Economics

Macro news

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CAPITAL MARKETS

US: HIGH CONFIDENCE LIFTS ECONOMY AND OUTLOOK

- Post-election confidence surveys have remained strong in early 2017, supporting expectations of accelerating economic growth
- The better sentiment seems to be feeding into the economy – strong December durable goods report and robust job gains in January
- Small businesses have become very optimistic and are starting to put their renewed energies to work, accelerating hiring in January
- Surveys also show that businesses expect product pricing to rise, suggesting heightened pricing power – and some combination of higher margins and inflation pressures
- There are a lot of moving parts in the fiscal reform proposals, but expect the tax reform package to be introduced in Spring, debated and modified and enacted by late summer

Sentiment

Sentiment indicators across a broad range of sectors – manufacturing, non-manufacturing, homebuilding, private consumption, financial – have risen since the November election and their latest readings remain elevated (see "US sentiment surges post-election", January 9, 2017 and Chart 1).

Chart 1: Change in Sentiment Measures Since October

(%)	Oct-16	Nov-16	Dec-16	Jan-17	Chg since Oct
Texas mfg	49.8	50.4	51.8	53.8	4.0
Empire State mfg	47.1	47.3	48.5	50.9	3.8
Philly Fed mfg	50.1	54.3	53.6	55.5	5.4
Richmond Fed mfg	-4	4	8	12	16
Kansas City Fed mfg	51.1	48.1	50.7	54.3	3.2
ISM mfg	52	53.5	54.5	56	4.0
ISM non-mfg	54.6	56.2	56.6	56.5	1.9
NFIB Small Business Optimisim	94.9	98.4	105.8	--	10.9
Home Builders housing market index	63	63	69	67	4.0
U Mich consumer	87.2	93.8	98.2	98.5	11.3
Conference Board consumer	100.8	109.4	113.3	111.8	11.0

Source: Institute for Supply Management, Federal Reserve Banks of Philadelphia, New York, Kansas City, Richmond and Dallas, National Federation of Independent Business, National Association of Home Builders, University of Michigan, The Conference Board and Berenberg Capital Markets

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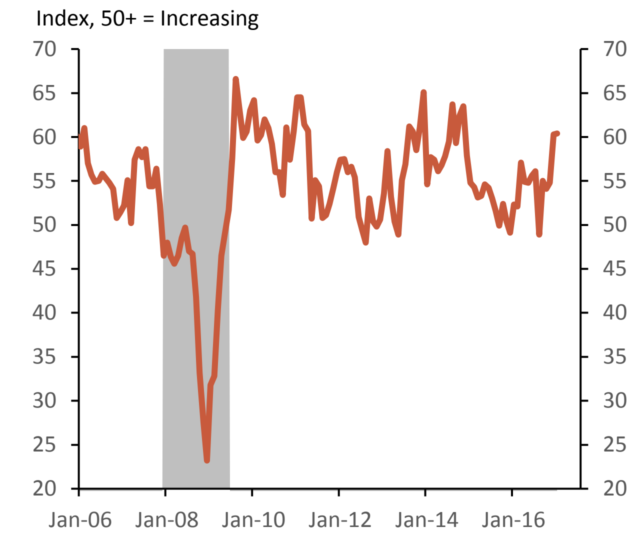
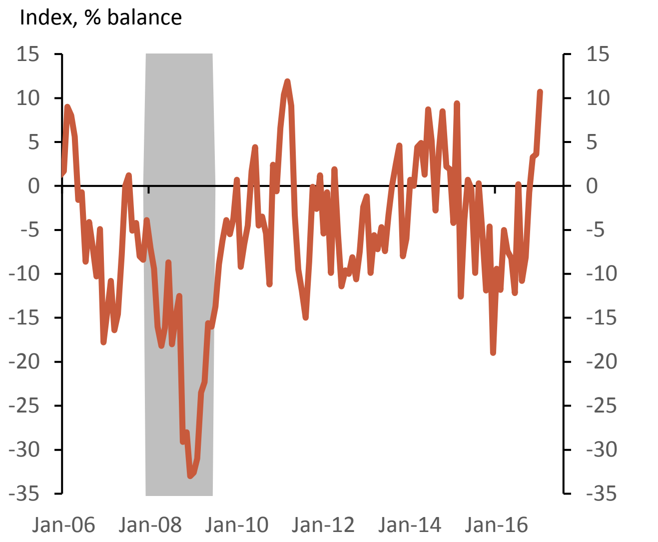
Chart 2: ISM Manufacturing New Orders Index



