Economic Update

December 2016

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Stronger Economic Growth in 2017, around 2.4%

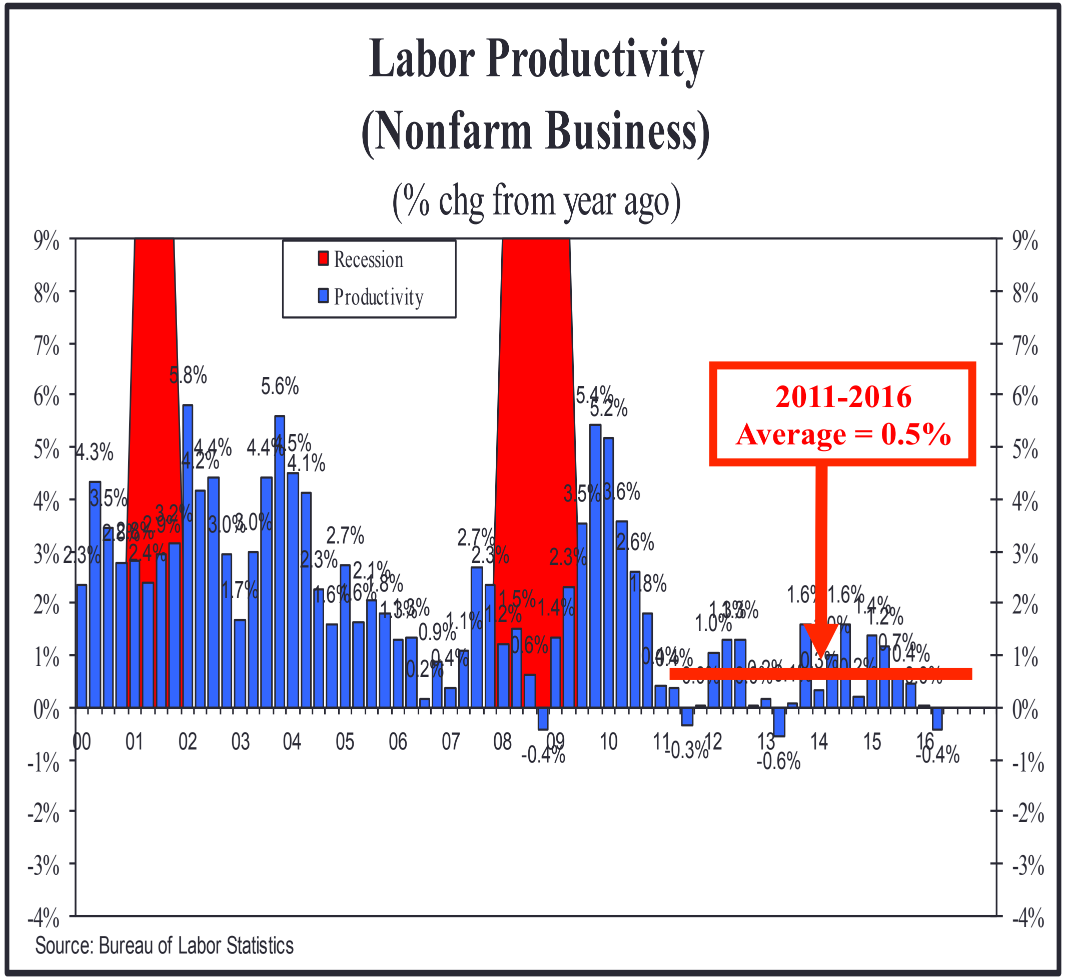
Trump's policies if implemented could boost short-run economic growth above the base case forecast (see chart).

1. Infrastructure Spending ($1 trillion in spending over 10 years)
   - Roads, bridges, water/sewer systems, border wall
   - Fiscal policy will take on a bigger role versus monetary policy
   - $100 billion in spending => faster economic growth (0.5% to 1%)
2. Tax Reform ($4.6 trillion in lower taxes over 10 years)
   - Lower headline corporate income tax rate (35% to 15%).
   - Lower personal tax rates and fewer brackets (7 tax brackets down to 3) (12% up to $37,500, 25% on $37,500-$112,500, 33% above $112,500).
   - One-off offer to repatriate foreign profits at 10% rate.
   - Move from global to territorial tax system.
   - Repeal estate tax and alternative minimum tax.
   - Full expensing of capital costs => increasing business investment.
3. Repeal and Replace Affordable Care Act
4. Modify Dodd-Frank Act to decrease credit supply constraints
5. Loosen environmental regulations, scale back climate change regulations and remove restrictions on energy production.
6. Anti-globalization and Trade Protectionism Policies => Trade War
   - Withdrawal/renegotiate trade deals (NAFTA, TPP)
   - Tariffs on Mexican (35%) and Chinese (45%) goods
   - Label China currency manipulator

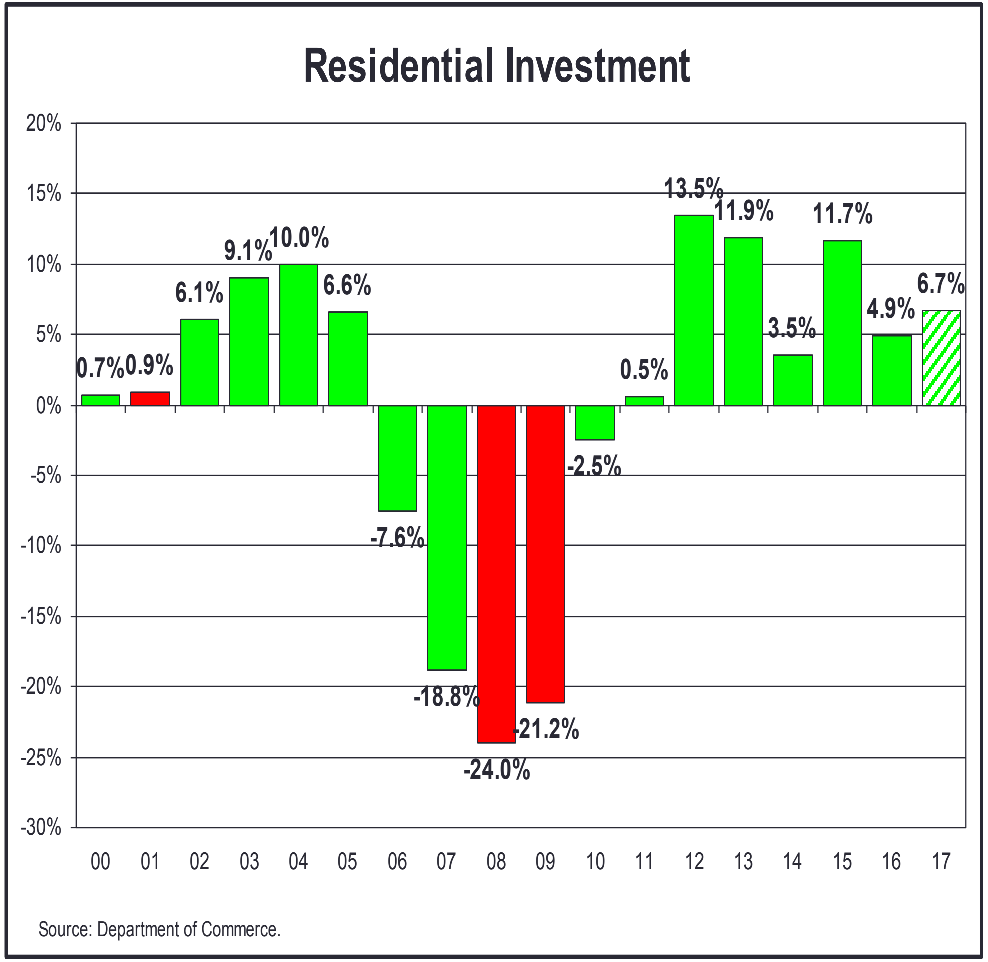
But policy uncertainty can have profound effects on spending:

- Business delay hiring and capital investment (but mostly hiring)
- Consumers delay durable goods purchases

