Its The Economy Stupid

In the months leading up to the Presidential election of 1992, Bill Clinton advisor James Carville coined the phrase ?*It?s The Economy Stupid*? as a rallying cry for his candidate. At the time the U.S. economy was mired in weak economic growth despite having recently emerged from a recession. Democratic hopeful Bill Clinton was quick to remind voters of the circumstance and place direct blame on his opponent, George H.W. Bush. The strategy James Carville and Bill Clinton employed focused on the fact that presidential incumbents fare poorly when the economy is suffering.

?Long in the tooth? and ?bottom of the ninth inning? are phrases we have recently used to describe the current economic cycle. In just a matter of days, this economic expansion will tie the period spanning 1991-2001 as the longest era of uninterrupted growth since at least 1857.

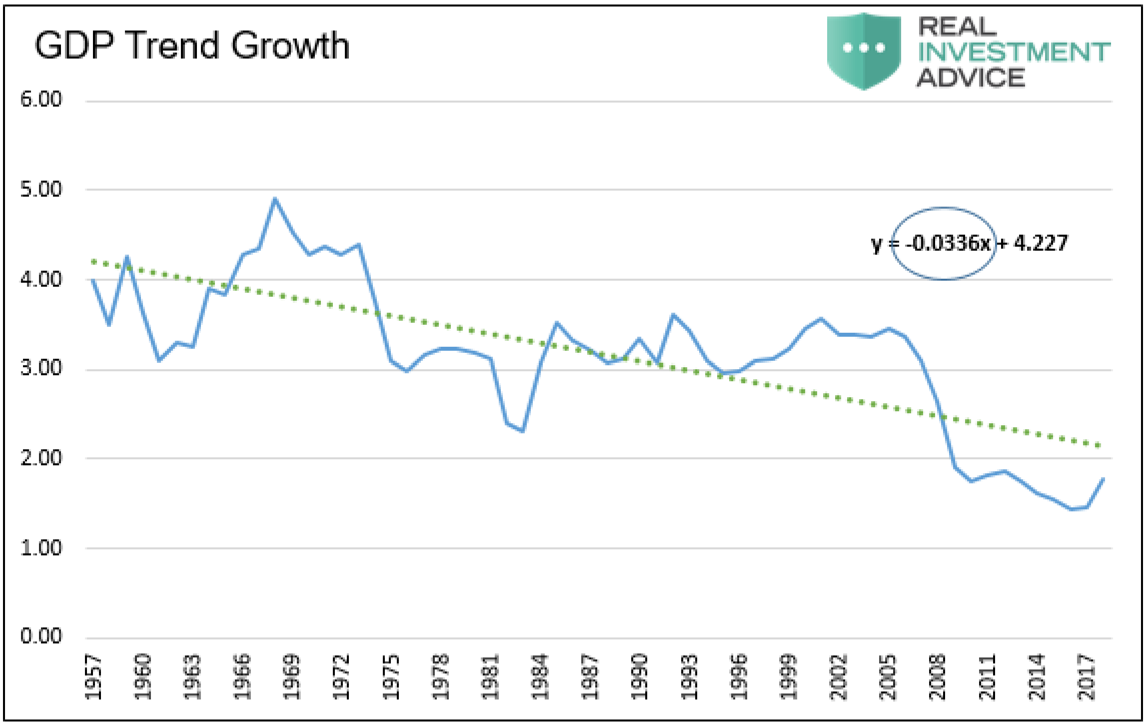
Whether the current expansion ends with a recession starting next week, next month or next year is unknown. What is known is that the odds of a recession occurring before the presidential election in a year and a half are reasonably high. As evidenced by public Fed-bashing for raising interest rates, this point is clearly understood by President Trump.

Boosting Growth Beyond Its Natural Bounds

Donald Trump can certainly win reelection, but his chances are greatly improved if he avoids a recession and keeps the stock market humming along. Accomplishing this is not an easy task for several reasons as we expand on.

