reducing language, education and economic barriers.
- Close private immigration detention facilities.

The Bottom line

- Immigration policy is an area of significant divergence between the two candidates – given the differing priorities of their respective bases.
- Estimates suggest that there are over 11 million unauthorised immigrants in the United States – with over half of them coming from Mexico, followed by Central America (just over 15%).
- Trump's promise to build a wall along the US-Mexico border has strong appeal among those who feel disenfranchised by the free trade agreement between the two countries. Various estimates suggest the cost of the wall far exceeds the cost ($5-$10 billion) Trump has proposed.
- Clinton's pathway to citizenship approach appeals to Latino voter base – which typically favours Democrats – along with socially liberal voters.
- Opinion polls indicate around two-thirds of Americans oppose deportation of unauthorised immigrants and oppose the construction of a border wall, while over 80% support a pathway for unauthorised immigrants to become US citizens (Gallup 2016).
- Different immigration outcomes have important economic consequences with Mrs Clinton's more open policies better supporting US labour supply and output.

UNAUTHORISED IMMIGRANT POPULATION HAS STABILISED IN RECENT YEARS



Sources: Pew Research Center, NAB Economics

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FEDERAL BUDGET AND DEBT

No political will or agenda to address growing US government debt

Trump

- Significant tax cuts and more modest public spending proposals.
- Reduced income taxes for low-middle income earners, a reduction in the business tax rate and a child care deduction.
- Spending proposals include rebuilding infrastructure, increased defence and veterans spending, paid maternity leave, and broadening health care access.
- Spending cuts also planned, including a "Penny Plan" which would reduce non-defence, non-safety net spending by one per cent of the previous year's total each year which may mean that overall spending is little changed.
- Assessments of Mr Trump's plans show them adding to US deficits and debt – The Tax Policy Center sees the tax changes adding $7 trillion to debt in the first decade, The Committee For A Responsible Federal Budget sees an increase in Federal debt by $5.3 trillion over a decade and the Tax Foundation sees US revenue falling by $4½ to $6 trillion.
- These are underestimates of the impact on the budget and debt as they only cover tax changes and do not include the fiscal impact of the proposed infrastructure spending.

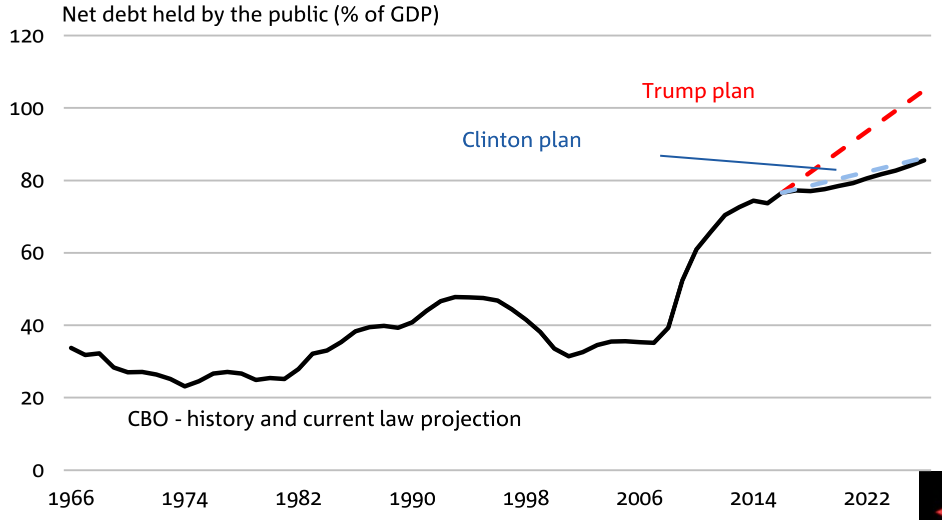
Clinton

- A range of new measures are proposed with big fiscal implications - college education subsidies; extra funding for preschools; a $275 billion infrastructure plan; expanded social security; extra health care spending, including an expansion of Medicare; investing in manufacturing through partnerships, tax incentives and apprenticeships; and paid family and medical leave.
- New tax surcharges and closing 'loopholes' allegedly used by wealthy individuals or large corporations raises revenue and helps pay for the extra planned spending. The Tax Policy Center estimates around $1½ billion in extra taxes would be raised over the next decade.
- The Committee For A Responsible Federal Budget estimates the taxing and spending plans would increase the Federal debt by $200 billion over a decade. Moody's Analytics estimates the plan would lift debt by around $750 billion.
- Given that the US is an $18 trillion a year economy, Mrs Clinton's fiscal proposals have limited fiscal impact over time (0.1 to 0.4% of GDP a year).