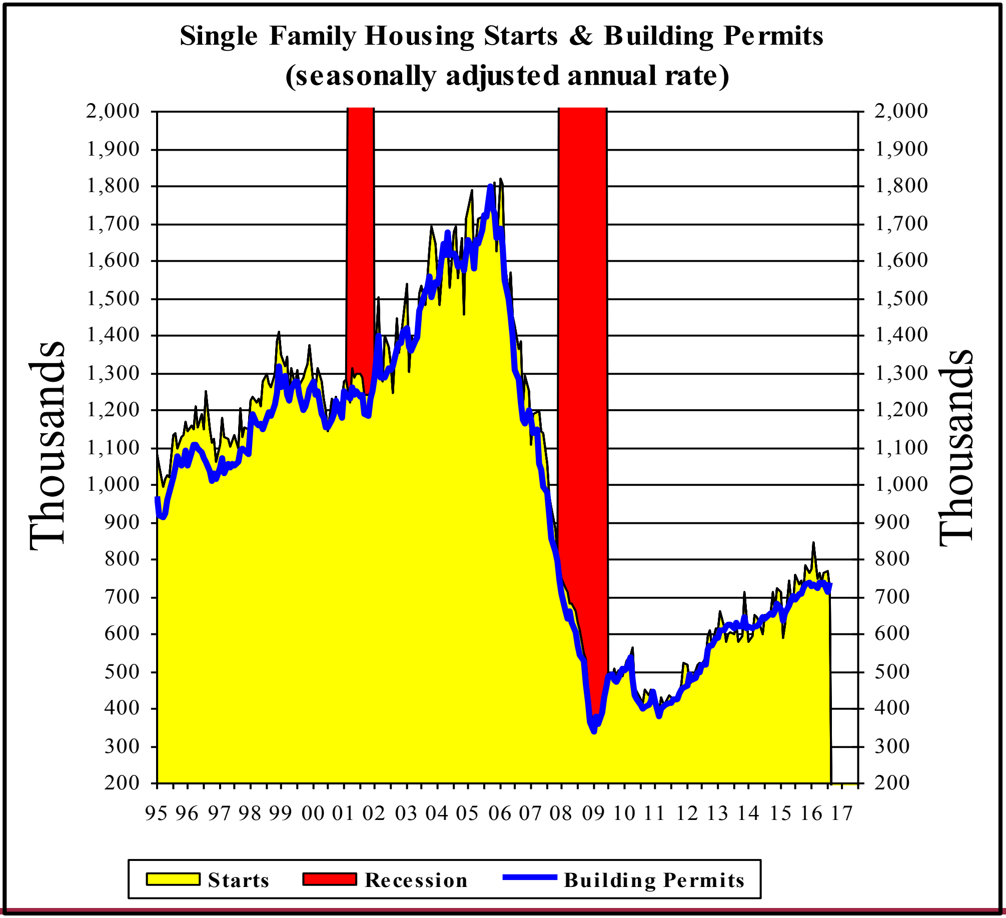
Very Low Productivity Growth is Biggest Economic Concern



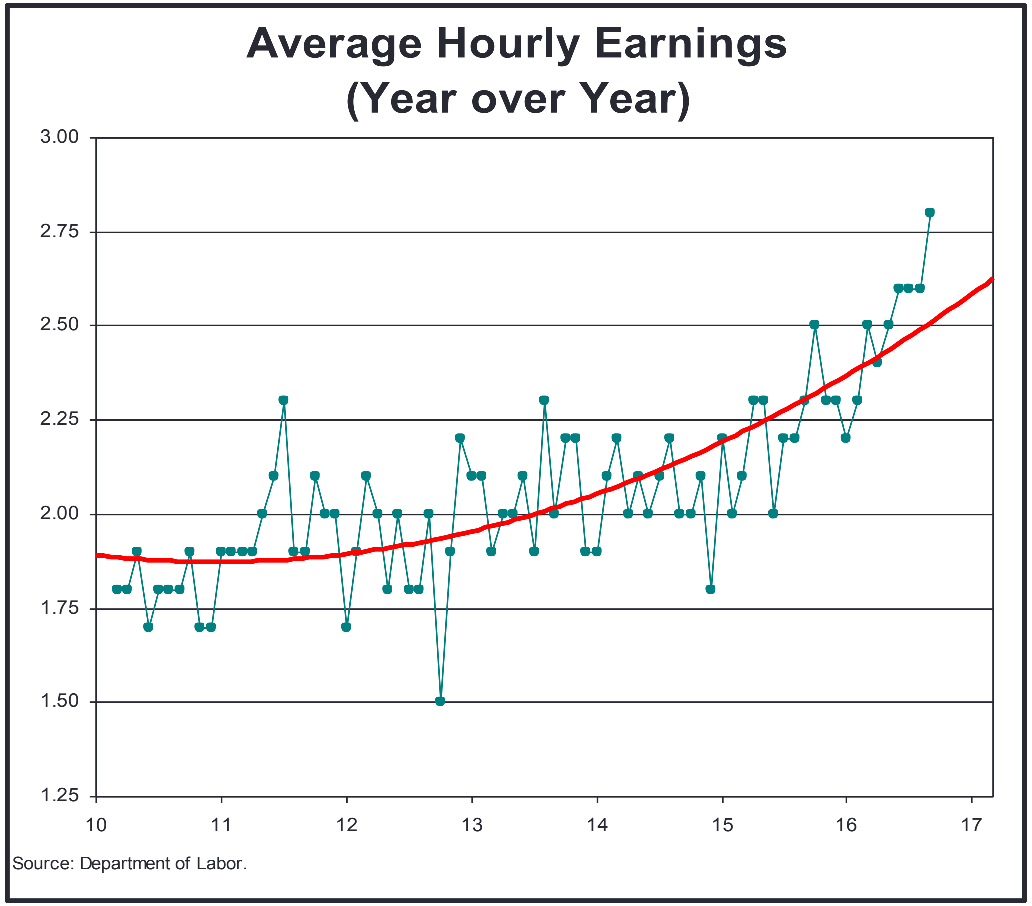
Housing Construction will Accelerate in 2017



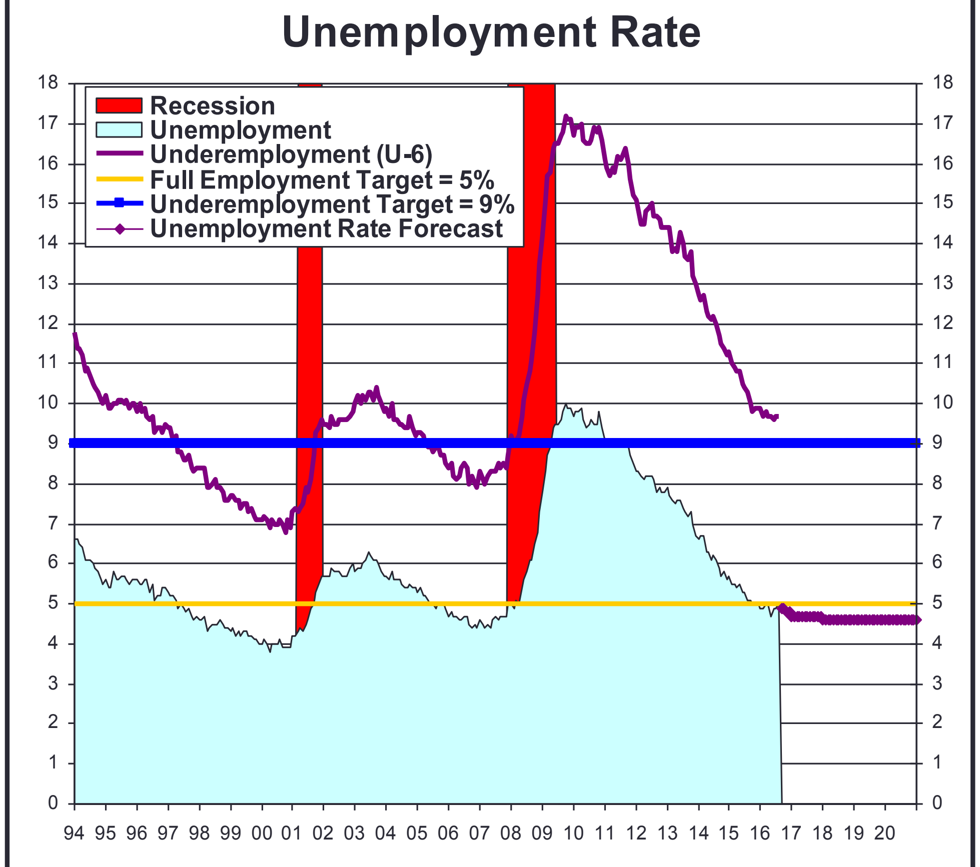
Housing Starts Limited by Few Unemployed Construction Workers



Average Hourly Earnings will Rise 3% in 2017



Unemployment Rate Hitting 4.7% in 2017, Reaching Full Employment



Source: Department of Labor.

