NEARLY TWO MONTHS OF TRUMP

MARCH 2017

Still far from clear what changes are coming

- Nearly two months into the Trump administration, there is still great uncertainty about just what is going to happen to US policy. The President set out a big reform agenda involving fundamental changes to trade, tax and environmental policy and they presented clear risks for a blow-out in US public debt as well as trade wars. If the full Trump campaign agenda were delivered it would have major consequences for us as the US has by far the biggest stock of direct investment in Australia, it is our third biggest export market and a big competitor in global commodity trade.
- Differing emphases between the President and his senior officials, the lobbying of competing US business groups and the need to choose between alternative tax plans and assess their impact on the budget make it hard to work out what is going on in the White House. We should get more details in the next few weeks but the markets seem to have already made up their mind and have focused on the reflationary aspects of the Trump agenda with share prices, bond yields and the US$ all moving up since the election.
- Parts of the Trump agenda have already been delivered – the US has pulled out of the TPP trade pact and environmental regulations are being wound back. A lot of work is under way in the administration on how far to cut US business taxes, whether a new 20% tax goes on imports into the US, how to run a more unilateral protectionist trade policy and whether the US will ignore adverse WTO rulings. So far the feared trade wars with China and Mexico have not occurred as the US has not taken any action yet – it may be coming.
- We still need to see the extent to which President Trump's ambitious reform agenda ends up being constrained by the traditional concerns of Republican politicians for free trade and holding down public debt, legal cases aimed at his immigration and environmental policies, the threat of retaliation by big trading partners and abiding by global trade rules. The President was elected on a clear platform of change and if that agenda is watered down, the risk is that his supporters will feel badly let down.

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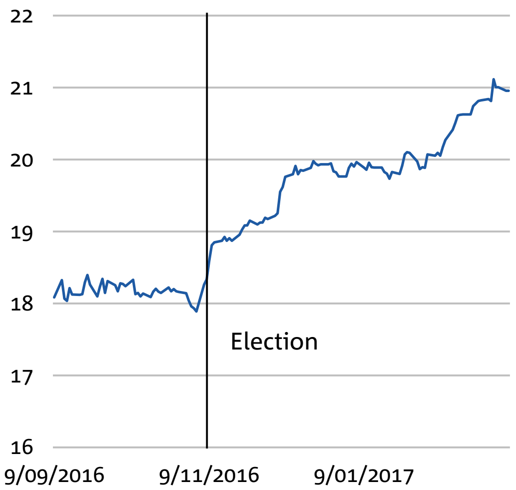
FINANCIAL MARKETS GRIPPED BY THE 'TRUMP TRADE'

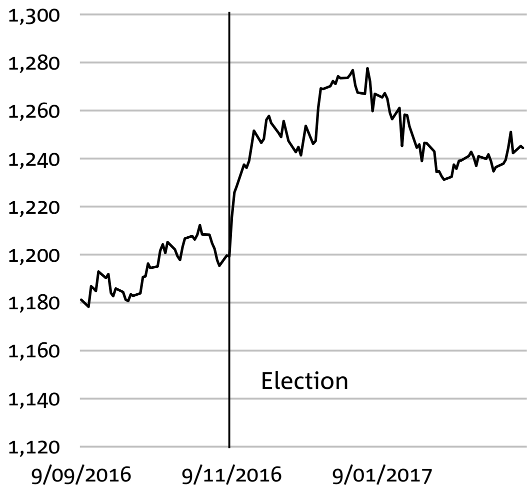
Financial markets have rallied strongly since the election

FINANCIAL MARKETS RALLY AFTER ELECTION…STOCKS, DOLLAR….

Dow Jones Industrial index (index, '000s)

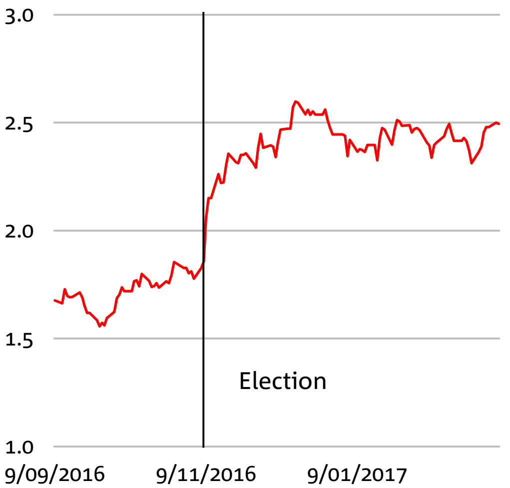


US trade weighted index (Bloomberg BBDXY)