The Bottom line

- After big reductions in the US budget deficit since 2009, 2016 is expected to see it widen again and the situation is expected to deteriorate further over the medium term. Average deficits of 4% look likely after 2021, up from the 3% seen till then as health and welfare spending lifts.
- Based on current policies, the US debt position is set to worsen steadily - from around 75% of GDP in 2016 to 86% by 2026, 110% in 2036 and 141% in 2046.
- With neither candidate running on a platform of tackling this mounting debt and both emphasising the need to lift infrastructure spending and support household incomes, the budget outlook could well deteriorate further. Mr Trump's plans appear to involve a sizeable lift in US public debt.
- As Congress has the power of the purse, full implementation of either candidates plan is unlikely, barring unexpected outcomes in the Congressional elections. The major agitators for fiscal restraint in recent times have been Republicans, but House Republicans most recent platform did not specifically address budget repair, so even this constraint may have weakened.
- With no appetite for budget repair, even in a US economy performing quite well and facing a mounting debt burden, those calling for austerity measures to address medium term problems seem likely to be disappointed.

DEBT BURDEN RISING AND NO PLANS TO ADDRESS IT



Sources: CBO, Commit. For A Responsible Federal Budget, NAB

MONETARY POLICY AND THE FED

Federal Reserve behaviour enters the campaign

Trump

- Criticised US monetary policy saying Fed has kept rates unduly low and helped inflate a bubble in the US economy – "they're keeping rates down so that everything else doesn't go down", "the only thing that is strong is the artificial stock market" and added that the Fed should lift rates but it would not do so "for political reasons".
- Said that Fed chair Janet Yellen has been "doing political things" and that she was being more political than Hilary Clinton. He would not re-appoint her when her term of governorship ends in 2018, adding "She is not a Republican". He cannot dismiss her because of a difference of opinion.
- Janet Yellen has replied to these criticisms, emphasising that partisan politics do not play a role in Fed decisions and there has been media debate on whether she would resign if Mr Trump won the Presidential election.

Clinton

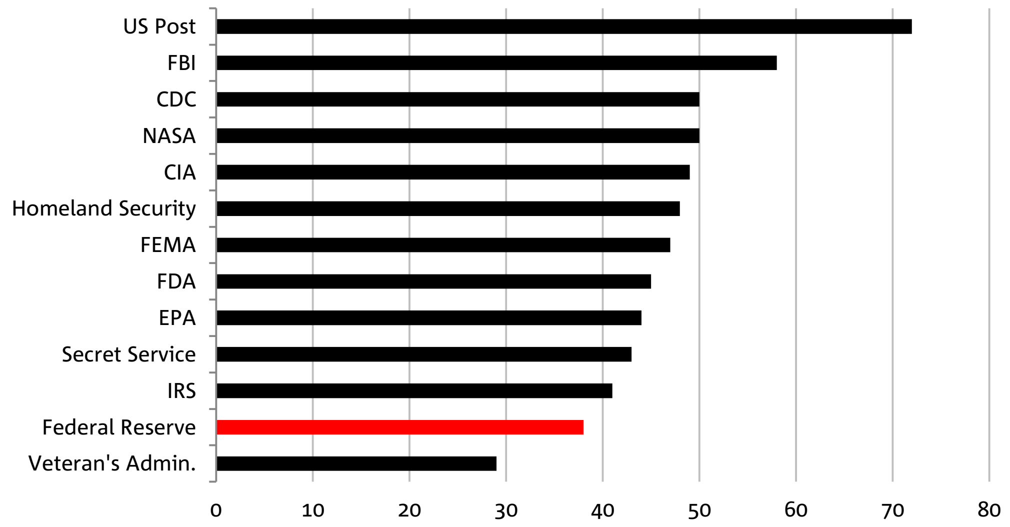
- Supports keeping Fed's focus on targeting inflation and securing full employment, a "dual mandate" that differentiates it from some other central banks whose legal mandate focuses just in inflation targeting.
- Wants to stop private sector bankers being appointed to the boards of the Fed's regional banks which have considerable power in the interest rate setting Federal committee.
- Criticised Mr Trump's comments on the Fed, saying that candidates for president should not be commenting on Fed actions and he should not be attacking the Fed as an institution (although she wants it changed too).
- Mrs Clinton faces a difficult balancing act here as there was a current within the party who supported Mr Sanders criticisms of the Fed and existing arrangements for monetary policy and bank regulation.