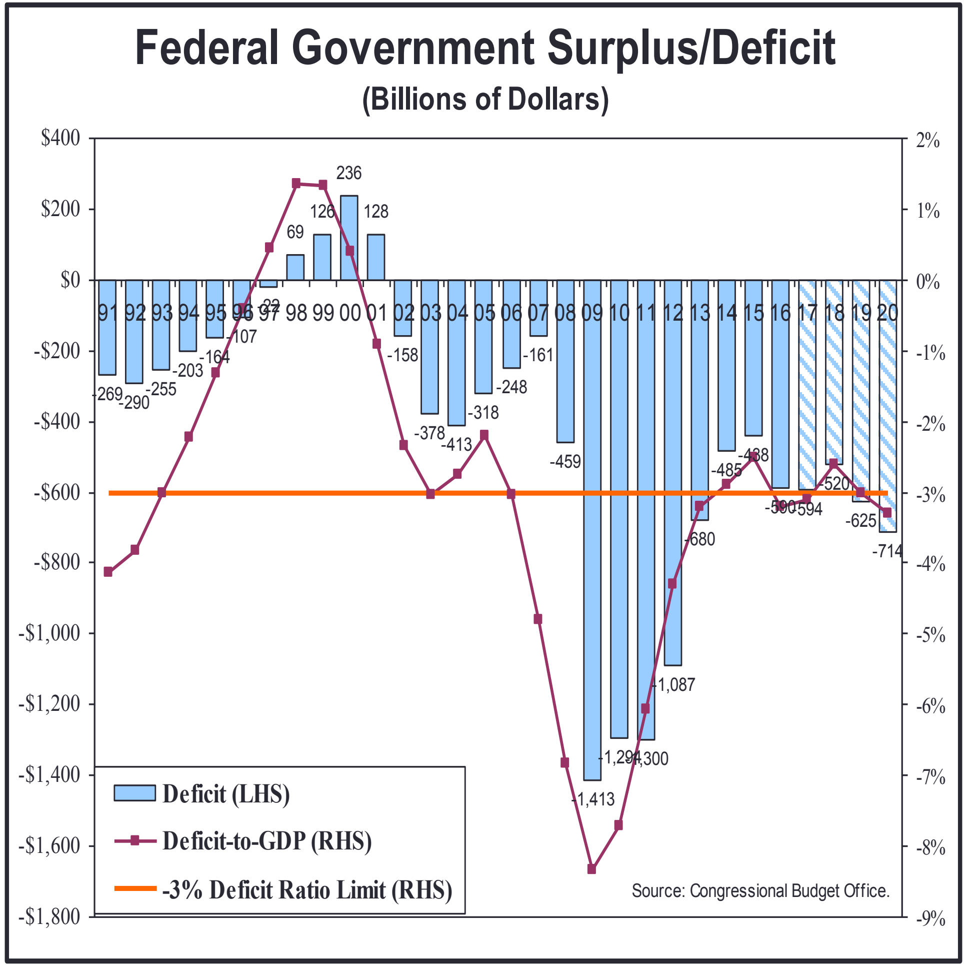
Trump's Policies on Labor Market

1. Trump's policies would lower the unemployment rate below the base case unemployment rate forecast (see chart).
2. Infrastructure Spending ($1 trillion in spending over 10 years)
   - $100 billion in spending => lower unemployment rate 0.3 percentage points compared to base case.
3. Hiring workers for infrastructure projects will put even more upward pressure on wage inflation.
4. Trump prefers minimum wage determined at state and local level

General Labor Market Trends

1. The unemployment rate is expected to fall to 4.6% in 2018 through 2020, which is considered full employment by this metric.
2. Wage inflation will accelerate from 2.8% annual rate today, to 3.5% in 2017 when the labor market is at full employment
3. The tightening labor market is now benefiting workers which will support consumer spending.
4. Payroll employment will growth 1.2% in 2017 and 1.0% for 2018-2020.
5. 2 million jobs will be added in 2017 (170,000 per month), down from the 200,000 pace set in 2014-2015
6. The employment-to-population ratio for prime age workers is now 77.9%, and is expected to reach the full employment 79.5% figure in late 2017, pushing wage growth above 3%.