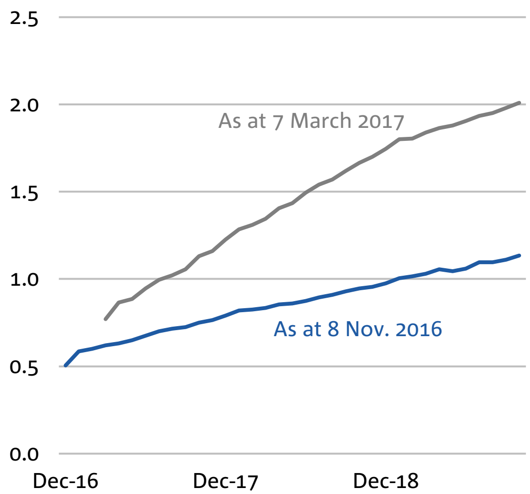


…BOND YIELDS UP AND FED RATE RISES LOOM

US 10yr Government bond yields (%)



Fed funds rate futures curve (%)



- Financial markets rallied strongly shortly after it was clear Donald Trump would be the next President. This was evident across stock, currency and bond markets, and there was also a decline in credit spreads.
- The Dow Jones Industrial index rose 3% in the first week and by early March it was up over 14% from its pre-election level. Factors behind this included expectations of a potentially large fiscal stimulus which would reflate the economy and, directly relevant to stocks, expectations of a cut in the corporate tax rate, as well as the prospects of a winding back of regulations (e.g. in finance, with bank stocks outperforming other stocks).
- The potential for a fiscal boost was also one of the reasons for the rise in government bond yields and in the US dollar. It is not the only factor – both the USD and yields were moving higher in the lead up to the election - but there was a noticeable strengthening in these trends once the result became clear. A fiscal boost increasing real economic growth or inflation increases the likelihood of Federal Reserve Bank (Fed) action to raise rates.
- In contrast, the President's reform agenda on trade and immigration has the potential to be a negative for growth prospects. However, for the US dollar, likely trade measures should be a positive – either through creating risk-off sentiment or through their direct impact on currency demand. This highlights a problem for the President in achieving the objectives of his trade platform with any protectionist measures likely to be at least partly offset by a rise in the US dollar.
- It has not been all clear sailing for markets since the election. Fiscal stimulus, including the corporate tax cuts, are still only a promise and not a fact. In periods where stimulus is not part of the regular news markets have tended to move sideways or backtrack. However, the President's comments to airline executives in early February promising a "phenomenal" tax announcement renewed the upward momentum.
- Looming over all of this is the Fed. Market expectations of the fed funds rate over the next several years have lifted significantly. This is hardly surprising, as with the Fed near to its targets, and the economy at full employment, the Fed is likely to be sensitive to the sort of large scale fiscal stimulus that could emerge from the new administration's agenda. The Fed has recently been signalling a rate hike is likely at its March meeting, and one factor cited is the prospect of fiscal stimulus which has added upside risk to the outlook for both growth and inflation.

