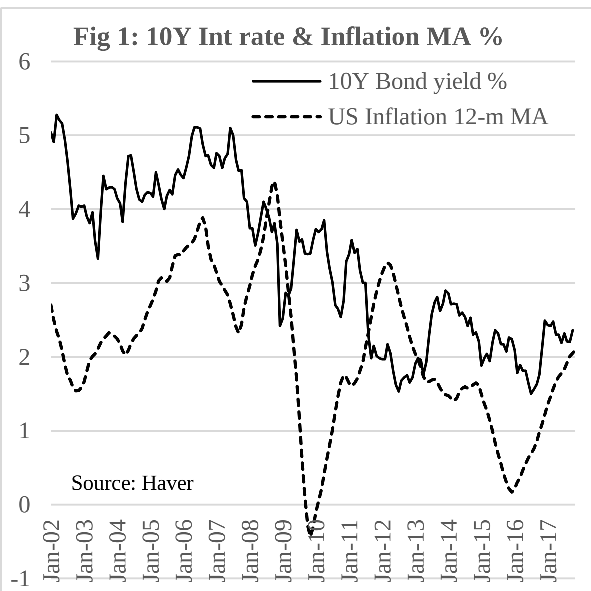
Could the US economy endanger Trump's presidency?

Dr Mushtaq Khan[1], February 8, 2018

Just as the bull-run in the Dow Jones should not be viewed as a reflection of the underlying strength of the US economy, the correction on February 2nd, is not an indication of weakness. Stock markets are inherently fickle, and the New York Stock Exchange is no exception. However, there are latent economic and political forces at play, which create an uncertain picture of what could happen in 2018.

The largest one-day loss of the Dow Jones Index on February 5th, was triggered by a report from the Bureau of Labor Statistics, which showed the strongest upward wage pressure since the Great Recession of 2008/09. Job creation in January 2018 was higher than market expectations, and unemployment remained very low at 4.1 percent. This good news was overshadowed by fears that wage pressures indicate that the US economy was beginning to overheat. Attention immediately focused on US interest rates, where 10-year yields have reached levels not seen since 2014.

Analysts realize that wage inflation is a leading indicator of demand pressures, as it reveals the country is near full employment, and workers have greater bargaining power. With US inflation trending up since Q4-2015 (see **Figure 1**), the market now expects more urgent tightening of US interest rates, as inflation and interest rates are two sides of the same coin – when inflation rises, interest rates follow.



This makes sense, as consumer demand drives US GDP growth, and a large component of this demand is sensitive to interest rates. However, even if the Fed were to increase interest rates to combat rising inflation, it may not work.

The orthodox policy response to reduce aggregate demand, is tightening monetary and fiscal policies. Increasing interest rates against a backdrop of an expansionary fiscal policy, could confuse the market and undermine the net impact on demand pressures. This is where the mix between politics and economics gets messy – sound economic management requires consistent fiscal and monetary policies, but President's Trump's $ 1.5 trillion tax cut (his first legislative victory since taking office) and his infrastructure plan (also estimated at $ 1.5 trillion), represent an aggressive fiscal policy. For monetary policy to overcome this loose fiscal policy, the Fed would require much sharper tightening. In our view, this degree of tightening would be resisted by the White House, which means the Fed could be targeted by Trump.

The issues is: under these circumstances, will the Fed be able to do the right thing?

[1] The author would like to acknowledge the many thoughtful discussions with Danish Hyder in preparing this paper.

It gets more complicated

US government paper is the safest financial instrument in the world, and American companies and foreign entities are keen investors. If US interest rates lag behind the rise in inflation, two things could happen: (1) market appetite for US paper will fall, which means the Fed will have to print dollars to meet the government's shortfall; and (2) investor interest would focus only on short-term US T-bills, as they would not want to lock in their funds in low yielding T-Bonds.

The first point may not necessarily increase the federal debt *per se*, but it would reverse the Fed's commitment to dial back central bank financing, which lay at the heart of the *quantitative easing* that allowed for a decade of cheap money. The second point is more alarming: as the maturity of US federal debt falls, roll-over risk increases (which could lead to more central bank financing in the future) and US debt servicing could become more unpredictable – the debt burden may balloon if interest rates are raised in the future (which is likely).

If that is not enough, the US government operates under strict fiscal rules, exemplified by the legislated debt ceiling. The mechanics are complicated, but the debt ceiling is formulated by the US Senate and House of Representatives. Failure to find common ground when facing a possible breach of the ceiling, can force the government to undertake *extraordinary measures*, like shutting down some branches of the federal government to reduce low-priority expenses.[2]

With starkly different policy agendas, the partisan disconnect in the US government (the House and Senate) will make management of the debt ceiling, Trump's expansionist fiscal policies, and the necessary Fed tightening, an impossible trinity.

Then there is the global stage. With growing skepticism about Trump's presidency, the end of petrodollar surpluses in the Middle East, and China's investment in its ambitious *One-Belt, One-Road* initiative, the world's ability (or appetite) to fund growing US deficits is much lower than it used to be. Again, if external appetite for US paper is weak, the Fed would have no choice but to print dollars.