The Bottom line

- It is unusual for either the Fed or its leadership to feature so prominently in a presidential election - representing a heightened politicisation of what has often been seen as technical non-partisan areas of economic policy.
- Polling shows that there is, however, a sizeable body of opinion in the US that is either critical of or lukewarm toward the Fed, with less than 40% of respondents saying it does an excellent/good job and rating it low among US government agencies and the Fed and its leaders have been criticised in the past by other senior US politicians.
- Mrs Clinton's policy toward the Fed is probably as neutral as could be expected, given that her Democrat rival Mr Sanders was very critical of the Fed, arguing for reforms that went far beyond anything mentioned by Mr Trump. The "Fed Up" movement has been campaigning for changes to US policy and finding support in parts of the Democratic party.
- The Fed has been responsive to social pressures and its critics – it has engaged with leaders of the Fed Up movement to hear their concerns and got involved in the US issues of growing inequality and lack of economic mobility long before other global financial institutions woke up to the importance of the issue for mainstream economic policy.

FED NOT SEEN AS DOING A VERY GOOD JOB

Government agency ratings (% excellent/good)



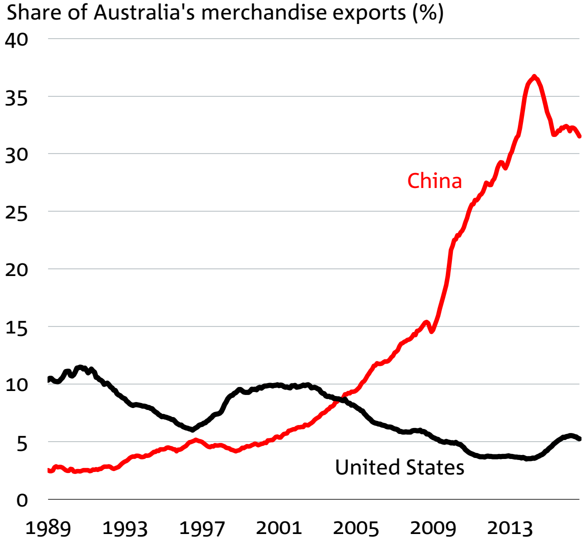
Souirce: Gallup (2014)

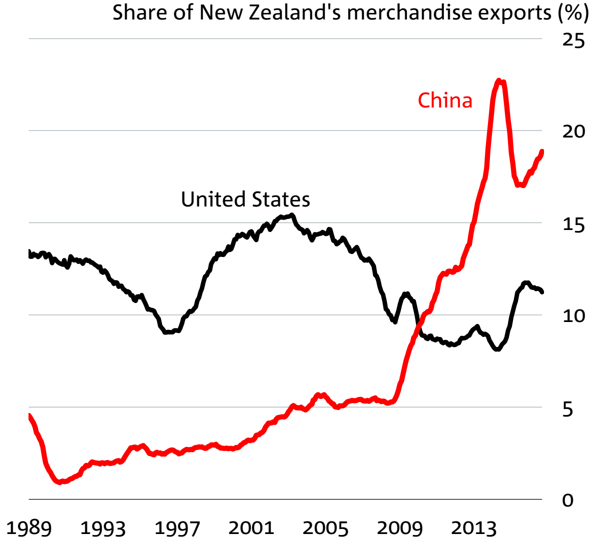
IMPLICATIONS FOR AUSTRALIA AND NEW ZEALAND

IMPACTS FOR TRADE

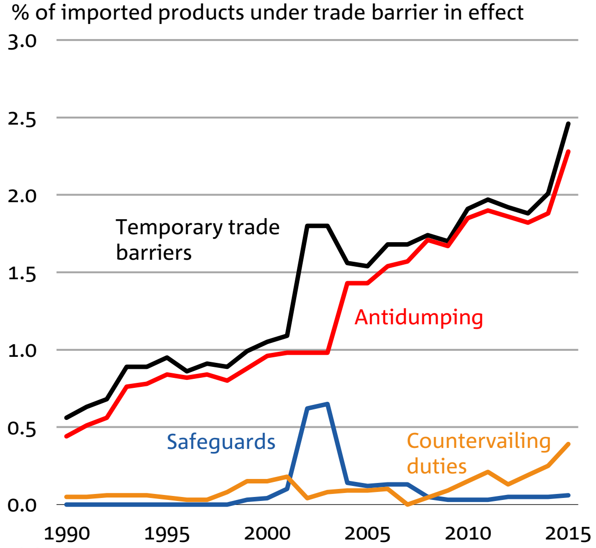
Australia and NZ big supporters of free trade, US politics going the wrong way

