

IMPLICATIONS OF THE TRUMP VICTORY

- 1) The election of Donald Trump as President and Republicans winning plurality in both the House of Representatives and Senate represent the **electorate's rejection of the Establishment's progressive agenda**. It will mean significant changes in the thrust of domestic and international policies. However, the many checks and balances in Washington, including the important role played by Congress and the various government agencies, will result in far less radical changes than many fear.

Markets often react—and over-react—before they think through the fundamental issues. Looking forward, much of Trump's erratic and offensive campaign rhetoric will be tamed. Some of his outlandish ideas have zero chance of being implemented. Congress will force Trump to greatly modify and rationalize his tax and spending policy promises and will prevent enactment of any legislation that significantly increases budget deficits.

Following the markets' initial negative response, global portfolio managers will refocus on the fundamentals, come to recognize that new policies will not unhinge the economy--and may help it--and recognize investment opportunities. Valuations will rebound.

- 2) Now that Trump is President-elect, his posture will be much more diplomatic. His public speeches will be closely managed. He will be less prone to erratic and off-the-cuff remarks. Every President-elect assumes the role of President and starts to behave Presidential. If this assessment proves wrong and Trump continues to conduct himself in a brash and erratic manner, uncertainties will persist, which will sustain market volatility and **forestall any forward movement in Trump's policy initiatives**.

Trump will have a lot to learn about policies, the policy-formation process and Washington. He enters as a Washington outsider without a deep knowledge of the policies. In contrast, Clinton is an insider and Washington insiders had prepared her entire platform in detail. Trump must create a transition team that adds details on the programmatic changes to the initiatives.

There are 100s of thousands of government officials in Washington that effect and implement laws and steer the policy process. This bureaucracy and the role of the President will force Trump to moderate and transform.

- 3) *The Congress and Congressional leadership will provide important checks and balances on Trump's proposals, particularly in tax and spending policies.* The Republican leadership—in the House led by Paul Ryan, Ways and Means Committee Chair Kevin Brady and Budget Committee Chair Joe Price generally favor pro-growth tax reforms—including many of the **initiatives in Trump's platform**—but they are also fiscal conservatives that will lean hard against proposed legislation that would materially increase budget deficits.

Deficits have receded to 3% of GDP, benefiting from 7+ years of economic expansion, but projections of deficits and government debt soar under current law. The Congressional legislative process on spending and tax

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policies will be deliberate and constrained by budget realities. There will be political squabbles about how the Congressional Budget Office - the official budget scorekeeper - measures the impact of different proposed spending and tax policy changes on budgets. *This process will result in spending and tax changes that are greatly modified from Trump's campaign promises.*

- 4) Spending proposals. *Trump has proposed sizeable increase in spending in areas like infrastructure (this was **actually mentioned in Trump's acceptance speech**), War Veterans (full access to Medicare providers), defense and national security. He proposes significant cost savings in other government programs, but has not been specific. Historically, cost savings have been hard to actually achieve.*

Trump has proposed repealing the Affordable Care Act (ACA), but there is zero probability of Congress approving this without a viable substitute. Congress will seek changes that will improve the efficiency of health care infrastructure coverage and medical costs, but an outright repeal is not in the cards. Several alternative modifications will get close attention. It is likely new legislation will allow interstate competition among health care insurers. This will be attractive to both political parties; for political reasons, the Obama Administration prevented it. Also, Trump has proposed legalizing the importation of select pharmaceuticals from Canada. Democratic candidate Bernie Sanders also proposed this, so it may be accepted as a viable way to generate competition and reduce the costs of pharmaceuticals.

- 5) Tax policy. *Trump has proposed tax reduction for individuals and estates and corporate tax reform. On individual taxes, Trump recommends lower individual income tax rate with fewer brackets and elimination of the Alternative Minimum Tax, elimination of the 3.8 percentage point surtax imposed by the ACA, and a significant reduction in the value of deductions. According to Trump's platform this would involve eliminating loopholes for wealthy tax filers.*

Trump proposes no changes to taxes on dividends, leaving them at 20% and keeping the tax on capital gains at 20%, while lowering capital gains taxes on lower income households.

Trump proposes significant corporate tax reform that would involve a sharply lower rate and a broader tax base, and also a one-time 10% tax on repatriated corporate cash held overseas. However, Trump's platform does not include any of the programmatic details on how deductions, deferrals, exemptions and credits would be changed in order to broaden the corporate tax base. These are critically important details that would be required to transform a campaign platform initiative into viable legislation.

Congress will require that any fiscal proposal involves spending and tax provisions that make sense, add up, and do not have a significant impact on budget deficits and projected debt. Congress would reject any spending increase proposal that is not accompanied by tax increases. Regarding corporate tax reform, Congress will push for a combination of rate cuts and base broadening that are close to, or near, deficit neutrality.

The Congressional Budget Office, the official budget score keeper for Congress, will estimate the budget impacts of the various legislative proposals over a 10 year projection period. Its estimated procedures will have a significant impact on policy deliberations and come under close scrutiny.