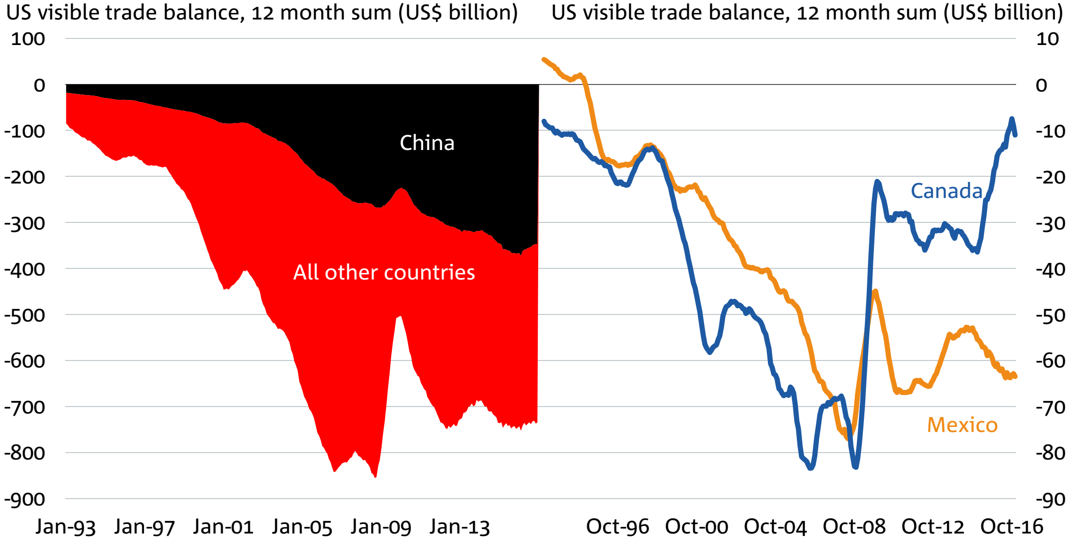
Sources: Bloomberg

A MORE AGGRESSIVE US-FOCUSSED TRADE POLICY

"President Trump has called for a new approach, and the Trump administration will deliver on that promise" - 2017 Trade Policy Agenda

7 MILLION LOST JOBS AND REAL WAGES BELOW 1970S LEVELS

CHINA AND MEXICO THE FOCUS IN US TRADE DEFICIT



Sources: US Census Bureau, BLS, NAB Economics

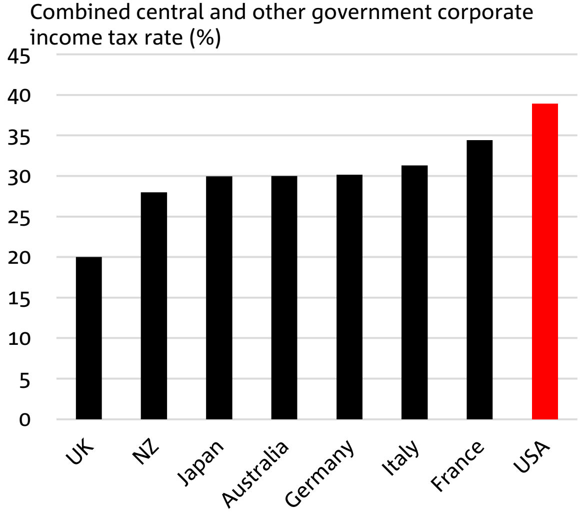
- Trade was important in President Trump's election campaign. Part of his programme has already been delivered, lots more is being drawn up. US Trade Representative, Robert Lighthizer – a hawkish veteran trade policy expert - has not been confirmed yet but other hawkish staffers are in place already.
- In its 2017 National Trade Policy Agenda the administration says that it intends to keep faith with the voters and deliver a more aggressive, unilateral, protectionist approach – the aim being to rebuild the US industrial base, create manufacturing jobs and increase wages. Recent studies highlight the extent to which the North American Free Trade Agreement (NAFTA) plus increased imports from China have depressed wages and cost jobs (almost 2½ million jobs lost between 1999 and 2011 because of increased imports from China alone).
- Running through the components of trade policy

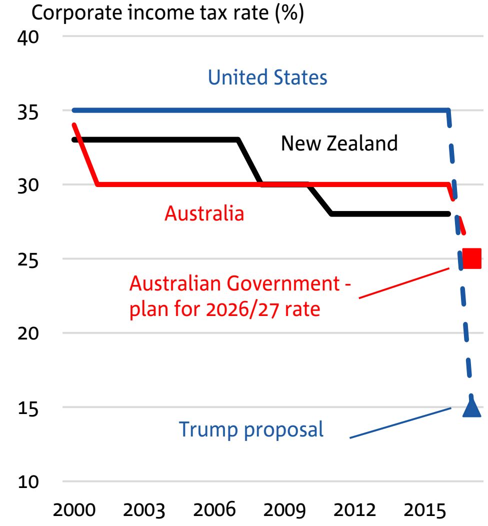
1. The US has withdrawn from the Trans Pacific Partnership trade agreement (TPP), fulfilling a Trump campaign promise. The rationale was to help American workers, whose interests it was said would be harmed by the agreement.
2. President Trump has made it clear that NAFTA must be renegotiated and the Canadian and Mexican governments have said they are willing to talk. One option is toughening up the local content rules, aiming to lift the American or possibly even US content in cars sold duty-free in the free trade area by displacing parts sourced from suppliers in Asia or Europe. The big car makers do not like the idea as it complicates their global sourcing models. Another idea is to include a clause forbidding currency manipulation into NAFTA.
3. No trade war with China has broken out yet - it has not been officially labelled a currency manipulator, although the President has restated that he sees China as the "grand champion of currency manipulation". The US Treasury releases its next global assessment of currency policies in April and its Secretary has said they will go through their normal processes - which cleared China last time. If China were found guilty, the penalties are not severe. However, there is another trade reform track under way which would make it easier to impose extra tariffs on imports from any country found to have undervalued its currency. This helps cut trade tensions with China for now – it is not being singled out but these currency manipulation penalties in US trade policy could well break WTO rules.
4. The emphasis will be on unilateral US trade measures punishing unfair traders with administration scepticism over the ability of the WTO to deal effectively with the problem. The idea of the US just ignoring adverse WTO rulings on its trade measures is even canvassed in the new Trade Policy Agenda.