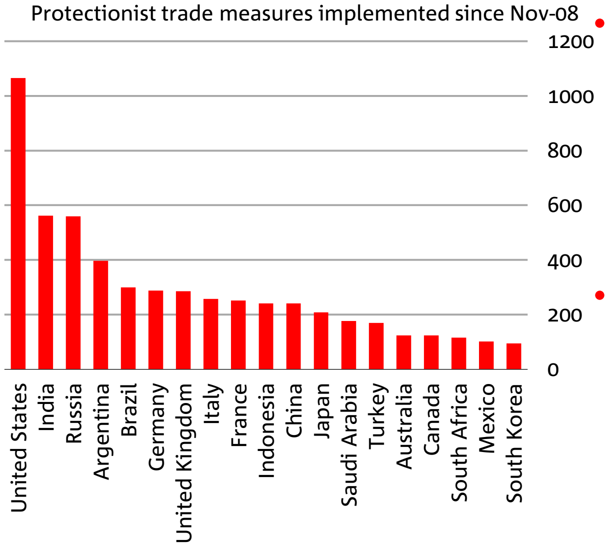
CHINA OUTSTRIPS US AS EXPORT MARKET FOR AUSTRALIA/NZ





GROWING PROTECTIONISM, US ACTIVE IN RAISING BARRIERS





Sources: ABS, Stats NZ, IMF, CEPR, NAB Economics

- Governments in Australia and New Zealand will be watching the trade debate in the US election campaign and the policy positions that each candidate has adopted.
- Both countries support ratification of the TPP trade agreement that the two US presidential candidates oppose in its current form. Australian parliamentary enquiries are currently reviewing the TPP. Some of the submissions they have received have been critical of the lack of public consultation during the negotiation of the TPP and the way the TPP's investor-state dispute settlement provisions could allow multi-national corporations to prevent governments from making laws and regulations. US opponents of the TPP have been making the same criticisms and US experience highlights what can happen if voters feel left out.
- The TPP includes the US and 11 other Pacific Rim countries but it excludes China and India. There is, however, another mega-free trade deal under discussion - the Regional Comprehensive Economic Partnership (RCEP) - which includes India and China plus ASEAN, Australia, NZ, Japan and S Korea but excludes the US. If the TPP fails, that could leave the China-centred RCEP as the only mega-free trade bloc left. This underlines Bill Clinton's point that the geo-political role of the TPP in the "pivot" of US policy towards the Pacific Region is clear – in his words "It's designed to make sure that the future of the Asia-Pacific Region, economically, is not totally dominated by China".
- Mr Trump's criticisms of China and his warning that a 45% tariff could be imposed on imports of Chinese goods raises the risk off a US-China trade war if the latter retaliated. China is easily Australia's biggest export market but the US is the biggest foreign investor here and the third biggest export market. China also buys around 18% of New Zealand exports, well ahead of the US's 12% share. Both countries would face an unenviable position if trade tensions arose between such important economic partners as China and the US.
- Australia and New Zealand have always been strong supporters of the WTO-based rules based system of international trade and would doubtless favour disputes being settled there rather than by unilateral action by aggrieved importing nations. Comments that big traders "get away" with unfair practices do not help build support for the existing system of rules-based trade that we have always supported.

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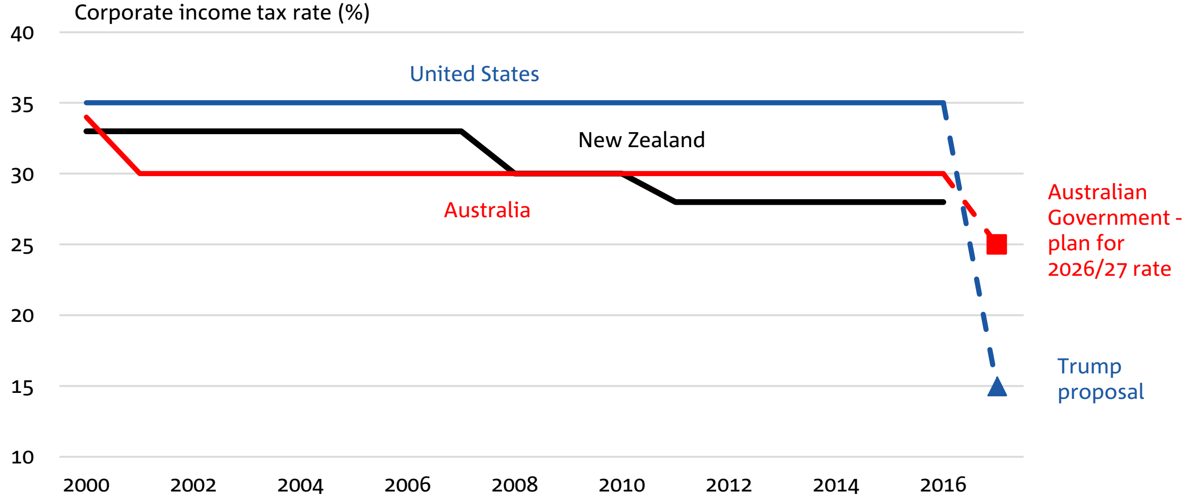
IMPACTS FOR TAX