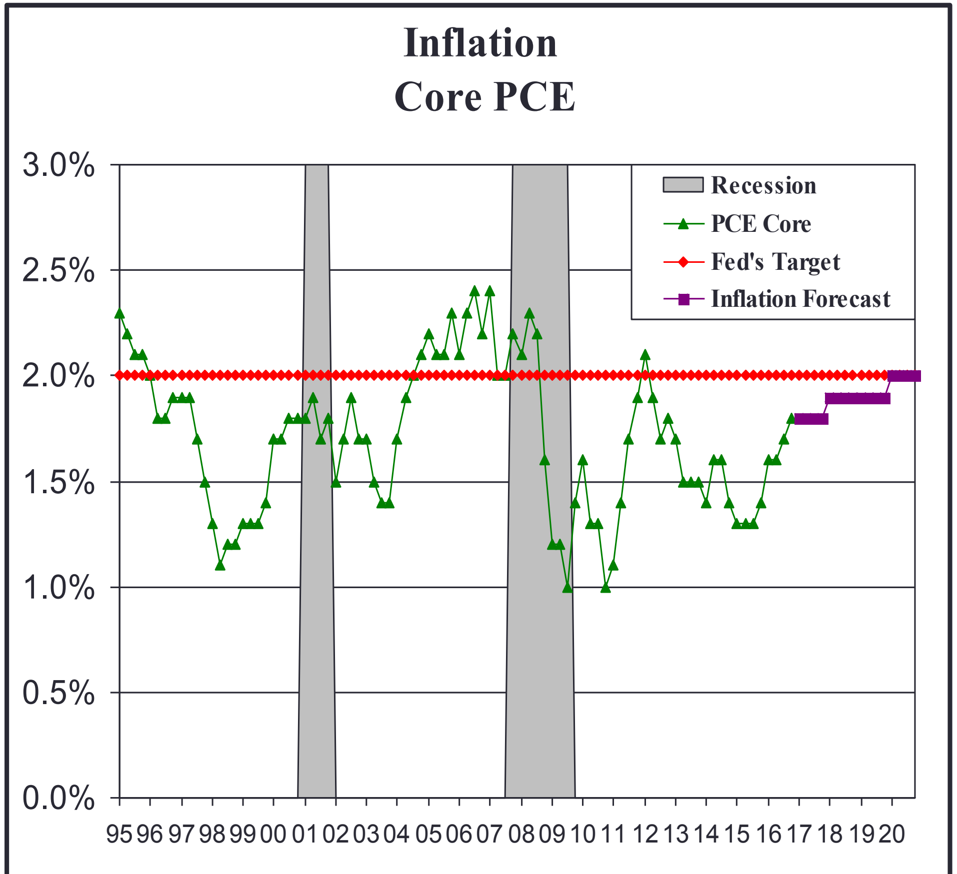
Rising Deficits Over Next 4 Years



Trump's Fiscal Policies on Deficits

1. Trump's deficit financing of government spending and tax cuts could double the deficit over the next 4 years compared to the base case deficit forecast (see chart).
2. Increased infrastructure and military spending along with tax cuts will result in large increases to the CBO forecasted budget deficit (see chart). The deficits will, however, lead to faster economic growth and inflation in the short run.
3. Trump's fiscal plan would increase the deficit $5.6 trillion over 10 years, or $560 billion per year, which is a fiscal expansion of 2.5% of GDP per year. This would take the forecasted deficit-to-GDP ratio from the current 3% to 5.5%.
4. Unified government increase chances of implementing Trump's policy after years of political gridlock. Fiscal policy legislative changes only need majority vote in house and senate.
5. Repatriation of overseas corporate profits => $180 - $250 billion in tax revenues.
6. Economic theory estimates the fiscal multiplier for a **$1 increase in government spending** can have a **$0.5 to $2.5 cumulative effect on GDP** over the next year, if the economy is operating below potential and the Federal Reserve interest rate responses are limited.
7. Economic theory estimates the fiscal multiplier for a **$1 tax cut for low-to-middle income households** can have a **$0.3 to $1.5 cumulative effect on GDP** over the next year.
8. Economic theory estimates the fiscal multiplier for a **$1 tax cut for higher income household** can have a **$0.1 to $0.6 cumulative effect on GDP** over the next year.
9. Deficit financing will increase interest rates because the Federal Reserve will not be purchasing the debt due to a desire to reduce their balance sheet, and private funders will be reluctant to purchase new bonds due to low current interest rates and their expectations for rising inflation. So nominal interest rates are poised to rise due to rising real interest rates and rising inflation expectations.

Core Inflation Will Remain Below Fed's 2% Target until 2019



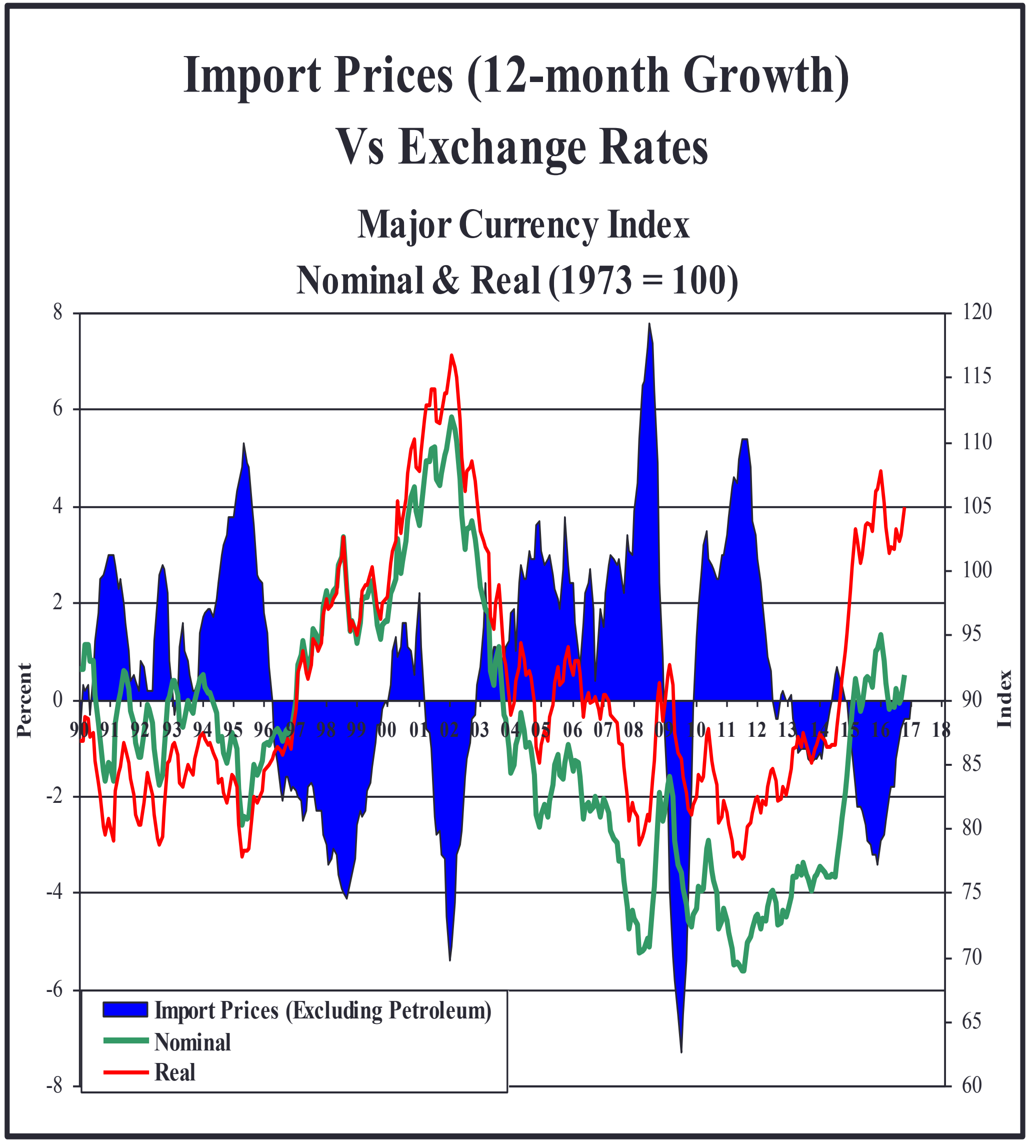
Source: BEA and BLS

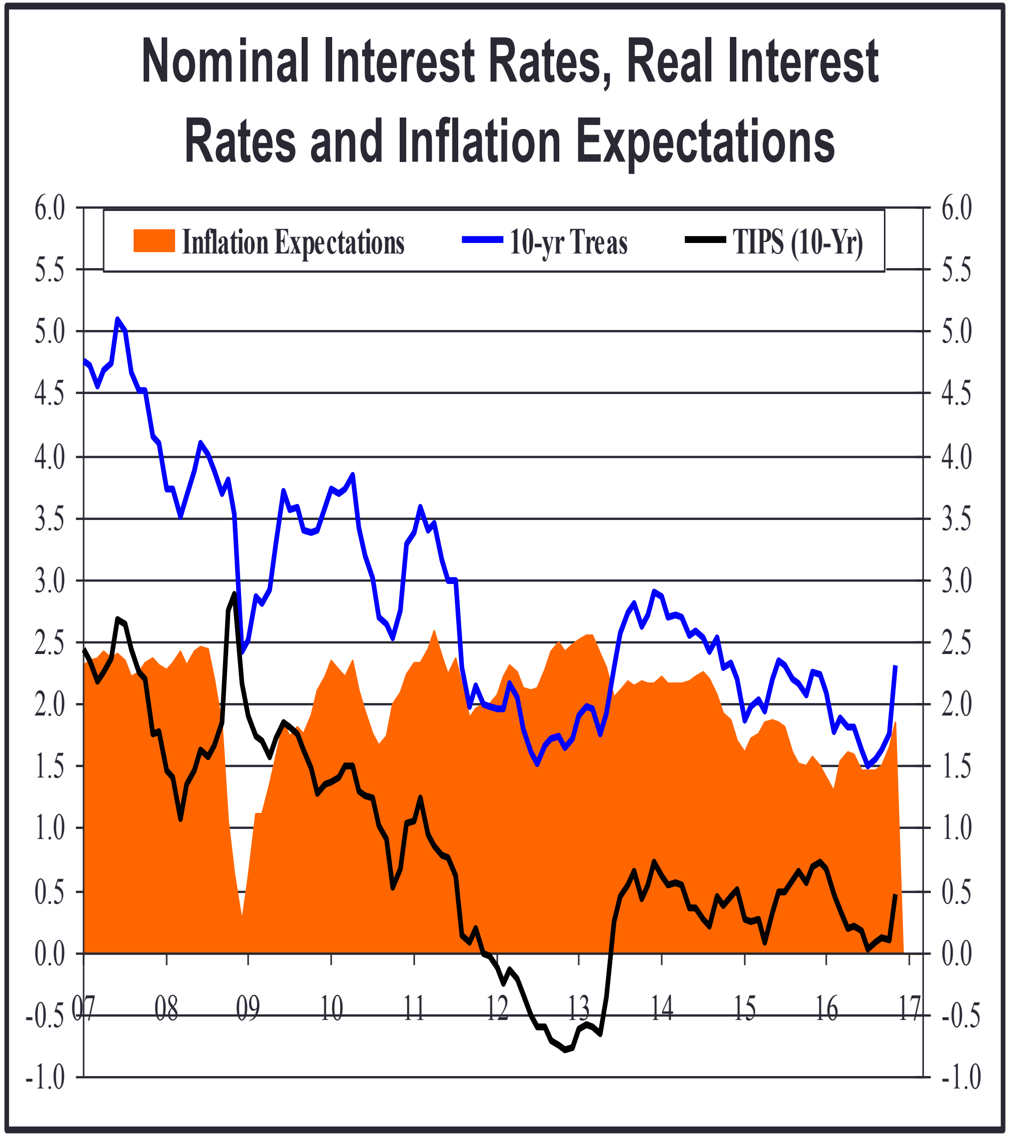
Trump's Policies on Inflation.

