City National Rochdale®

INVESTMENT MANAGEMENT

Economic Perspectives

TAX RELIEF LIKELY TO PROVIDE MODEST BOOST

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Figure 1

Source: Congressional Budget Office (CBO)
October 30, 2017

The U.S. economy appears to have taken the one-two punch of Hurricanes Harvey and Irma in stride. Despite the storms' devastation, GDP growth posted its second consecutive quarterly gain of at least 3%, and with rebuilding likely to boost growth over the rest of the year, there is a good chance that yet another 3% gain is in store for the economy over the fourth quarter. This would mark the best stretch of growth in a number of years, and a significant increase over the 2% or so rate experienced thus far during this expansion.

But is such a pace sustainable? Last year's presidential election victory has certainly generated a wave of optimism among investors that policy change out of Washington, and in particular tax reform, will help reignite "animal spirits" and lift potential GDP growth into the 3-4% range. We too believe enthusiasm over economic prospects are warranted. After eight years of modest gains, the U.S. economy would undoubtedly benefit from polices designed to lift its productivity and potential growth rate. However, we think investors should also be realistic.

Economists generally agree that tax reform is pro-growth if it broadens the base (such as by eliminating deductions) and reduces complexities, while increasing incentives to work and invest. There is less agreement in other respects, such as which types of households should see tax cuts, whether a lower corporate rate would benefit shareholders or workers, and if it's a good idea to let government bring in less tax revenue overall. History shows a lot depends on circumstances.

For starters, size matters. The large Kennedy and Reagan tax cuts (see *Figure 1*), for example, were indeed followed by periods of strong growth. However, marginal rates today are much lower to begin with, and the reductions currently being proposed appear more comparable to the limited 2001 cut, which ended up providing a rather limited boost to the economy. Similarly, a reduction from 35% to 20% in the corporate tax rate may sound huge at first, only until you realize that effective rate on nonfinancial corporations—due to exemptions and loopholes—is an already quite low at 21.8%.

At the same time, there is ample evidence that tax cuts don't just "pay for themselves." While it's true that there are growth effects linked with reductions in marginal rates, they typically don't amount to anywhere near 100% of the tax revenue lost, much less 150% or whatever our politicians are selling this month. In fact, echoing what happened in the early 1980s and 2000s, the more likely outcome of tax cuts being proposed today would be a marked increase in the Federal deficit.

The difference is that the Reagan tax cuts came at a time when the Federal debt burden was 20% of GDP, while the Bush tax cuts occurred when the debt burden was 35% of GDP and the budget was in surplus. Government debt today stands at $20 trillion, or 77% of GDP. Add another trillion dollars plus over the next decade, throw in higher interest costs, and the country's net debt burden would be well on its way to 100% of GDP.

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And just as taxes can be a drag on growth, so too can higher deficits. Government debt attracts capital that would otherwise be invested in the private sector and puts upward pressure on interest rates, something our policymakers have spent the better part of the last decade taking extraordinary measures to keep down.

Critically, research shows that the powers of fiscal multipliers are significantly smaller during economic expansions than they are during downturns. Going back to the Reagan and Bush tax cuts, both were enacted at a time when the economy was sliding into recession. The resulting slack left more scope for the economy to grow at an above-potential pace for several years before reaching capacity constraints and triggering a rise in inflation.

With the output gap almost eliminated and the unemployment rate below most estimates of the long-run equilibrium level, there is limited scope today for the economy to continue growing above potential without putting upward pressure on wages and prices. In that case, the most likely outcome of a fiscal stimulus would be to cause the Fed to accelerate its plans for monetary tightening and it wouldn't be long before higher interest rates caused economic activity to slow once more.

All this means is that tax reform is more likely to play a supporting role in terms of overall growth, rather than be a game changer. Still, over eight years into this expansion, economic fundamentals remain strong and risk of recession low. We think that is something to be encouraged by. But if you're waiting for sustained 3-4% annual real growth, you may be disappointed.

The race for the next Federal Reserve chair is entering its closing stages.

THE FED

The race for the next Federal Reserve chair is entering its closing stages. In the past few weeks the news stories have tried to figure out what metrics President Trump is using to judge his candidates. If recent history is a guide, newly elected presidents have reappointed the Fed chair even if there has been a change in the political party of the White House. Reagan reappointed Volker (Carter's appointment), Clinton reappointed Greenspan (Bush 41's appointment), Bush 43 reappointed Greenspan again, and Obama reappointed Bernanke (Bush 43's appointment). The belief is that the presidents want continuity of monetary policy in the early years of their presidencies. But the current president views himself more of a disruptor than recent predecessors of the Oval Office (for example, appointing Scott Pruitt to EPA and Rick Perry to the Department of Energy).