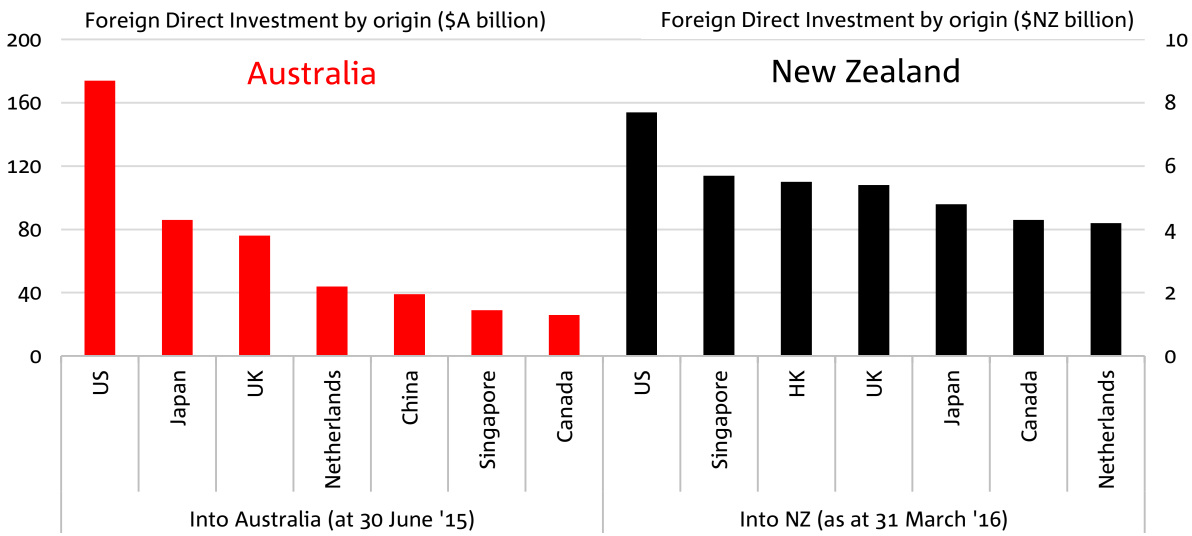
Mr Trump's radical plan will affect countries around the world

MR TRUMP'S TAX PLANS WOULD OVERTURN HISTORIC TAX RELATIVITIES



Source: OECD (central government corporate income tax rate)