Source: Monthly Data. Source: Institute for Supply Management and Berenberg Capital Markets

Chart 3: Philly Fed Manufacturing Unfilled Orders Index

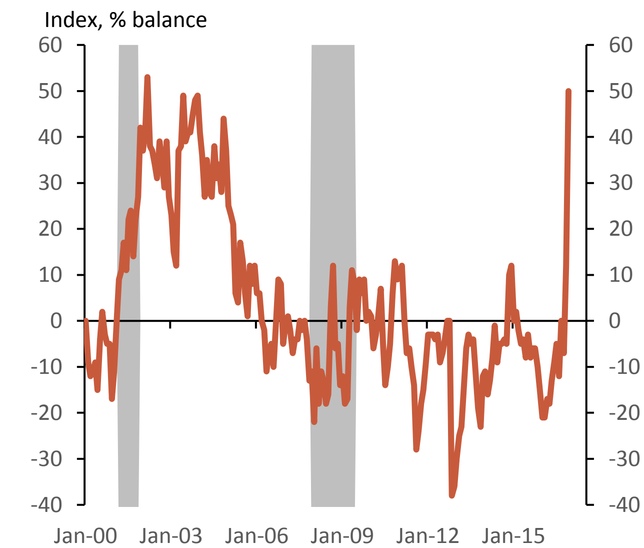


Source: Monthly Data. Source: Federal Reserve Bank of Philadelphia and Berenberg Capital Markets

Key planned measures of capital spending plans have remained high, and measures of current orders and unfilled/backlog orders have jumped (see Charts 2 and 3). These suggest that businesses will have to boost their activity in coming months in order to meet the robust demand.

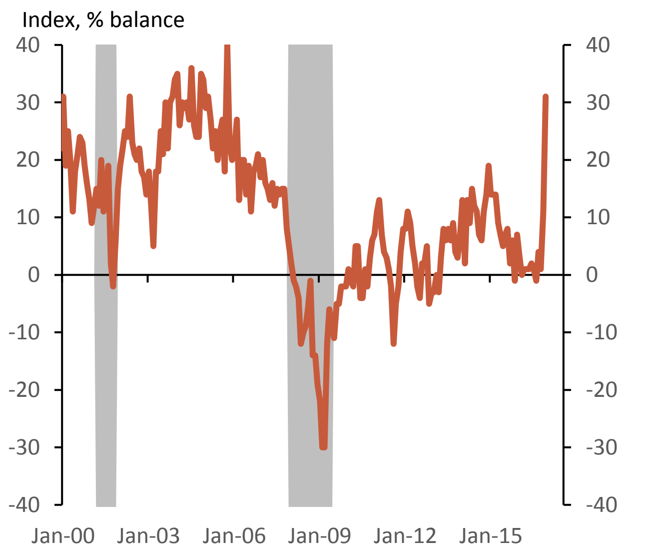
The National Federation of Independent Business's (NFIB's) December report on small business economic trends show that small firms, which are so vital to broader US economic activity and jobs, are optimistic about the impact of fiscal reforms and have boosted their plans. In December, the net share of small firms expecting the economy to improve jumped to 50% - the fifth highest reading of this metric since the series started in 1973 (see Chart 4). There were also big increases in the net share of firms expecting higher real sales and those believing now is a good time to expand (see Chart 5).