Figure 2

Figure 3

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There are two fundamental differences that the current administration has toward Janet Yellen. First, the administration would like a Fed chair who champions their efforts to help reduce the current burden of financial regulations, whereas Yellen is a strong supporter of Dodd-Frank. Second, the administration is full of supply siders who believe that a cut in taxes and reduction of regulation can get the yearly change in GDP out of the current 2.0-2.5% trough and propel us to a rate above 3.0%. Yellen on the other hand, is more in the camp that believes economic growth is demand driven, and that is currently around 2.0-2.5%. If growth were to exceed that rate, she would be more inclined to raise interest rates to help prevent the build-up of inflationary pressures, which could hurt the chances of a faster pace of economic growth.

Nonfarm payrolls fell by 33,000 in the September payroll report.

LABOR

Nonfarm payrolls fell by 33,000 in the September payroll report, which marks the first decline in this series since September 2010, ending a record 83 months of gains. Neither economists nor the financial markets appear concerned by this change, since the drop seems to be an aberration brought on by recent hurricanes. The trend in labor gains remains strong, outpacing the number of workers entering the workforce. That said, the trend in gains has been weakening since hitting a peak back in February 2015 (see *Figure 3*). This is attributed to the longevity of this expansion (which is currently in its ninth year) and the difficulty of finding qualified workers (who are already employed and not willing to leave their current positions). The unemployment rate, calculated from a different survey, was not affected by the hurricane and fell to 4.2% in terms of overall growth. The biggest surprise came from a 0.5% surge in hourly earnings to the level of 2.9%, matching the cycle high that last occurred this past December.

The labor market is robust. This strength is the main reason the Fed is raising interest rates. Since 1950, the unemployment has only been this low three other times: during the strong manufacturing period of the 1950s, the "butter and guns" period of the 1960s, and tech-induced strength of 1999-2001.

The lack of inflation has been a hallmark of this expansion.

INFLATION

The lack of inflation has been a hallmark of this expansion. Since January 2012, when the Fed started targeting inflation at 2.0%, the yearly change in inflation has been at 2.0% or higher only 6.0% of the time. This is not just a domestic issue; central bankers around

Figure 4

Figure 5

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the world are perplexed as to why the inflation rate remains subdued despite the declines in the unemployment rate.

Inflation occurs when demand outpaces supply of goods and services. In this expansion, the unemployment rate has fallen from a peak of 10.0% back in October 2009 to the present level of 4.2%. Demand has picked up during that period of time, yet the inflation rate has remained subdued. The Fed's preferred metric for measuring price pressures, the core personal consumption expenditure price gauge (core CPE), is reading just 1.3% (see *Figure 4*); last October is was at 1.9%. Most members of the Fed believe the recent slump in inflation is a result of one-time events (decrease in mobile phone bills, used cars prices, etc.) and that inflation will rebound in 2018. But there are a minority of members who are starting to believe that we may be in a period of low inflation, and that the rate may not get back to 2.0%. Time will tell.

HOUSING

One of the weak spots in the economic expansion has been housing.

One of the weak spots in the economic expansion has been housing. It comprises just 3.5% of GDP; during the heydays of the previous expansion, it peaked at 6.1% in 2005. Housing starts so far this decade have been averaging about 900,000 units per year, which is well below the average of 1.5 million units for the 50 years prior (see *Figure 5*). Despite housing affordability being at levels higher than the past two expansions, making it more affordable to purchase a home, the younger population doesn't have the same appetite for owning their own homes as their parents did in years prior.

For those who do want to purchase their first home, the current problem is that there are too few homes available for sale. This is especially true in cities where young people want to live (urban areas with mass transit and universities nearby). This mismatch has sent home prices soaring for those cities and has helped lift the national average price for homes above the previous peak in the previous expansion. This price rally is not uniform. In the 20 cities that the Case Shiller Home Price Index monitors, only nine of the cities have prices higher than the previous peak.

Index Definitions

The Core PCE price index is defined as personal consumption expenditures prices excluding food and energy prices and measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

The Case-Shiller Home Price Index tracks changes in home prices throughout the United States. The index is based on a constant level of data on properties that have undergone at least two arm's length transactions.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.

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