US CORPORATES MAJOR DIRECT INVESTORS IN AUSTRALIA/NEW ZEALAND



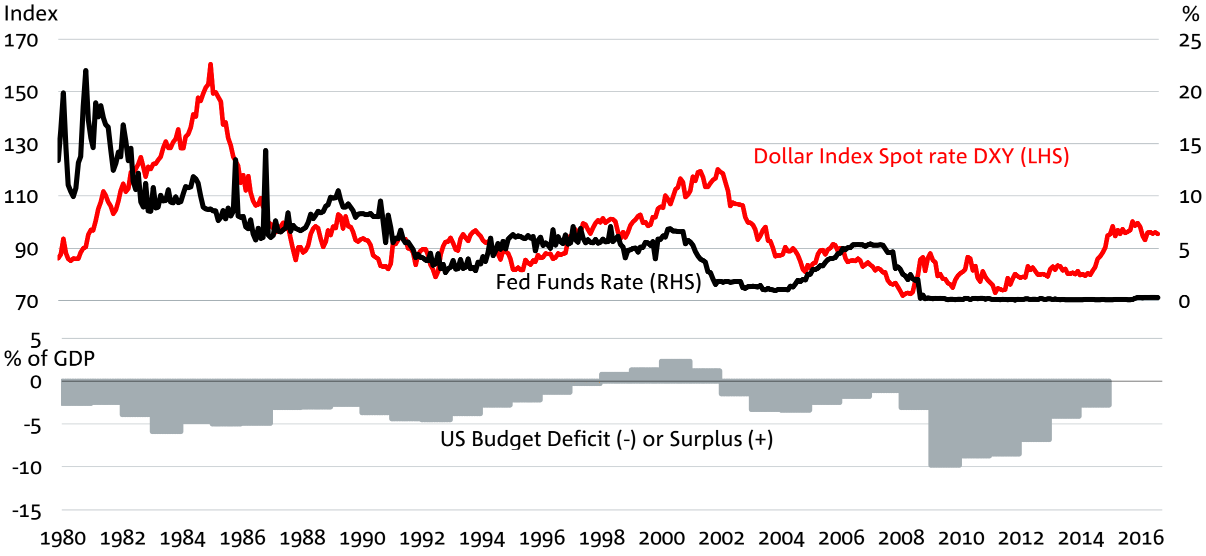
Sources: ABS, Statistics NZ, NAB Economics

- Company tax rates have been central in recent economic debates in the US and Australia with Mr Trump's plan to cut the US rate from 35% to 15% and the planned phased reduction in Australia's rate from the current 30% to 25% by 2026/27.
- Currently US firms earning profits in Australia would have to pay a top up 5 percentage points to the US revenue when they repatriate their profits to the US and another 7 percentage points on New Zealand sourced earnings (as US corporates are taxed on their entire global earnings, but allowed to defer sending the money back to their US head office).
- If Mr Trump's 15% US company tax proposal were implemented, the US statutory rate would be well below the current rates in Australia and New Zealand as well as the proposed 25% Australian rate outlined in the last budget. This would encourage US corporates to send their earnings straight back to the US rather than hold funds in Australia or New Zealand.
- US corporates currently hold around $US2½ billion in earnings that are supposedly "permanently reinvested" offshore and sizeable annual profits are earned here by US multinationals- $US16 billion in Australia in 2013 and $US1½ billion in New Zealand. We do not know how much of this cash they leave sitting in Australasia but a lot of money supposedly held "offshore" is actually sitting in the US financial system. Moreover, a lot of the residual balance – funds that that are really held offshore – are kept in low tax locations. So it looks unlikely that allowing US corporates to repatriate their stock of foreign profits at a concessional tax rate would lead to large scale repatriation of funds out of Australia or New Zealand to the US.
- Nevertheless, the scale of US corporate investment in Australia and New Zealand is so large that the issue has to be monitored. US business has the largest stock of direct investment in Australia ($A174 billion at end 2015) and the second biggest stock in New Zealand ($NZ7.7 billion in early 2016 – second only to Australia). Anything that affects the operations of US multi-nationals is worth following closely as they loom so large - majority owned US corporates employed 310,000 people in Australia and 32,000 in New Zealand.