Trend Economic Growth

The natural growth rate of the economy is about 2% per annum and declining. The graph below shows the ten-year average growth rate and its trend over the last 60 years.



Data Courtesy: St. Louis Federal Reserve

The slope of the trend line is -0.0336x, meaning that trend growth is expected to decline further by 0.0336% per year or approximately 0.34% per decade.

Fiscal Stimulus

During Trump?s term, economic growth has run 0.50-0.75% above trend in large part due to various forms of fiscal stimulus, including tax reform, hurricane/fire relief, and increased deficit spending. In 2018 for example, Treasury debt outstanding increased by $1.48 trillion as compared to an increase of $515 billion in the prior year. The difference of nearly $1 trillion directly boosted GDP for 2018 by approximately 1.30%.

Even if the Treasury?s net spending were to increase by another $1.48 trillion this year, the incremental contribution to GDP growth for 2019 would be zero. Any decline in Treasury spending from prior year levels will reduce economic growth. It is a story for another day, but most economic measures are centered on percentage growth rates and not absolute dollars, meaning what matters most is the rate and direction of change.

Given that control of the House of Representatives is in Democratic control we find it unlikely that deficits can increase markedly from current levels. Simply, the Democrats will not do anything to boost the economy and help Trump?s election chances.

Monetary Stimulus

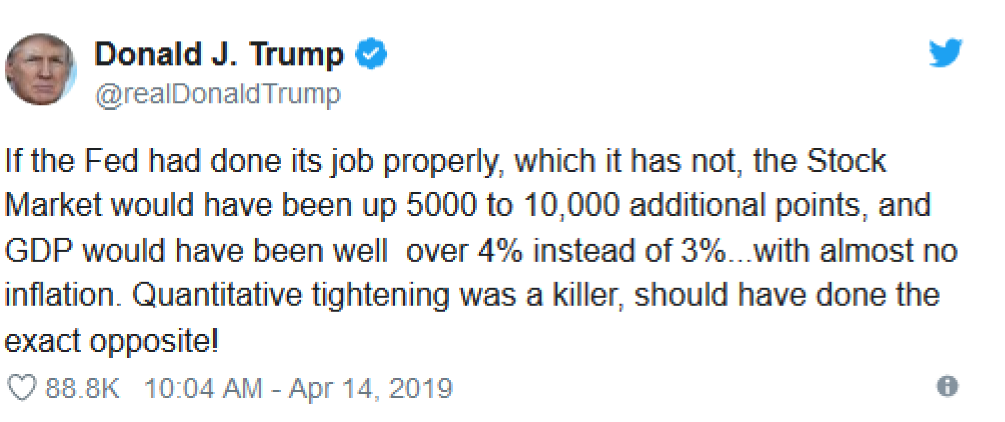
Without the help of fiscal stimulus and a low rate of natural economic growth, Trump?s best hope to sustain 3-4% economic growth and avoid a recession by 2020 is for the Fed to lower interest rates and quite possibly re-introduce QE. Trump and his economic team have been publically insistent that the Fed does just that. Consider the following clips from the media:

> 3/29/2019 - White House economic advisor Larry Kudlow says he wants the Fed to cut its overnight lending rate by 50 basis points ?immediately.?

4/5/2019 - (Reuters) - ?I think they should drop rates,? Trump told reporters. ?I think they really slowed us down. There?s no inflation.?&#2013266080; The U.S. president also suggested that the central bank pursue an unconventional monetary policy called ?quantitative easing? that was used to nurse the economy back after the global financial crisis. ?It should actually now be quantitative easing,? Trump said.

3/26/2019 - Stephen Moore, Donald Trump?s nominee for a seat on the Federal Reserve Board, told the New York Times that the central bank should immediately reverse course and lower interest rates by half a percentage point.

