The Changing of the Guard

Examining the effects of a rapidly changing landscape

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THEMES

Animal Spirits
• Optimism in the Face of Uncertainty

Fuzzy Math
• Policy Ambition vs. Budget Discipline

The Trials and Tribulations of Trade
• Does “America First” Mean Closing Borders?

Voice of Reason
• Central Banks and Economic Stability
Keeping Calm And Carrying On
LOOKING UP

- Business and consumer confidence have soared since the election
- Sentiment does not always presage economic trends

**Overview - Small Business Optimism**

**Optimism Index**
Based on Ten Survey Indicators
(Seasonally Adjusted 1986=100)

**Consumer Confidence**

Sources: NFIB, Conference Board
GAINING MOMENTUM

- **Leading indicators are heading up**
- **Incoming data is surprising on the up-side**

![Manufacturing PMIs](Source: Bloomberg)

![Global Economic Surprise Index](Source: Citigroup, Morgan Stanley Research)
• **Despite dire predictions, equities have moved ahead to record levels!**

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**UK: Stock Price Index**

- Brexit

**US: S&P 500**

- Elections

Source: Bloomberg
POST-ELECTION FORECAST REVISIONS
WALL STREET JOURNAL SURVEY

• Few are expecting a significant lift from fiscal policy
• The feedback loops could be significant

Real GDP Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth</th>
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</thead>
<tbody>
<tr>
<td>2017</td>
<td>-0.02%</td>
</tr>
<tr>
<td>2018</td>
<td>0.25%</td>
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</table>

Inflation

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>0.03%</td>
</tr>
<tr>
<td>2018</td>
<td>0.15%</td>
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</tbody>
</table>
Fuzzy Math
• Health care costs are rising more rapidly
• Sustaining cost discipline is critical

U.S. Health Care Inflation

Higher Cost Growth
Baseline
Lower Cost Growth

U.S. Federal Debt in 2045 Given Alternative Paths of Medicare Costs

As a Percent of GDP

Sources: Haver Analytics, Congressional Budget Office
SUSTAINING POPULATION

- Promoting fertility rarely works
- Accepting new entrants successfully is key

Fertility Rates Per Woman, 2015

- Germany: 1.4
- U.K.: 1.9
- Japan: 1.5
- U.S.: 1.9
- Canada: 1.6

Immigrant Population, 2013

- China
- Japan
- U.K.
- Germany
- U.S.
- Ireland
- Canada

Sources: CIA, United Nations
REVENUE REFORMS

• Corporate tax rates push activity away
• Individual reform may be too complicated to complete

Corporate Tax Rates

<table>
<thead>
<tr>
<th></th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worldwide</td>
<td>29.8%</td>
</tr>
<tr>
<td>OECD average</td>
<td>25.0%</td>
</tr>
<tr>
<td>U.S</td>
<td>35.0%</td>
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</tbody>
</table>

Source: Haver Analytics

HOUSE GOP SIMPLIFIED TAX REFORM PROPOSAL

<table>
<thead>
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<th>Step</th>
<th>Description</th>
<th>Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wage and compensation income</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Add 1/2 of investment income</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>Subtract contributions to specified savings plans</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Subtract standard deduction OR</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td>Subtract mortgage interest deduction</td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>Subtract charitable contribution deduction</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Taxable income</td>
<td>7</td>
</tr>
<tr>
<td>8</td>
<td>Preliminary tax (from tax table)</td>
<td>8</td>
</tr>
<tr>
<td>9</td>
<td>Subtract child credit</td>
<td>9</td>
</tr>
<tr>
<td>10</td>
<td>Subtract earned income credit</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Subtract higher education credit</td>
<td>11</td>
</tr>
<tr>
<td>12</td>
<td>Total tax</td>
<td>12</td>
</tr>
<tr>
<td>13</td>
<td>Subtract taxes withheld</td>
<td>13</td>
</tr>
<tr>
<td>14</td>
<td>Refund due / taxes owed</td>
<td>14</td>
</tr>
</tbody>
</table>
Boundary Conditions
• Free trade and open markets bring important benefits
• More adjustment assistance for those who are displaced?

Sources: International Monetary Fund, United Nations
IS FREE TRADE FAIR TRADE?