Healthy tension

In a balanced economy, there should be a degree of healthy tension between the central bank and the Ministry of Finance (in the US, between the Fed and the US Treasury). The government (operating through the US Treasury) functions under political directives, favoring stronger economic growth and high employment, while the Fed has to temper such policies to ensure that a short-term growth strategy does not unleash inflationary pressures. In a balanced economy, key stakeholders insist that the central bank is not politicized – i.e., the central bank is not singled out for political score-settling.

In Trump's presidency, however, anything is possible. More specifically, Trump's economic policies are expansionary, with little regard for the resulting debt build-up. With a larger fiscal deficit that needs to be financed at higher interest rates, accelerating debt dynamics will surely complicate the bipartisan setting of the debt ceiling.[3] One must be clear that while an agreement of the debt ceiling would be good news for the market, this is only a temporary reprieve. This issue will keep recurring until both sides can find middle ground in their ideologically opposed vision of how the US economy should operate.

[2] Debt servicing is the largest single expense for the federal government, and interrupting such payments would mean US sovereign default. This would decimate the global financial system.
[3] While a compromise will eventually be made, it is the hard negotiations that could further unhinge the US markets.

President Trump's decision not to extend Janet Yellen's term as Chair of the Fed, has not been criticized much. Although Powell is a Trump appointee, unlike the Treasury Secretary Mnuchin, Powell enjoys bipartisan support for his competence. But this does not mean Powell will be free of political pressure from the White House.

What could happen?

Focusing on the US stock market, one of two possibilities could play out: one, the Dow Jones Index overcomes the hiccup and bullish sentiments return to propel the stock market to record levels; and two, there is a proper market correction and valuations align themselves with underlying fundamentals. Surprisingly, in these two scenarios, the end result could be about the same.

In the first scenario, leveraged investment funds and the wealth effect from the tax cut, continue to push up asset values. However, this means the wage pressures that had surfaced earlier remain in play, which means the market would again get edgy with expectations that the Fed will have to tighten more seriously. This sentiment could become self-fulfilling as banks reluctantly participate in the Fed auctions, which means the maturity of US debt would fall, and the Fed would have to step in to finance the federal government. When the Fed does raise interest rates, President Trump would have a lot to say, blaming the central bank for the troubles in the US economy.

In the second scenario where the stock market correction is more sustained, President Trump will need someone to blame. Sensing an opportunity to score some political points, Trump is likely to blame the Democrats for souring market sentiments, and publically call on them to rectify the damage (they have done) by increasing the debt ceiling and by approving his infrastructure spending plan. In our view, with a market downturn, the White House may decide that a further fiscal boost (infrastructure) is required to change market sentiments.

Assuming Trump is able to get what he wants (i.e., Democrats are likely to favor infrastructure with some reservations, and certainly not want to push the US government towards default), the fiscal boost could shore up business sentiments. This means the US economy may again begin to experience demand pressures, which creates expectations of rising inflation. This brings us back to the scenario where the market expects the Fed to increase interest rates, which it should do. Again, this will place the Fed in the firing line of the White House.

Since President Trump has no compunctions about targeting his own appointees (e.g. the FBI Director), and criticizing the FBI for indulging in bipartisan politics, there is a distinct possibility he will do the same with the US Federal Reserve and its Chairman.

However, unlike the current standoff between the White House and the FBI, a clash with the Fed will have very serious market consequences, which the White House may not be able to handle. A loss of confidence in the US economy by domestic and foreigner stakeholders, will derail the growth momentum, and could result in asset price corrections in both the stock market and real estate. The influential *New York Times* columnist Paul Krugman, said in an op-ed (February 7th) that while US stocks are not as overvalued as they were in 2000, and that real estate is not as over-priced as it was in 2006, the fact that both are *simultaneously* showing signs of being bubbles, does create the sobering possibility of a "double-bubble" burst. This happened in Japan during 1986-91, and it took the country over a decade to get out of its deflationary phase – nominal GDP in FY12 was 4 percent *lower* than in FY02.

Conclusion

What has surprised most – and exacerbated many – is President Trump's tendency to provoke global outrage on a host of issues, and to do so compulsively. From showing support for white nationalists; indulging in a childish exchange with the North Korean leader; threatening to fire the FBI's Special Counsel; and calling Democrat lawmakers un-American and treasonous – it almost seems the Trump administration needs to stir up controversy to stay operational. While such behavior has all the makings of a top-rated primetime reality show, when it comes down to a clash with the Federal Reserve Bank that adversely impacts the US economy, Americans will not think it's all that amusing.

While the list of issues on which President Trump could be impeached keeps growing, an abrupt market correction or rising inflation that necessitates stern policy actions, could set off a series of events that even President Trump will not be able to deflect. On the back of divisive tax reforms, a stalling US economy will create enemies on both sides of the political aisle. Even the compliant, self-serving Republicans who have stood by President Trump so far, could decide that enough is enough, and use the list of impeachable offences to send him packing.