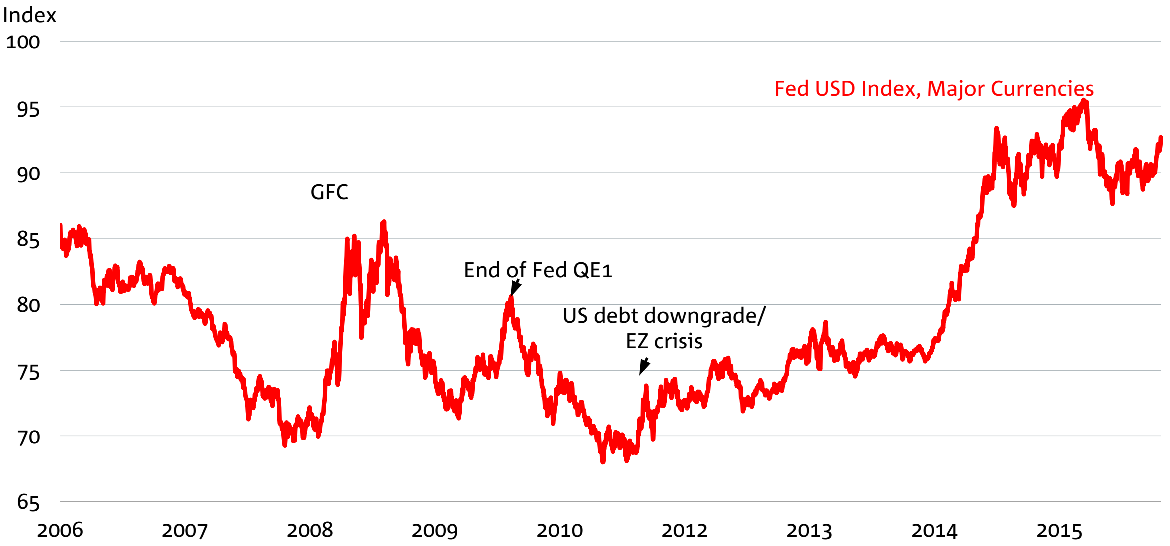
IMPACTS ON FINANCIAL MARKETS

US dollar set to strengthen – whoever wins

FISCAL/FED POLICY MIXES AND THE US DOLLAR



THE US DOLLAR DURING PERIODS OF MARKET STRESS



- If polls predicting a Clinton victory prove accurate, the US dollar is seen benefiting in the immediate aftermath, if only modestly. This is predicated on belief that the elimination of residual political uncertainty removes one of the remaining obstacles to a Fed rate hike on 13 Dec.

- Under the most likely scenario of a Clinton victory with Republicans retaining control of the House, there is a widespread presumption of continued political gridlock and so preservation of the status quo. In particular, chances of The House approving the significant tax increases on high income earning/wealthier Americans as proposed by Clinton to fund fiscal spending plans, seem negligible. As such, direct FX consequences of a Clinton administration appears to be slight.

- A significant point of departure with the foregoing is the likelihood of a tax reform/infrastructure spending deal. Clinton proposes a $275 billion five-year infrastructure program partly paid for by business tax reform, including a repatriation package that allows firms to return overseas profits to the US at a much reduced tax rate. House leader Paul Ryan and Senate leader Chuck Schumer have reportedly already discussed the idea. If approved, it opens the door to growth-enhancing infrastructure spending worth some 0.3% of GDP per year. If funded from corporate money held offshore, the fiscal multiplier on such spending would be high. A looser fiscal/potentially tighter monetary policy mix has traditionally meant a stronger US dollar (and weaker AUD/USD).

- If Trump wins the short term market response is likely to be risk-negative but with the USD seen as strengthening, as has occurred during prior periods of global market stress, even when the US has been at the epicentre (e.g. GFC, 2011 debt ceiling debacle and loss of AAA status). This would be particularly negative for the risk-sensitive AUD, alongside risks of Australia being caught in the cross-fire of a China-US trade war.

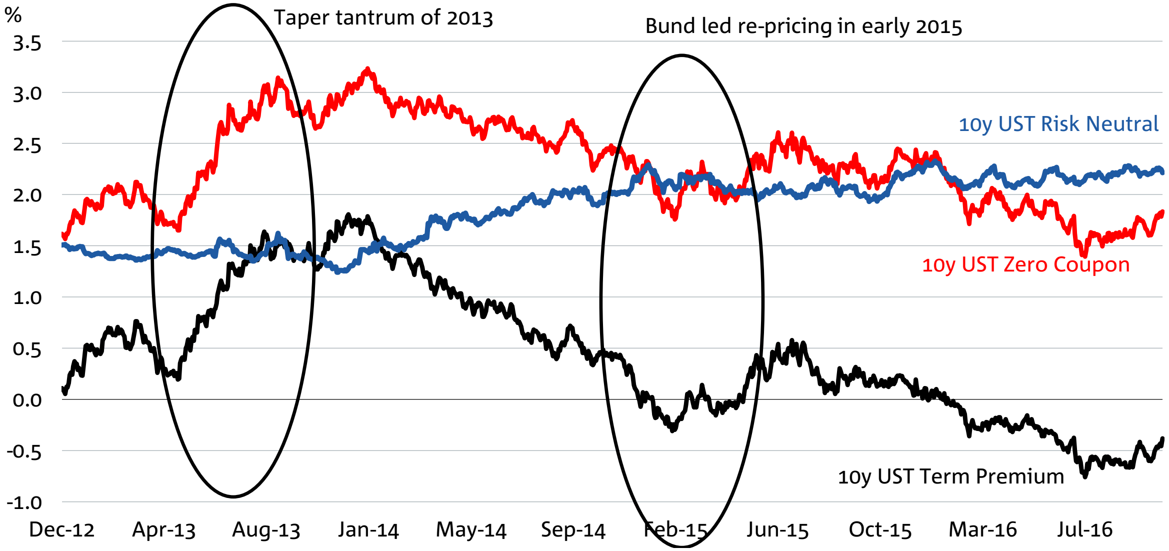
- Trump's policy proposals on trade, immigration and big tax cuts not matched by cuts to spending, are inherently inflationary. If implemented (a big 'if) and if Fed policy continues to be conducted in line with the existing mandate, monetary policy could be tighter – and the dollar stronger.