1. Increased government infrastructure and military spending will boost aggregate demand and inflation above the base case forecast (see chart).
2. Trade and immigration restrictions will lead to supply-side constraints and inflationary pressure.
3. Import tariffs on Mexico (35%) and China (45%) will be inflationary.
4. Trump can raise tariffs without congressional approval, but only for a short time period and only with limited scope.
5. Rising inflation will entice the Federal Reserve to raise interest rates sooner and faster than previous estimates.
6. Rising inflation expectations will increase the 10-year Treasury interest rate.

General Inflation Trends

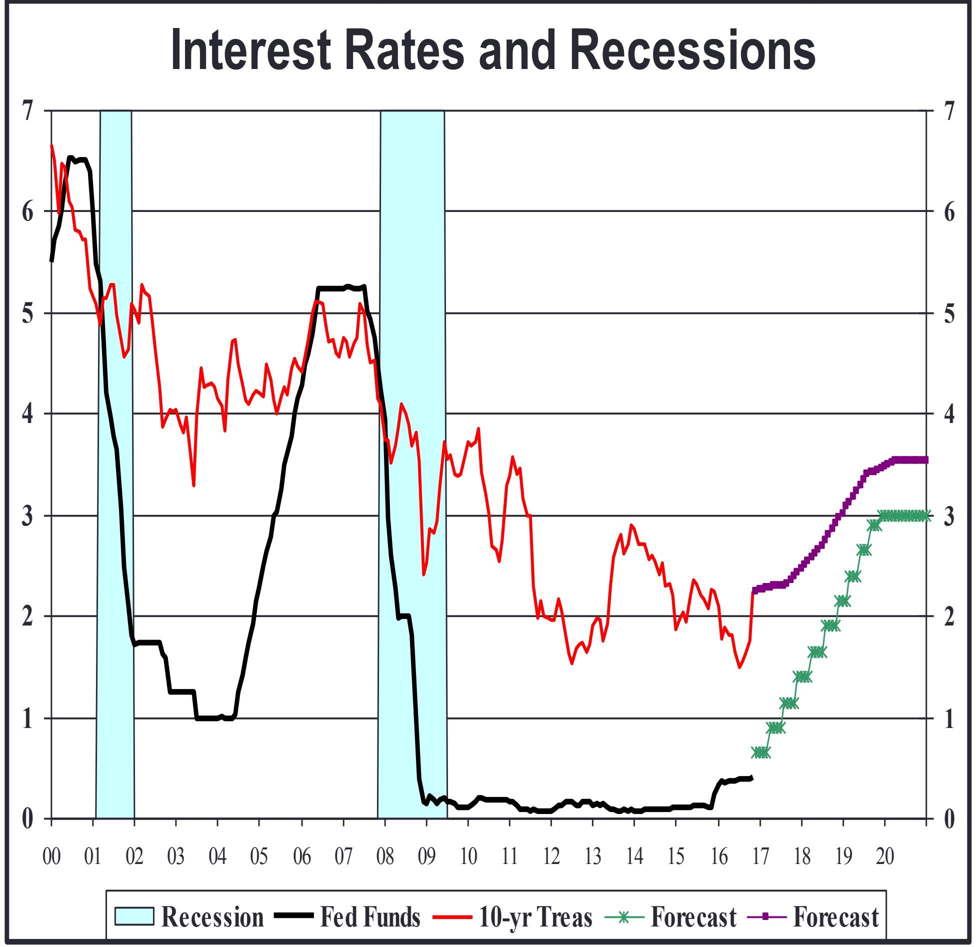
1. Rising commodity prices (oil and metals) will push up inflation in 2017.
2. With the economy approaching full employment and potential output, wage and price inflation will accelerate soon.


Import Prices (12-month Growth)
Vs Exchange Rates
Major Currency Index
Nominal & Real (1973 = 100)
Percent
Index
8
6
4
2
0
-2
-4
-6
-8
120
115
110
105
100
95
90
85
80
75
70
65
60
90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18
Import Prices (Excluding Petroleum)
Nominal
Real


Nominal Interest Rates, Real Interest
Rates and Inflation Expectations
Inflation Expectations
10-yr Treas
TIPS (10-Yr)
6.0
5.5
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
07 08 09 10 11 12 13 14 15 16 17

Federal Reserve will Raise Fed Funds Interest Rate 0.75 pp in 2017

10-Year Treasury will increase 0.40 percentage point in 2017



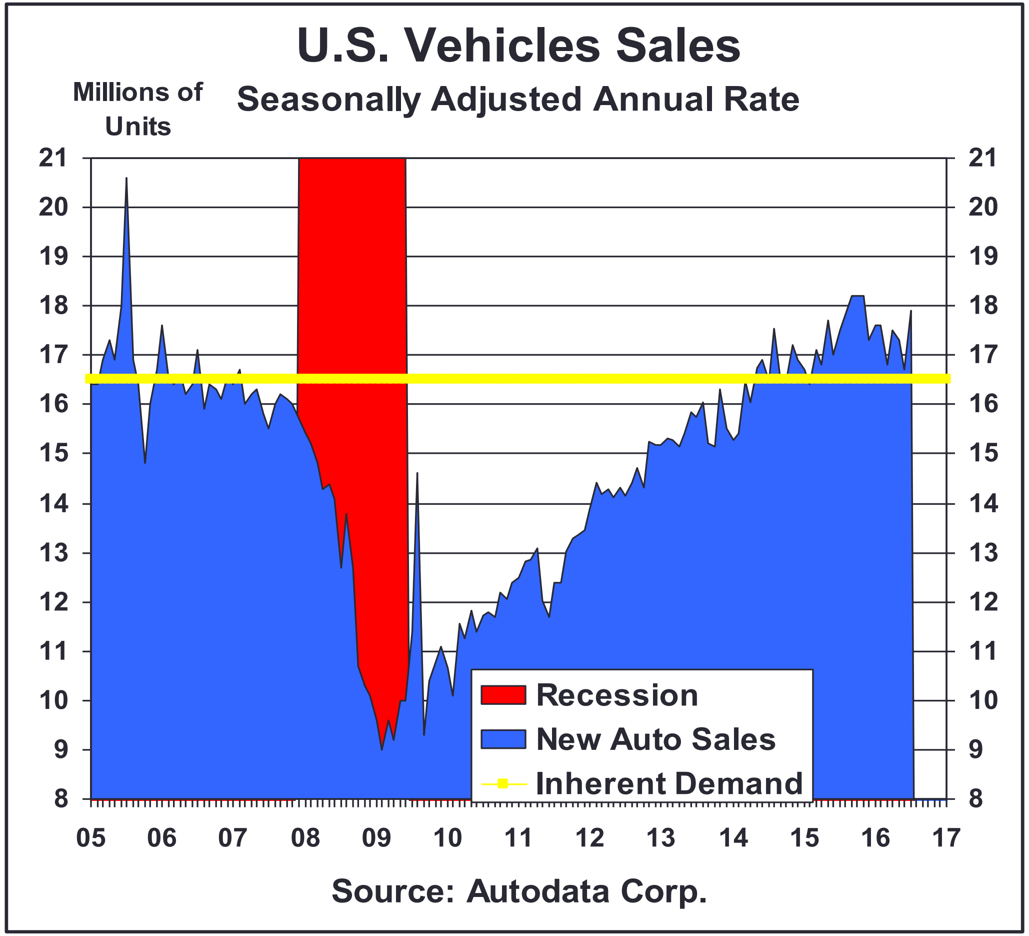
Trump's Policies on Interest Rates

1. Trump has stated he will appoint more hawkish Federal Reserve Governors which will mean short-term rates move higher sooner and faster than expected.
2. Trump will replace Janet Yellen as Fed Chair with a more hawkish individual when her appointment runs out in January 2018.
3. The Fed will raise the fed funds rate 0.25 percentage point in December 2016
4. The Fed will raise the fed funds rate 0.75 percentage point in 2017 and 2018.
5. The Fed will raise the fed funds rate 1.00 percentage point in 2019.
6. The fed funds rate will reach the 3% "neutral" fed funds rate at the end of 2019. The long run equilibrium fed funds rate is lower today due to slow productivity and labor force growth.
7. Bigger deficits will increase Treasury interest rates and interest payments.
8. The 10-year Treasury interest rate jumped from 1.76% in October to 2.25% right after the election, which is a tightening in financial conditions.
9. The 10-year Treasury "term premium" jumped 20 basis points in 2 days after the election, from -19 basis points to a positive 1 basis point. The term premium is still significantly below its 20-year average of 1.2%.
10. Interest rate "normalization" has begun.