BIG TAX REFORMS THAT SHIFT THE GLOBAL PLAYING FIELD

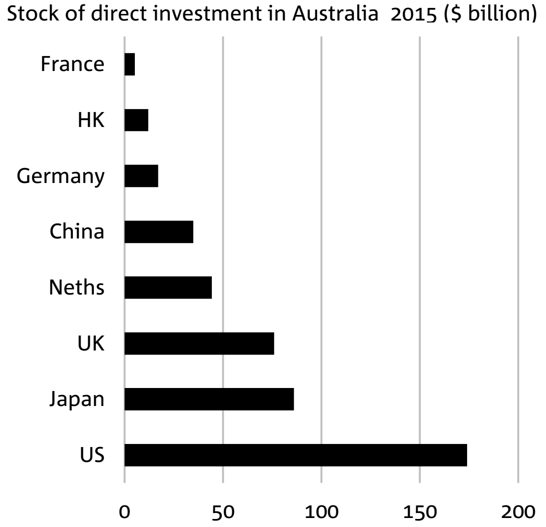
"Something phenomenal" in terms of tax reform has been promised, maybe in the next few weeks

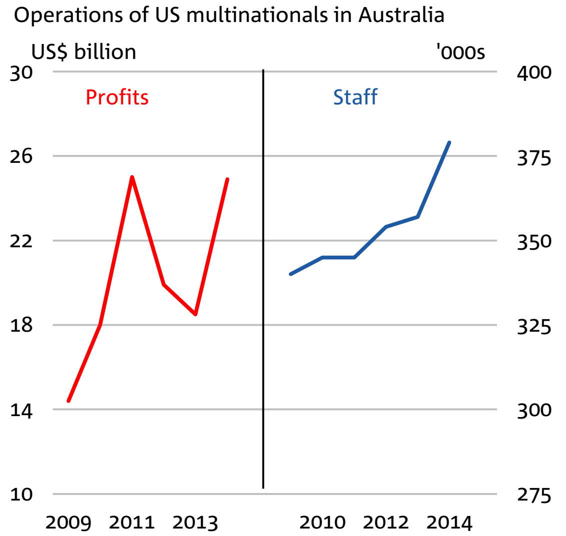
US MOVES FROM HIGH TAX LOCATION TO VERY LOW RATES





TAX CHANGES CAN IMPACT MASSIVE US CORPORATE PRESENCE HERE





- Significant tax reform has been promised but it is still not clear what form it will take. Despite unanimity that the US business tax system desperately needs reform, deciding what to do and implementing it is trickly as:

1. There are two blueprints for possible tax reform - the one released by President Trump last September and the one released by the House Republicans last June and they differ in important ways. Lots of debate must be going on behind the scenes on which plan should be adopted or whether bits of them can be merged
2. There are big corporate interests involved and the risk of higher prices to consumers - a 20% border tax on imported goods and tax relief for exporters is a key part of the House Republican's plan. Understandably that idea is bitterly opposed by retailers like Walmart who import lots of product whereas it is popular with big exporters like Dow, Boeing and GEC. The Trump administration have to navigate their way through these competing lobbies to reach a decision.
3. Tax reform costs money, the US government already has a deficit and debt problem and key Republican politicians do not want to make it any worse. Revenue neutral tax reform implies big tax hikes elsewhere but President Trump has promised big personal tax cuts too. Limiting the impact on the deficit by cutting spending runs into the President's plans to lift defence spending and pre-election promise to maintain welfare payments.