 Sources: Datastream, NAB Economics

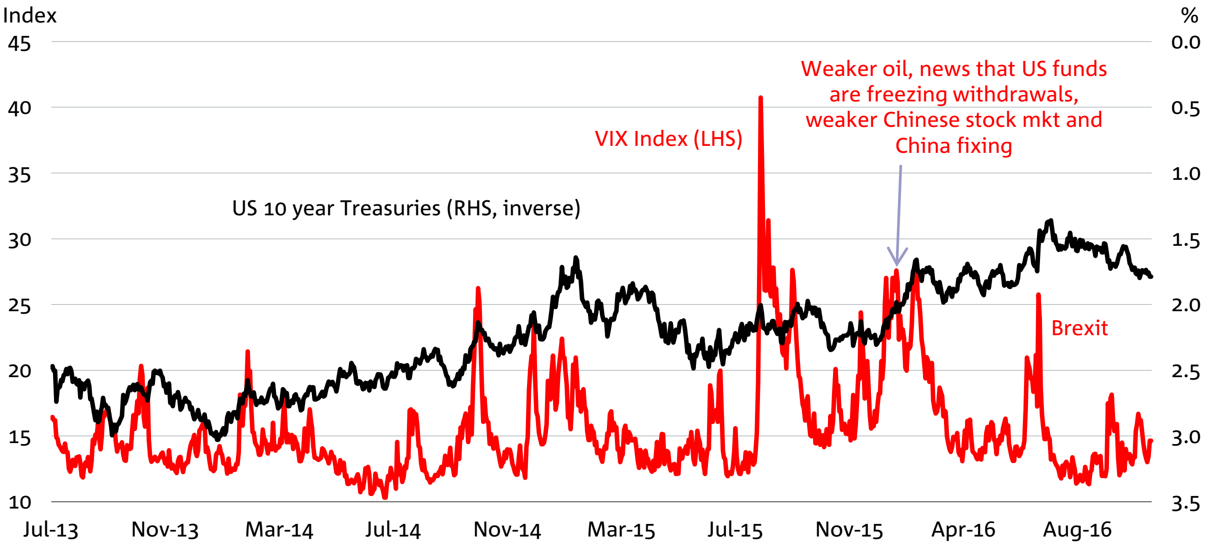
IMPACTS ON FINANCIAL MARKETS

Some noise but eventually higher yields and steeper curve

TERM PREMIUM DRIVING RISE IN YIELDS



YIELDS LOWER ON SPIKES IN VOLATILITY



Sources: NAB, Bloomberg

- For the rates market the key driver of yields remains the outlook for global growth/inflation and implications for monetary policy.
- Negative and zero interest rates as well as central bank asset buying are seen to be a key driver of the recent increase in longer dated bond yields, highlighting the importance of central bank actions to the market. We expect the Fed to lift interest rates late this year in the event that the opinion polls are correct in predicting a victory for Mrs Clinton.
- The market does not need to aggressively alter its outlook on monetary policy to take yields higher. This can come from re-pricing in the term premium.
- In isolation the US election is not expected to be a ‘game changer’ for bonds. What may be is a shift away from monetary stimulus towards fiscal policy in an attempt to boost growth and inflation.
- We could see a higher yields and a steeper curve if the outcome of the Presidential and Congressional elections delivers an administration able to implement policies that appear able to boost US growth and move inflation closer to the Fed’s 2% target.
- Most assessments suggest that Mr Trump’s tax cutting agenda would deliver a bigger short-term stimulus to US demand, at the cost of a higher public debt, than Mrs Clinton’s fiscal plans which have a more balanced profile of increases in taxes and spending.
- According to the latest opinion polls, a Trump victory looks less likely and if one were to occur it could result in a spike in market volatility (which is currently very low by historical standards).
- Over the past couple of years such a spike in volatility has been accompanied by lower bond yields. We do not see this relationship changing anytime soon and so the immediate reaction to a Trump victory is likely to be lower yields. Supporting this move would be the expectation that heightened financial market volatility will keep the Fed on hold when it meets in late December.
- Over the medium term a Trump victory may result in higher yields and steeper curves if he is able to get his tax cuts passed. In addition the introduction of trade barriers would likely eventually result in higher inflation.

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