- A renewed desire to level the playing field
- Each side has important leverage

![Graph showing U.S. Merchandise Trade Position with China and Total U.S. Manufacturing Employment]

Source: Haver Analytics
NORTH AMERICAN NEIGHBORS

• Continental trade is immense
• NAFTA has accelerated merchandise flows

America’s Total Trade with Major Partners

U.S. Trade History

Source: US Census Bureau, Haver Analytics
• **Important risk of financial and political stability in Mexico**
• **No one wants a re-run of 1994**

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**Mexican Currency & Yields**

- 10-year Bond Yield (Left)
- USDMXN (Right)

**Mexican External Debt Profile**

- External Debt/GDP
- External Debt Service/Exports

**Sources:** Haver Analytics, World Bank
EU DECISION DATES

• The rise of populism is closely correlated with the flow of immigration

Upcoming Milestones

• Brexit negotiations begin: March 2017
• Dutch parliament: March 2017
• French Presidential contest: April/May 2017
• German parliament: September 2017
• Italian elections: ?
The Last Line of Defense?
ISSUES FOR THE FED

Renewed risk of inflation
• A marked change from last summer

Macroprudential risks
• Low rates may be feeding rising asset valuations

Political activism
• Can the Fed retain its independence?
TWO LABOR MARKETS

• Education gaps explain differences in outcomes
• Monetary policy may not be the best tool to address this

Sources: BLS, Haver Analytics
INFLATION AND INFLATION EXPECTATIONS

- **Price levels are advancing across markets**
- **Inflation expectations are also higher**

**Consumer Price Trends**
- US
- UK
- EZ
- Crude (Right)

**Inflation Compensation**
- U.S.
- U.K.
- Germany

*Source: Bloomberg*
FROTHY?

- Markets have done very well... too well?
- Are the makings of market instability accumulating?

Source: Bloomberg
**PRICED FOR PERFECTION**

- **Equity valuations may be assuming policies that won’t come to fruition**
- **Market volatility is at a historical low**

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**Source: Bloomberg**

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**Equity Market Valuations**

**VIX Volatility Index**
• Does the administration prefer low rates or high rates?
• Market expectations for the Fed have moved higher

Sources: Federal Reserve Bank of Atlanta, Bloomberg
CHANGING OF THE BOARD

Janet Yellen, 70
Chair: January 2018
Governor: January 2024

Stanley Fischer, 73
Vice Chair: June 2018
Governor: January 2020

Jerome Powell, 64
January 2028

Lael Brainard, 55
January 2026

Daniel Tarullo, 64
Departing April 2017

Two Seats Open
President Trump says he plans to roll back Dodd-Frank financial regulations because so many friends of his in business can't borrow money.
SHOTS ACROSS THE BOW

January 31, 2017

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chair Yellen:

I am writing regarding the Federal Reserve’s continued participation in international forums on financial regulation. Despite the clear message delivered by President Donald Trump in prioritizing America’s interest in international negotiations, it appears that the Federal Reserve continues negotiating international regulatory standards for financial institutions among global bureaucrats in foreign lands without transparency, accountability, or the authority to do so.

This is unacceptable.

Continued participation in international forums such as the Financial Stability Board, the Basel Committee on Banking and Supervision, and the International Association of Insurance Supervisors is predicated on achieving the objectives set by the new Administration. That will likely require a comprehensive review of past agreements that unfairly penalized the American financial system in areas as varied as bank capital, insurance, derivatives, systemic risk, and asset management.

It is incumbent upon all regulators to support the U.S. economy, and scrutinize international agreements that are killing American jobs. Accordingly, the Federal Reserve must cease all attempts to negotiate binding standards burdening American business until President Trump has had an opportunity to nominate and appoint officials that prioritize America’s best interests.

Sincerely,

Patrick McHenry
Vice Chairman
Financial Services Committee
**The economy hasn’t been starved for credit**

**New bank formation hindered by more than new rules**

**Lending Growth**
- Total Loans
- C&I Loans

**Industry Entry and Exit**
- New Charters
- Reductions

Sources: Haver Analytics, FDIC
NOT RULES, BUT PRINCIPALS

Janet Yellen, FRB
January 2018

Mary Jo White, SEC
Stepped Down

Thomas Curry, OCC
April 2017

Timothy Massad, CFTC
Stepped Down

Martin Gruenberg, FDIC
November 2017

Richard Cordray, CFPB
July 2018...or sooner?
TWEETS I DON’T WANT TO SEE

Donald J. Trump @realDonaldTrump
The Fed’s interest rate increases reward investors and foreign banks, but HURTS ORDINARY AMERICANS! #ByebyeYellen

Donald J. Trump @realDonaldTrump
The Fed’s regulation is KILLING small banks and small businesses. Wait until you see who I appoint to fix that! #RandPaul

Donald J. Trump @realDonaldTrump
The markets are a HUGE reflection of all the great things we’re going to be doing. What is the Fed doing RUINING things? #Savethepunchbowl
PARTING THOUGHTS

We need to recall why international commerce is so beneficial

• Nationalism is damaging to global markets

We’ll need to get used to a new leadership style

• Policy formulation and communication are being done very differently

Checks and balances remain important

• Congress, the Fed, and the courts may be called upon to be more active
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