- The outcome of these US tax debates matters a lot to Australia as:

1. Both US tax plans call for deep cuts in US federal corporate tax rates from the current 35% to either 15% or 20%, well below our current rate and the lower 25% rate proposed in last year's budget.
2. The House Republican plan advocates imposing a 20% tax on goods imported into the US as part of business tax reforms. This not a tariff but it still lifts the price of Australian goods to US consumers, and our bilateral free trade agreement does not necessarily prohibit it. Whether this proposed new US tax is legal in terms of global trade rules is unclear but, once implemented, a challenge in the WTO appears inevitable.
3. A once-off concessional 10% tax levied on the $US2½ trillion or so in profits held offshore by US multinationals if they bring the money back home into the US tax system. This is instead of the normal 35% tax rate and the money may be routed to support infrastructure spending. US multinationals have big operations here that come into the orbit of this plan.

 Sources: Datastream, ABS, OECD, BEA, NAB Economics

National Australia Bank

GETTING RID OF REGULATIONS

"Excessive regulation is killing jobs" – President Trump

US REGULATION BURDEN NOT WORLD'S BEST BUT NOT BAD EITHER

- Winding back regulations to help business creation and expansion was a hallmark of President Trump's campaign and, once in office, he has moved quickly to act on that agenda

1. New presidential orders have been signed instructing federal agencies to get rid of two existing regulations for each new one they create and creating regulatory reform groups within each agency to see which rules are worth revising or scrapping.
2. Regulations that made life harder for energy firms have been a particular target with oil and gas firms and coal miners benefitting already – reducing "burdensome regulations on our energy industry" is a key part of the new administration's energy policy.
3. A freeze on all new or planned regulations has been announced by the White House Chief of Staff as their need and efficacy is reviewed – this has already caught four new energy efficiency standards.
4. President Trump sees scope to significantly cut the burden of regulations on business, telling business leaders in February that "we don't need 75% of the repetitive, horrible regulations that hurt companies, hurt jobs".
5. Environmental regulation, especially limiting ozone and how to handle greenhouse gas emissions, climate change and the extent to which wind and solar power should be subsidised are of particular concern to Republicans. A long-time EPA critic was appointed to head the agency, whose controversial Clean Power Plan was already facing court challenge and it is not clear how far the system for regulating CO2 emissions will change.

- While the extra cost and complexity that regulation imposes on US business is a hot topic, the country does not fare badly in global comparisons of regulatory burden. The US ranks 7th out of 189 countries in the World Bank's ease of doing business assessment, ahead of Australia's 13th ranking.
- The US business environment scores particularly well on accessing credit (second best out of 189 countries) and the legal system (5th rank for resolving insolvency and 21st rank for enforcing contracts out of 189 countries). It ranks much lower when it comes to the complexities of paying tax and starting a business. The falling US business start-up rate was raising concern a couple of years ago about a decline in US entrepreneurial spirit but the number of new businesses created has rebounded in the last few years so the burden of US regulation has not stifled business start-ups.

Sources: World Bank, NAB Economics

INFRASTRUCTURE

"Crumbling infrastructure will be replaced with new roads, bridges, tunnels, airports and railways gleaming across our very, very beautiful land ", President Trump, 28 February 2017