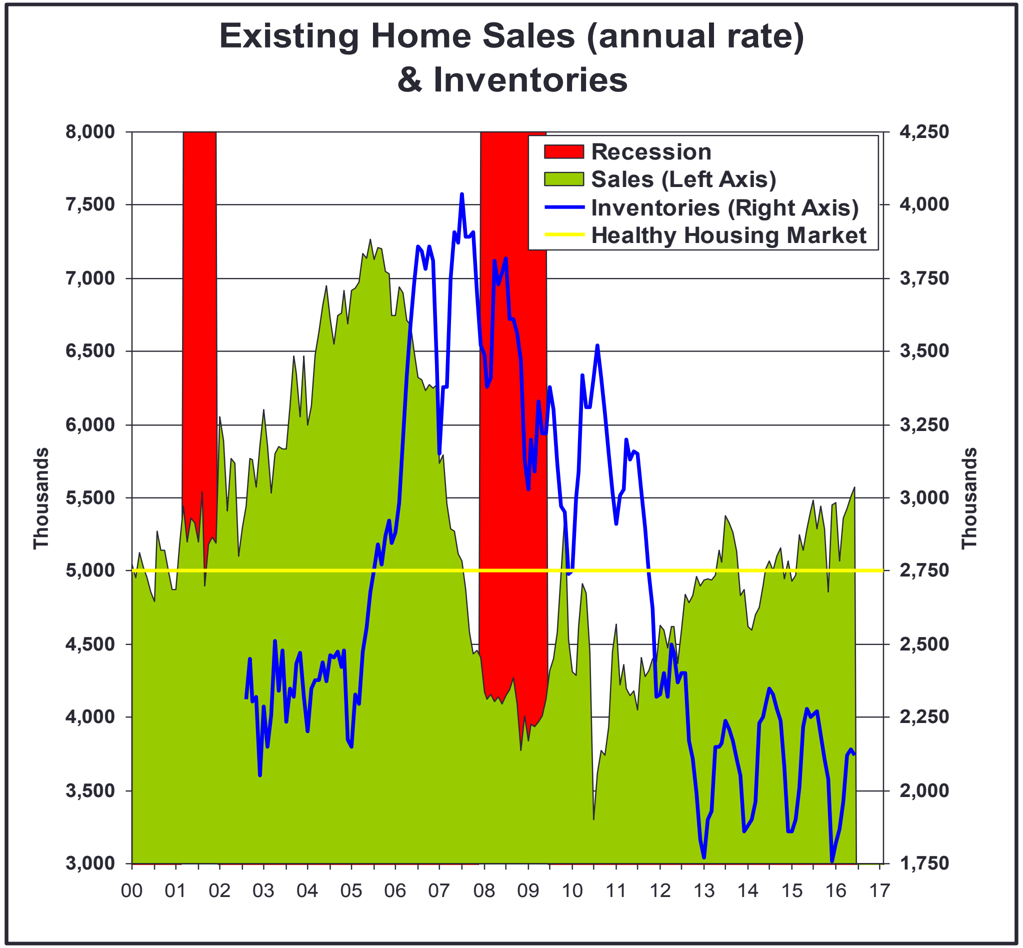
General Interest Rate Trends

1. Strong job growth, accelerating wages, rising inflation and rising commodity prices will cause upward pressure on interest rates.

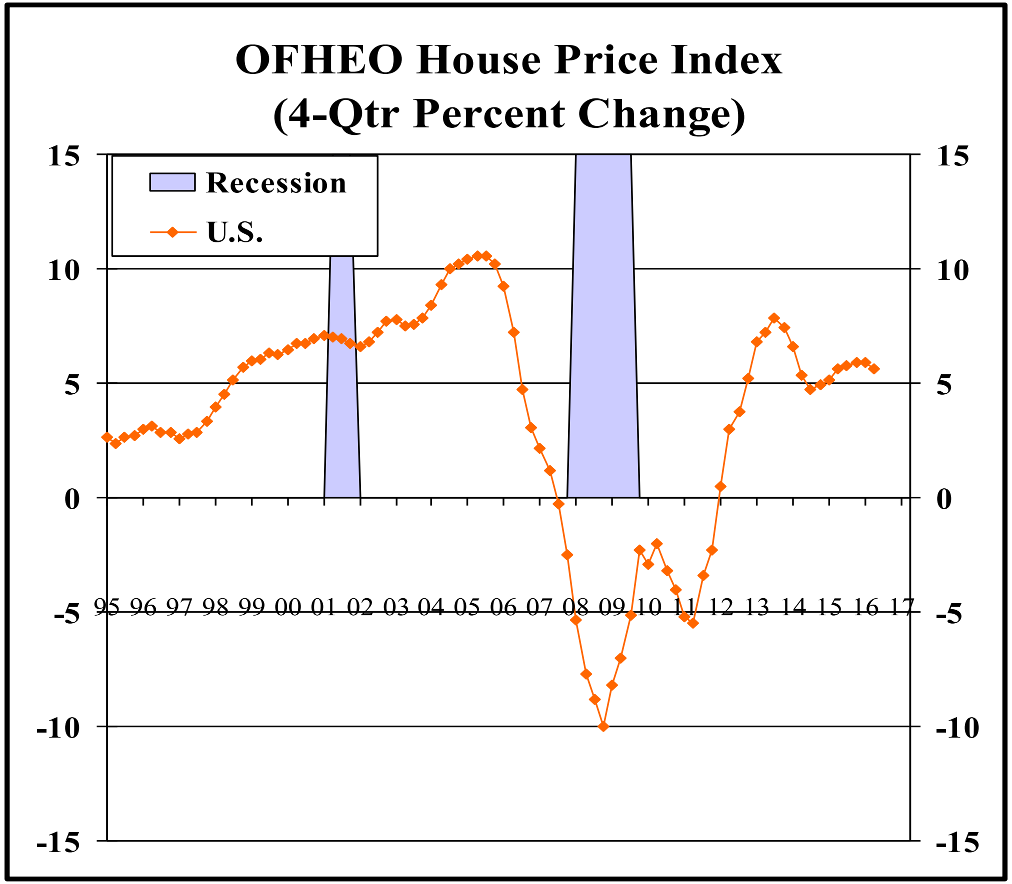
Record Vehicle Sales of 17.75 million in 2017