4/14/2019



Donald J. Trump
@realDonaldTrump

If the Fed had done its job properly, which it has not, the Stock Market would have been up 5000 to 10,000 additional points, and GDP would have been well over 4% instead of 3%...with almost no inflation. Quantitative tightening was a killer, should have done the exact opposite!

88.8K 10:04 AM - Apr 14, 2019

The Fed has partially acquiesced to Trump?s public demands. Over the last three months, the Fed has gone from a steadfast policy of further rate hikes and QT on ?autopilot,? to ending the prospect of interest rate increases this year and halting QT by the end of the third quarter.

As far as the next step, reducing rates and possibly reengaging in QE, the Fed does not seem willing to do anything further. Consider the following clips from the media:

3/27/2019 - ?I doubt we?re accommodative, but I also doubt we?re restrictive,? said Dallas Fed President Robert Kaplan. ?If we?re restrictive, it is very modest.?

4/12/2019 ? Minneapolis Fed President Neel Kashkari says it isn?t time to cut rates.

3/20/2019 ? Per the FOMC statement from the most recent meeting- The Fed expects the benchmark rate to stay near 2.4 percent by the end of 2019.

4/11/2019 - ?We?re strictly nonpartisan? ?We check our political identification at the door? -Jerome Powell

4/12/2019 ? Per Bond Buyer: Powell said to tell Democrats Fed won't bend to pressure.

Based on the statements above and others, the Fed appears comfortable that their current policy is appropriate. It does not seem likely at this time that they will ?bend to pressure? to get Trump and his team off their backs.

Summary

Given that fiscal stimulus and the anemic growth trend will do little to help Donald Trump win reelection, all eyes should focus on the Fed. Pressure on the Fed to lower rates and start back up QE will become much stronger if the economy slows further and/or the stock market declines.

We believe the Fed will try to protect its perceived independence and keep policy tighter than the President and his team prefers. **This dynamic between the President wanting a stronger economy to help his election chances and a Fed focused on maintaining their independence is likely to fuel fireworks on a scale rarely if ever seen in public.** The market implications of such a publically waged battle should not be ignored.

This article is a prelude to another following soon which discusses the investment implications and consequences if Donald Trump were to fire or replace Chairman Powell.

Just in case you are wondering we believe the President can fire the Chairman despite no historical precedence for such an action. The paragraph below is from the Federal Reserve Act.

2. Members ineligible to serve member banks; term of office; chairman and vice chairman

The members of the Board shall be ineligible during the time they are in office and for two years thereafter to hold any office, position, or employment in any member bank, except that this restriction shall not apply to a member who has served the full term for which he was appointed. Upon the expiration of the term of any appointive member of the Federal Reserve Board in office on the date of enactment of the Banking Act of 1935, the President shall fix the term of the successor to such member at not to exceed fourteen years, as designated by the President at the time of nomination, but in such manner as to provide for the expiration of the term of not more than one member in any two-year period, and thereafter each member shall hold office for a term of fourteen years from the expiration of the term of his predecessor, unless sooner removed for cause by the President. Of the persons thus appointed, 1 shall be designated by the President, by and with the advice and consent of the Senate, to serve as Chairman of the Board for a term of 4 years, and 2 shall be designated by the President, by and with the advice and consent of the Senate, to serve as Vice Chairmen of the Board, each for a term of 4 years, 1 of whom shall serve in the absence of the Chairman, as provided in the fourth undesignated paragraph of this section, and 1 of whom shall be designated Vice Chairman for Supervision. The Vice Chairman for Supervision shall develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board, and shall oversee the supervision and regulation of such firms. The chairman of the Board, subject to its supervision, shall be its active executive officer. Each member of the Board shall within fifteen days after notice of appointment make and subscribe to the oath of office. Upon the expiration of their terms of office, members of the Board shall continue to serve until their successors are appointed and have qualified. Any person appointed as a member of the Board after the date of enactment of the Banking Act of 1935 shall not be eligible for reappointment as such member after he shall have served a full term of fourteen years.