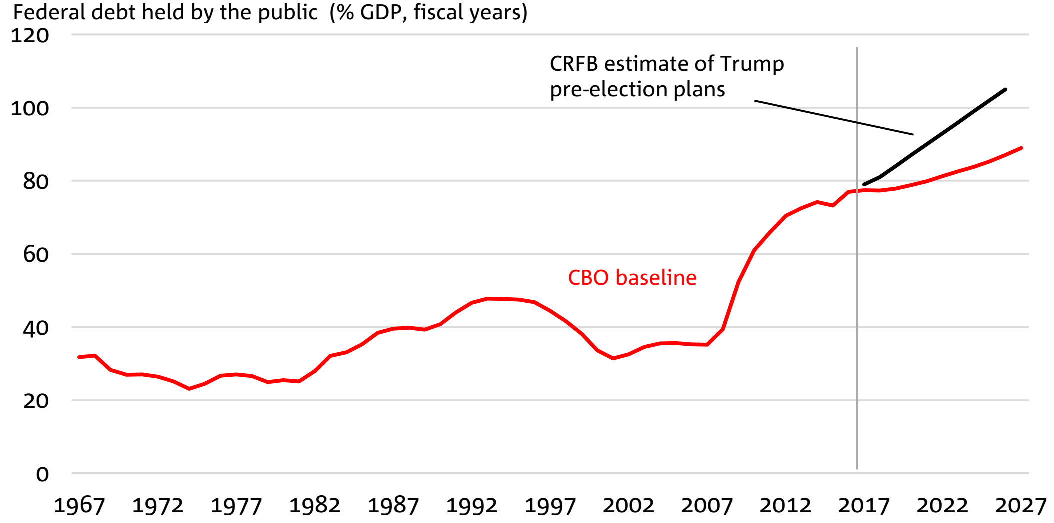
- A theme of President's election campaign – and speech on election night – was the need to rebuild America's infrastructure. While details were scant, they include the use of tax credits, increased funding for revolving fund programs to help state and local government water infrastructure and streamlining regulatory processes.
- On coming into office, the President's 100 day action plan provided some further detail, including removing roadblocks to projects such as the Keystone Pipeline, cancelling payments to U.N. climate change programs and redirecting the money to water and environmental infrastructure, an American Energy and Infrastructure Act that would utilise public-private partnerships and leverage private investment through tax incentives to spur $1 trillion in infrastructure over ten years.
- Consistent with this, in his 28 February speech to Congress, the President committed to ask Congress to approve legislation aimed at generating $1 trillion in investment in infrastructure, to be financed by both public and private capital.
- Other steps taken by the new administration include:
  - Presidential memoranda aimed at clearing road blocks to Keystone XL Pipeline project and to facilitate completion of the South Dakota Access pipeline, as well as a requirement that, where possible, pipeline projects use US materials and equipment.
  - An Executive Order aimed at expediting environmental review and approval processes for domestic infrastructure projects.
- It is possible that the budget outline expected to be released in mid-March may provide some extra guidance about the planned legislation aimed at generating $1 trillion in infrastructure spending, although reported statements from the Office of Management and Budget Director suggest that we might have to wait to a 'full-blown' budget in May.
- To put the $1 trillion figure into context, according to the Congressional Budget Office, $416 billion (2.4% of GDP) was spent on transportation, drinking and wastewater infrastructure by all levels of government in 2014, with about a quarter of this coming from the Federal government. This would suggest that a $1 trillion extra investment over ten years would represent a doubling of the Federal government's commitment. However, this is not an apples-for-apples comparison as the administration is clearly not planning that all of the $1 trillion will be actual government spending.
- Moreover, another issue to watch is how much of the $1 trillion infrastructure investment simply leads state and local governments to cut back on their spending, reducing the net impact of the program.

Sources: US Census Bureau, NAB Economics

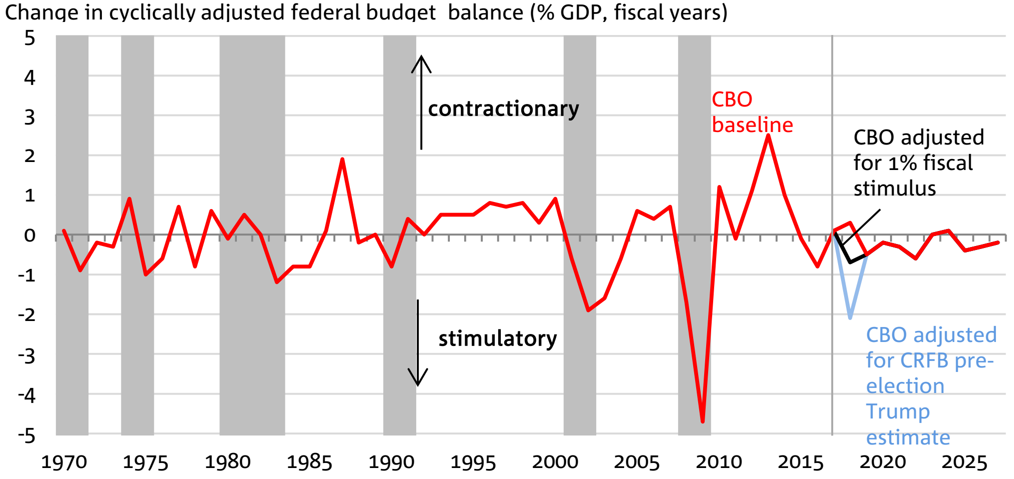
BUDGET – STILL AWAITING DETAILS BUT LIKELY TO GET 'SKINNY' VERSION SOON

"…we're gonna knock it down [Federal debt] and we're gonna bring it down big league…", Donald Trump, 12 October 2015

US DEBT OUTLOOK A REAL CONSTRAINT



TRUMP'S BUDGET TO FACE CONSTRAINTS BUT STIMULUS EXPECTED



Sources: CBO, NAB estimates based on CRFB analysis, NBER business cycle dating committee. Grey areas represent recessionary periods .