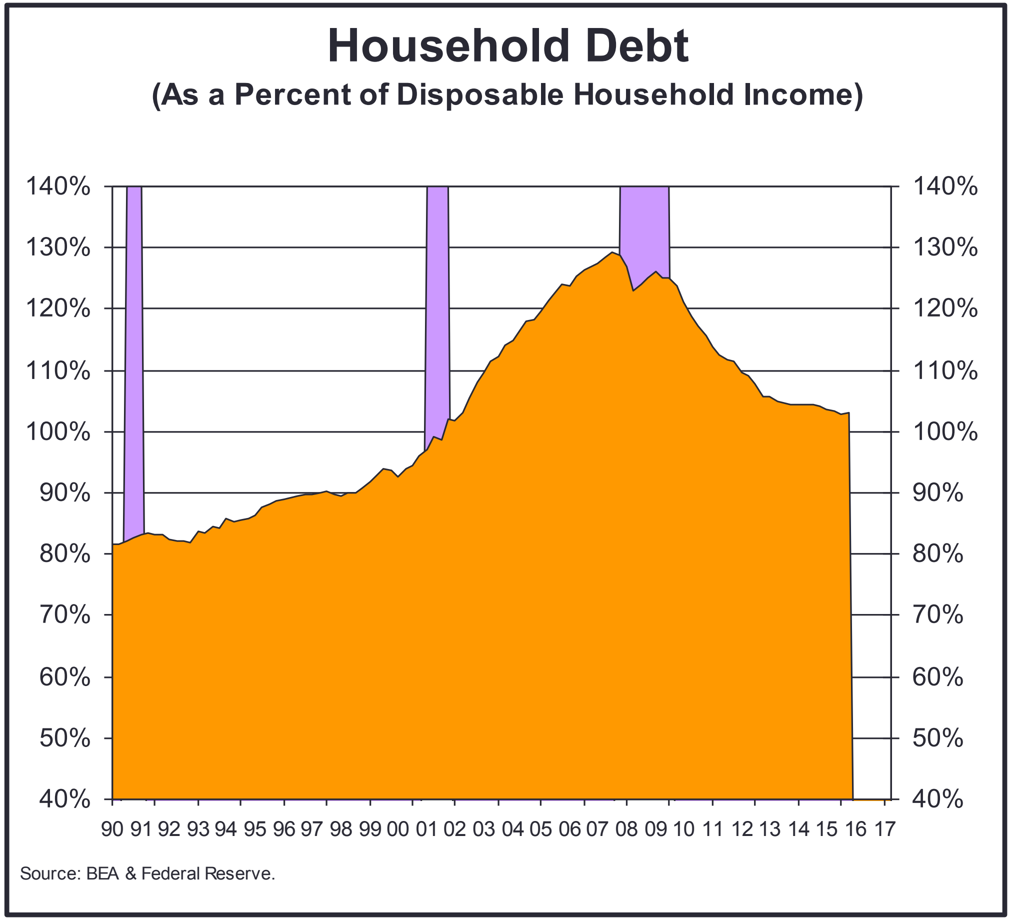
Home Sales will Accelerate to 5.5 million in 2017



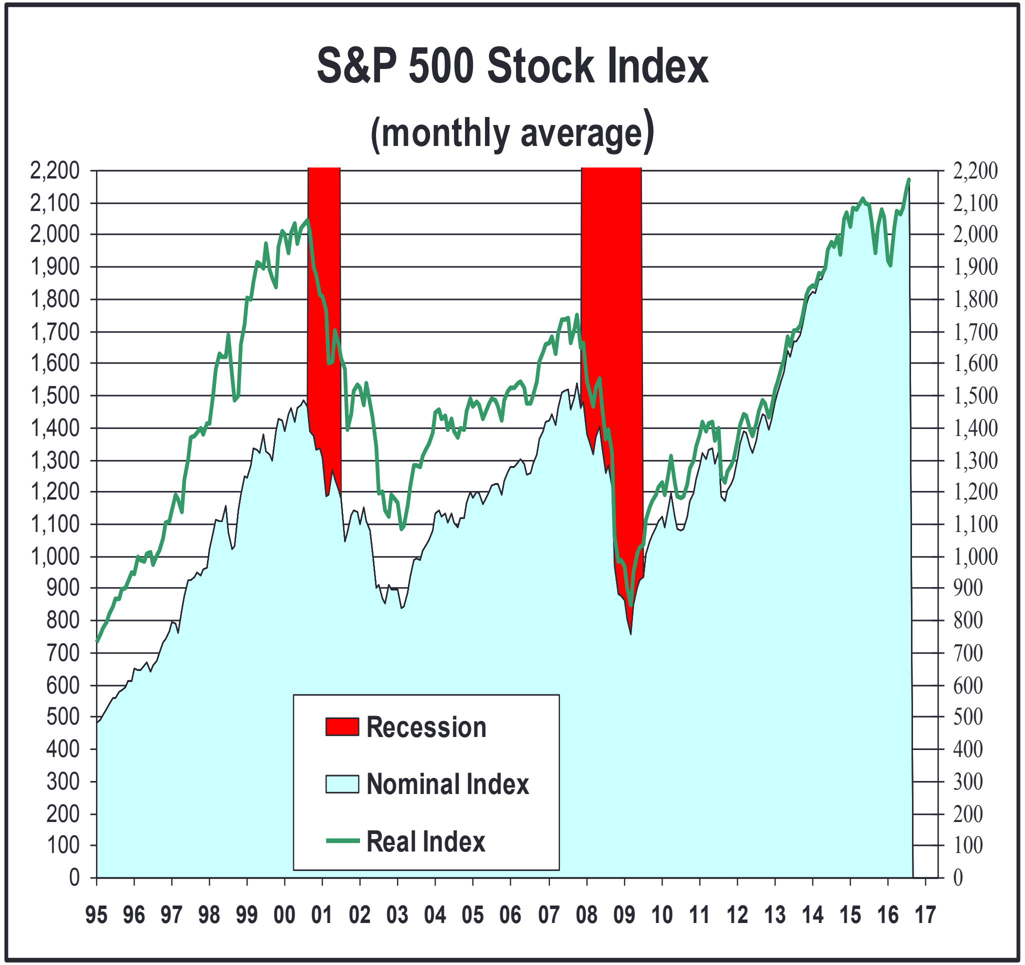
U.S. Home Prices will Rise 5% in 2017



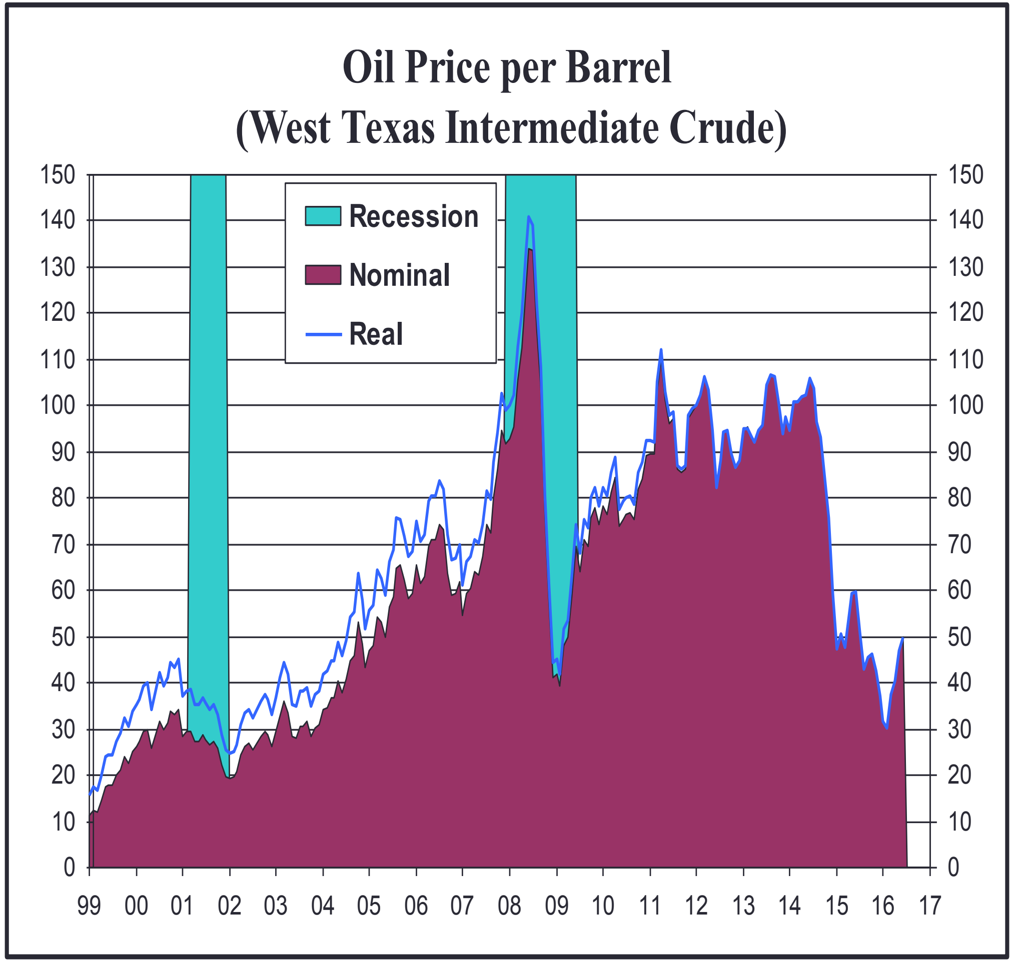
Household Balance Sheets will be Strong in 2017