*The bottom line is, that while the Republican-controlled House and Senate favor pro-growth tax reform, they are also fiscal conservatives who will push back on legislation that would raise deficit and debt projections. **As a result, Congress' checks and balances will play a critical role in modifying and shaping tax and spending policies.***

- 6) *If President-elect Trump is able to work with Congress and enact a fiscal package that includes more infrastructure spending and corporate tax reform, it would boost economic growth and longer-run potential growth. In light of the Congressional legislative process, the serious budget constraints and normal Washington politics, enactment is likely to be some time in the future and the size of the program might be reduced because of budget concerns. As described in our earlier report on infrastructure, expect any legislation to be wide-ranging and focus more on longer-term projects (with delayed actually spending) aimed at raising productive capacity rather than spending quickly on shovel-ready projects (see [US infrastructure spending – a roadmap for thinking broadly](#), October 24, 2016).*
- 7) In his platform and while campaigning, Trump is favored fewer government regulations, but does not provide and specific details. This would be an extremely important initiative with direct impacts on efficiencies in business production and operating costs as well as the mobility of labor, but several caveats are appropriate: the web of regulations is complex and often in the “fine print” that requires a whole bunch of minor changes to make a material macroeconomic impact, and also, the web of regulations is as onerous on the

State and Local levels as it is on the Federal level. Nevertheless, Presidential appointments to the Department of Labor, Environmental Protection Agency, the International Trade Commission and the like are very important.

- 8) Trump has said that he would like to revamp the Federal Reserve. *Trump may criticize the Fed and Chair Janet Yellen, but Yellen is expected to remain as Chair through the end of her term in February 2018.* While Yellen **may come under pressure, she knows that resigning would be damaging to the Fed's independence and credibility.**

There are currently two vacancies at the Fed's Board of Governors. Trump will nominate 2 new governors who are expected to be open to the idea of more rules-based policy rather than the current discretionary policy approach employed by the Fed. The Senate Budget Committee, led by Chairman Shelby, is likely to proceed **quickly with confirmation hearings (Senator Shelby has postponed nomination hearings of President Obama's 2 nominees until the Fed appoints a Vice Chairman from bank supervision as required by Dodd Frank).** Several current Fed Governors may opt to retire. A primary candidate is Dan Tarullo, who leads the Fed's efforts on bank supervision and the stress-testing of the large banks. This would provide more openings for new Governors.

In recent years, the Fed has come under increasing pressure from both sides of the political aisle in Congress, for different reasons. The new Congress, spurred on by the Trump administration, is likely to hold hearing on initiatives that would enhance and improve Congressional oversight of the Fed. In these hearings, there may be an impetus toward instituting more rules-based policy at the Fed. The Fed rejects such an approach. It will argue strenuously against any change to the Fed's organizational structure and operations. However, this debate would not affect the timing of the Fed's interest rate changes.

Expect the Fed to proceed with its rate hike in December.

- 9) International affairs. *Trump will learn quickly that international affairs are very complex and he will quickly **come to rely on the various government agencies and experts that understand and influence the US' approaches on international affairs.*** This will serve to soften some of his brash statements during the campaign.

No changes are **expected to the US's relationships with either the European Union or the United Kingdom.** The Trump Administration is expected to express the importance of maintaining strong relations and trade with both the EU and the UK, but no new trade agreements are expected.

Other campaign statements will fade, with no material follow through or implementation. No dramatic change is expected on the US role in NATO. No wall will be built between Mexico and the US.

The Trump Administration is expected to pursue a tougher stance on diplomatic and trade relations with Russia than has been pursued by the Obama Administration.

Trump's approach to China is uncertain, however, and potentially troubling. He has said that he would identify China as a "currency manipulator." Although this makes little sense in the current situation, it could add a lot of uncertainty. Trump has also proposed high tariffs on imports from China. Congress would block this initiative; the Senate Finance Committee and the House Ways and Means Committee have jurisdiction over tariffs and quotas. More likely, the Trump Administration could influence US trade with China – and erect some barriers – through changes in the fine print on agreements.

China and Mexico are two of the US's largest trading partners. Neither wants to enter a trade war with the US, and neither can afford to do so. The US relies heavily on imports from those partners. Current concerns about major trade barriers being erected are over stated and not realistic.

- 10) The quick market reaction in stocks and the fall in the US dollar will be reversed as the market comes to acknowledge that the checks and balances in Congress and government offices will smooth out (most of) **Trump's rough edges.** Current fears of crazy, destabilizing legislation and international initiatives are overblown. Eventually, policies may emerge that lift economic growth. The Fed will proceed to raise rates very gradually toward their new normal level and bond yields will rise but only modestly relative to historic levels. There is a history of market over-reactions to regime shifts and subsequent reversals. The biggest lasting changes in response to Trump's victory will be in Washington, not in financial markets.

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