- During the election campaign President Trump indicated that he would reduce the national debt. However, details of actual policies released suggest that implementation of his program will significantly increase the national debt. Even before any changes to government spending or taxation the CBO estimates that Federal debt is scheduled to rise, and the President's pre-election plans, if implemented in full, would almost certainly accelerate that lift in debt.
- In terms of major components of the federal budget, the emphasis has not changed – on the revenue side, the administration continues to promise large tax cuts and on the spending side an expansion of defence and infrastructure, Savings are to come from government operations but not cuts in welfare spending. However, as the latter are a major component of spending that makes reconciling the administration's spending/tax and debt promises more difficult.
- Announcements to date include:
  - Congress will be asked to approve legislation to produce a $1 trillion investment in infrastructure (with an unspecified split of public/private spending).
  - Confirmation that the administration is working on reducing corporate tax rates and 'massive' middle-class tax relief.
  - A hiring freeze on federal employment.
  - Confirmation that the President's budget will propose a $54 billion (0.3% of GDP) increase in defence spending to be financed by cuts to the budgets of federal departments and agencies, although some analysts have claimed the effective increase is really only $18 billion.
- A Budget outline or 'skinny' Budget is expected to be delivered by the President mid-March followed by a 'full-blown' Budget in May. How much detail about the administrations tax and infrastructure plans will be included in the outline is unclear, but it should provide 'topline' numbers and provide a guide to budget priorities at the very least.
- Because of the difficulties likely to be faced getting legislation through Congress, as well as the poor starting fiscal position, we expect the end result will be a fiscal stimulus smaller than the President's pre-election promises implied. Nevertheless, this could still lead to fiscal stimulus for an economy close to full employment, which is unusual at this stage of the economic cycle, and appears to have been a factor behind recent signals from the Fed that it will hike rates this month.

IMMIGRATION

"We want to ensure that we are not admitting into our country the very threats our soldiers are fighting overseas" – Mr Trump 28 January 2017

- The highest profile action regarding immigration was an executive order on January 27 that limited immigration and refugees from seven predominantly Muslim countries (Iran, Iraq, Libya, Somalia, Sudan, Syria and Yemen) from entering the United States.
- The order was suspended by a New York Federal judge and blocked by the US Ninth Circuit Court of Appeals. A revised version of the Executive Order, which notably excludes Iraq and removes a blanket suspension on Syria, was signed on February 6. The American Civil Liberties Union has vowed to fight the new plan, but the direct economic impact of this order would in any event be small.
- Less attention has been paid to the temporary suspension of premium processing of H1B visas – which allows foreign professionals to work in the US for up to six years. This route has been used extensively by Indian-based IT outsourcing firms, who fear this move is a stepping stone to abolishing the H1B program altogether.
- Memos from the Department of Homeland Security point to tougher enforcement of regulations against undocumented immigrants – estimated at around 11 million people, primarily from Latin America. These documents suggest any undocumented immigrant charged or convicted of any crime (including minor offenses) will become an enforcement priority. Previous policies only targeted people who committed serious offenses.
- This plan will require the recruitment of thousands of Immigrations and Customs Enforcement agents, require local law enforcement to assist in arrests and potentially strip federal funding from so-called "sanctuary cities" that currently do not enforce existing legislation.
- Overall, these immigration policies (if enacted) are expected to have a net negative impact on US GDP, although the impact on the unemployment rate and other measures is less clear.
- A recent study finds that removing all undocumented immigrants would reduce the level of US GDP by around 3%, although other estimates put the cost at around half of this. Of course, this is the extreme case; a less extreme scenario would be zero net international migration. According to the Census Bureau estimates would reduce population growth by 0.4ppt and exert similar downward pressure on GDP growth (depending on the proportion of migrants of working age and their skill level).

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