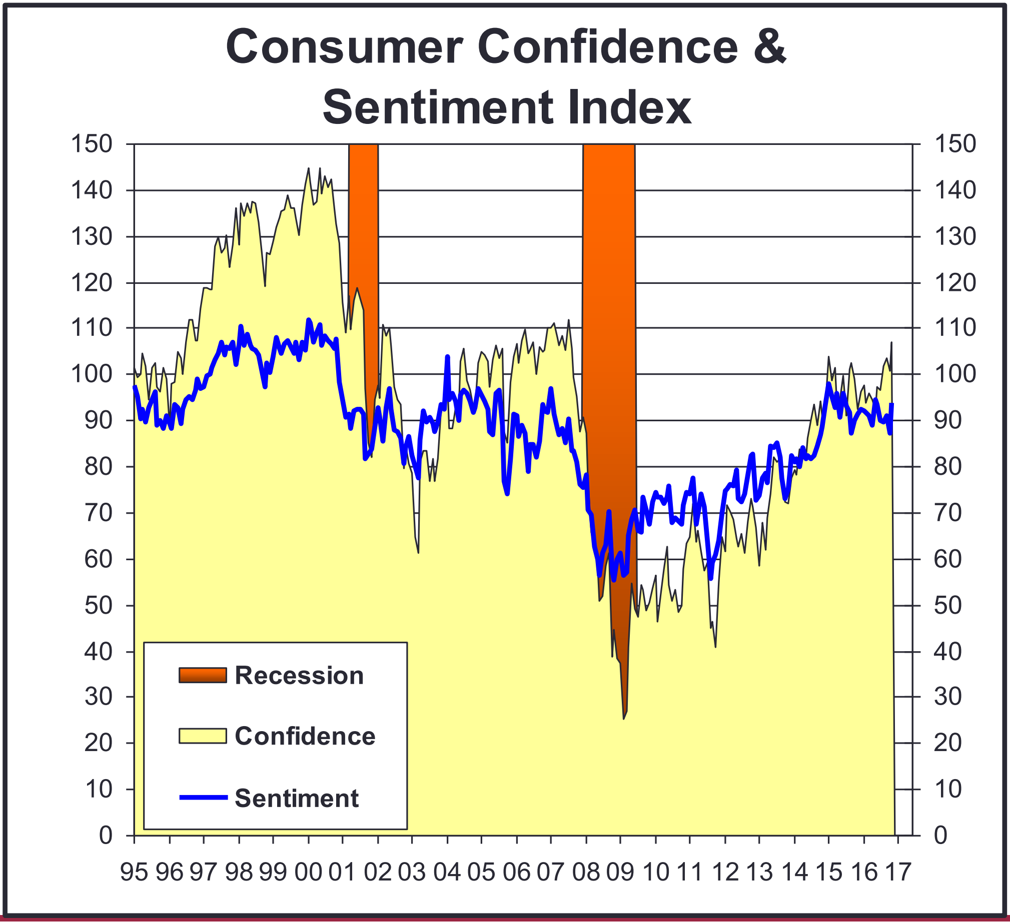
High Stock Prices Producing "Wealth Effect" among High-Income Households



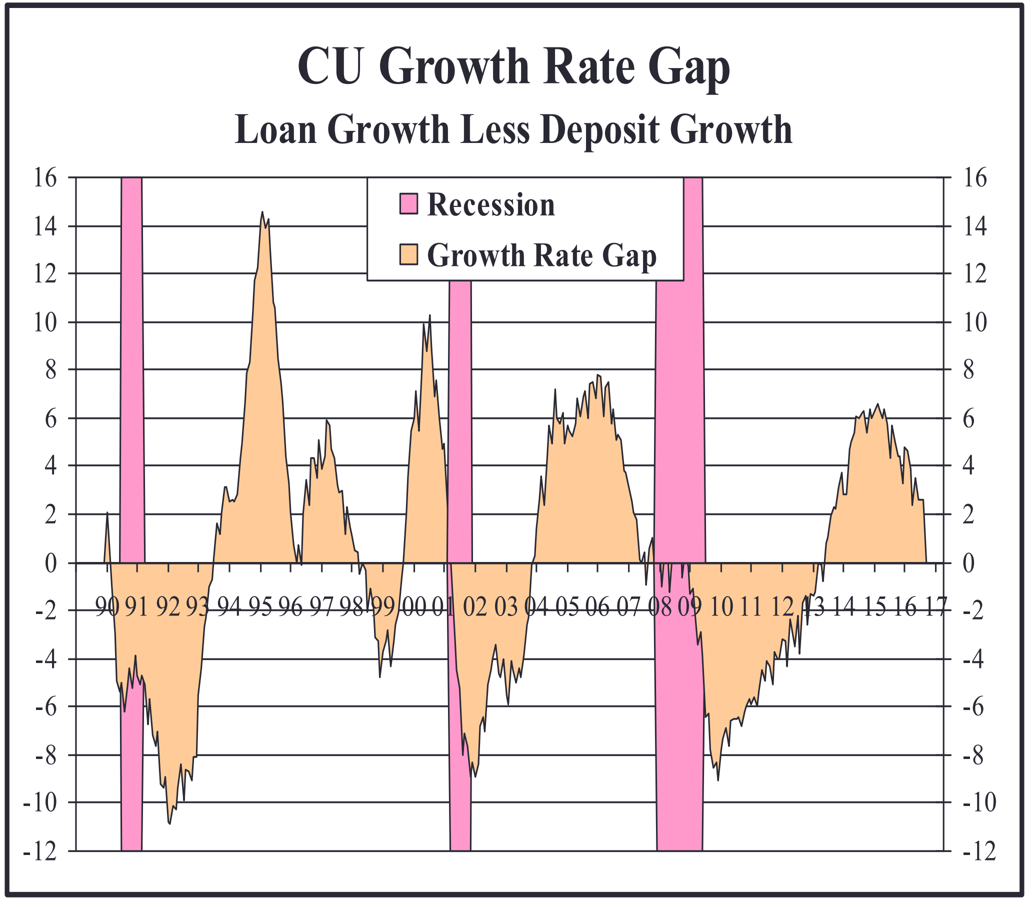
Low Oil Prices in 2017



Consumers' Confidence Will Remain High in 2017



The Short-Term Debt Cycle and Forecasting Recessions



Economic Forecast

September 2016

	Actual Results		Quarterly Results/Forecasts				Annual Forecasts	
	5Yr Avg	2015	2016:1	2016:2	2016:3	2015:4	2016	2017
Growth rates:								
Economic Growth (% chg GDP)*	2.00%	2.40%	0.80%	1.40%	2.50%	2.50%	1.80%	2.40%
Inflation (% chg CPI)*	1.55%	0.67%					2.00%	2.25%
Core Inflation (ex. food & energy)*	1.92%	2.09%					2.25%	2.25%
Unemployment Rate	5.16%	5.00%	5.00%	4.90%	4.80%	4.80%	4.80%	4.60%
Federal Funds Rate	0.17%	0.24%	0.36%	0.38%	0.36%	0.60%	0.60%	1.40%
10-Year Treasury Rate	2.21%	2.24%	1.89%	1.64%	1.60%	1.90%	2.40%	2.50%
10-Year-Fed Funds Spread	2.04%	2.00%	1.53%	1.26%	1.24%	1.30%	1.80%	1.10%

*Percent change, annual rate. All other numbers are end-of-period values.