Chart 4: NFIB: Net Percent of Firms Expecting Economy to Improve



Source: Monthly Data. Source: National Federation of Independent Business and Berenberg Capital Markets

Chart 5: Net Percent of Firms Expecting Higher Real Sales in Six Months



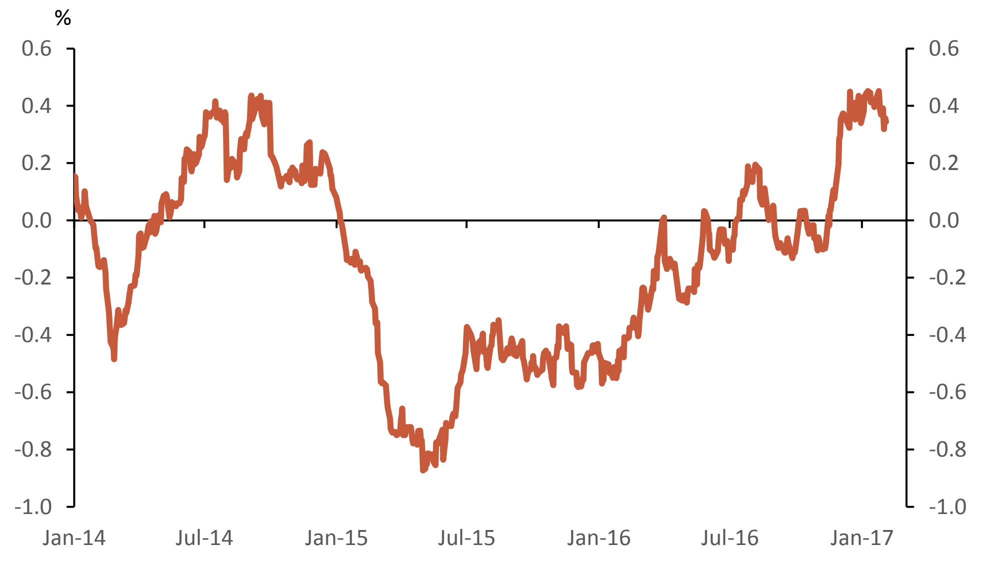
Source: Monthly Data. Source: National Federation of Independent and Business and Berenberg Capital Markets

Confidence is very important to the economy and particularly the expected successes of current tax and economic reform initiatives, and the recent surveys are very positive. The combination of lower taxes on income from capital and deregulation aim to boost confidence and encourage business investment, hiring and expansion. One clear risk to the current economic and policy environment is a reversal in the recent gains in confidence; two possible sources of that reversal may be if Congress or the Trump Administration gets sidetracked in their fiscal reform deliberations or if business and household concerns about the Trump Administration's immigration, trade and diplomatic initiatives start to overwhelm their enthusiasm about the fiscal and regulatory initiatives. Accordingly, the survey results in coming months deserve close scrutiny.

Economic Momentum

Early indications suggest that the improved sentiment has started to feed into the economy. Year-end 2016 economic data were solid, setting a favorable starting point for 2017. The Bloomberg economic surprise index has been very elevated (see Chart 6). *Real private consumption gained momentum during year-end 2016, shipments of core capital goods picked up in both November and December, and unfilled orders for core capital goods are on an upward trend*. Private consumption will continue to be the main driver of economic growth in Q1, but the industrial sector's leading indicators point to a pickup in capital spending.

Chart 6: Bloomberg US Economic Surprise Index



Source: Daily data. Source: Bloomberg and Berenberg Capital Markets

The improved sentiment contributed to the acceleration in hiring in the January Employment Report. The goods sector is adding jobs again and the financial services sector seems to be experiencing a renaissance in hiring, adding 55,000 job in the last two months.

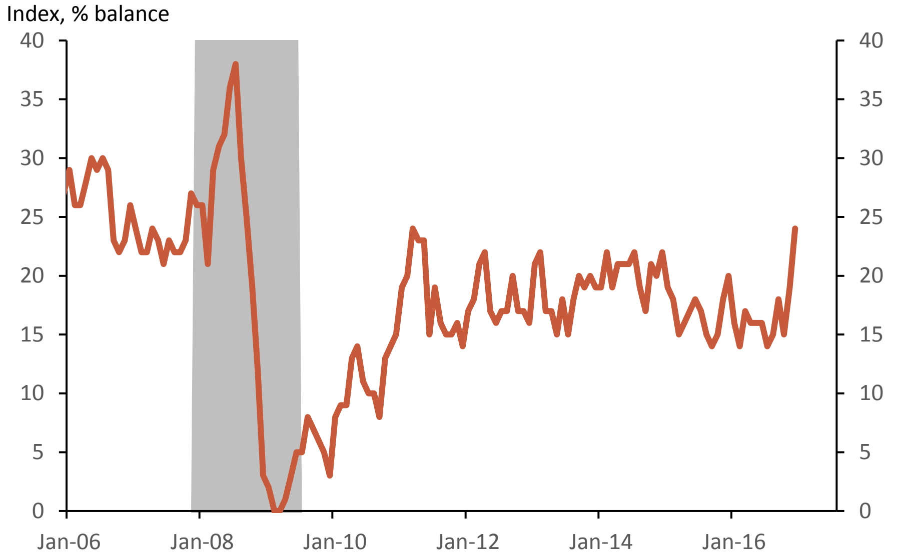
The ADP private employment report detail revealed that employment gains have jumped in small businesses; their hiring in January rose at the fastest pace in six months.

Expectations

While the current optimism is beginning to support a pickup in economic activity and clearly suggests that the responses to economic reforms will likely be very positive, they also raise the bar high for the expectations that must be met. If the new Administration and Congress fail to enact a decent proportion of their proposals, or fail to do so in a timely manner, and if there are any policy missteps, confidence would fall and economic activity--particularly business investment--would suffer.

The significant rise in US stocks, bond yields and the US dollar have priced in a pickup in growth and profits. *We expect further upside surprises for markets: our forecast of 3% economic growth in 2018--a year in which economic momentum will build following enactment of policies in the second half of 2017-- remains significantly above the* ***Bloomberg consensus and the Federal Reserve's economic forecast*** (*US: stronger growth, higher rates, more uncertainty*, November 30, 2016 and *Critical current issues facing the US in 2017*, January 4, 2017). If the anticipated fiscal reforms generate an acceleration in economic growth, businesses will have greater pricing power. Indeed, the NFIB December report showed an increase in the net share of small businesses planning to raise average selling prices to its highest level in this economic recovery (see Chart 7).

Chart 7: NFIB: Net Percent of Firms Planning to Raise Average Selling Prices



Source: Monthly data. Source: National Federation of Independent Business and Berenberg Capital Markets

Policy Update and Timeline

The critical point is that with all of the attention ***being drawn to President Trump's initiatives, blunders and missteps*** *on immigration, trade and diplomacy, Congress continues to pursue its goals of achieving tax and fiscal policy reforms*. Key tax and budget committees in Congress are working with Trump's economic advisors on the basic framework of the tax proposals even as other committees are working on proposals for modifying the Affordable Care Act.

Continue to expect that corporate tax reform will be enacted--the hunch is in late summer. Typical of the success new Presidents (both Democrats and Republicans) have in getting fiscal policy changes enacted early in their administrations, expect that the House of Representatives will quickly approve the reform legislation while the Senate will take several months to deliberate and modify.

History also suggests that modifications to the proposals should be expected. That is likely to hold true of the House Republican blueprint for tax reform. That blueprint is the basis for the current internal policy deliberations - expect more details about tax reform to emerge as spring unfolds.

Meanwhile, the initiatives toward deregulation in both the non-financial and financial industries, many initiated by the Trump Administration, will continue to proceed.

Typical of a lot of new Presidential regimes, there are a lot of policy initiatives flying around. ***At this point, it's important*** *to prioritize them in terms of their potential impact on the macroeconomic and financial landscape*. In this regard, importantly, the tax and fiscal reform initiatives are continuing to move forward.

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