ECONOMIC SITUATION AND STRATEGY

President Trump: US economy's savior or death knell for the upswing?

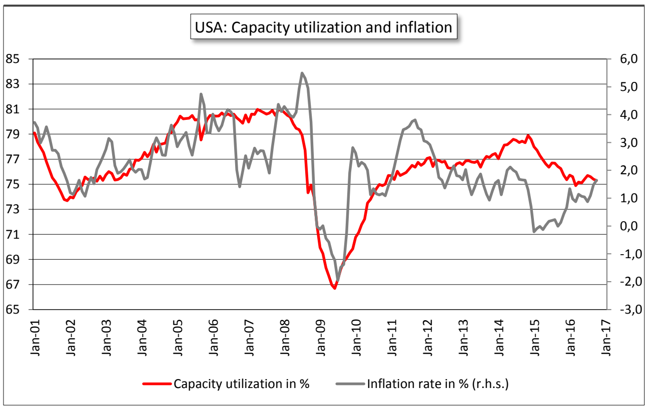
The United States is on the verge of the most radical political change in postwar history upon Donald Trump's inauguration as president, not only in social but also in economic respects. Trump promises to stimulate the economy and create jobs with huge tax cuts and increased public-sector investment.

According to Keynesian economic theory, expansionary fiscal policy is an appropriate mean of rescuing an economy as quickly as possible from a steep downturn in a crisis. In good times, on the other hand, a fiscal policy of liberal spending will only stimulate growth temporarily until advancing inflation and consequently rising interest rates cause the economy to contract again.

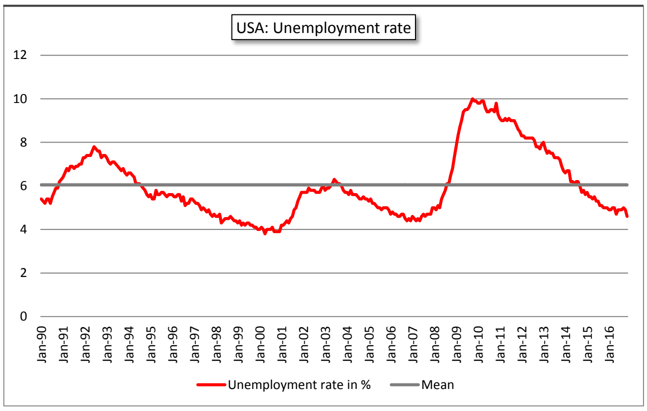
The crucial issue for the success of policy is therefore the state in which the US economy finds itself. In technical terms, the question is therefore specifically whether the output gap, i.e., the difference between a national economy's realized gross domestic product and its production potential is negative or positive. For the average citizen, this comes down to whether capacities are still underutilized or already utilized to an extent that leads to wage and price increases. Trump's policies would make sense if the output gap were negative, but would not be constructive with a positive output gap because they would initiate the end of the upswing.

The output gap is thus hugely important for economic policy, but unfortunately difficult to estimate. Global economic institutes like the OECD have consequently developed elaborate methods of estimating it. Currently, the OECD calculates a negative output gap for the United States of 1.2% that would not close until sometime in 2018, which should (for now) justify Trump's position. But some history and an analysis by the German central bank (Bundesbank) in its monthly report of April 2014 show that such estimates are flawed or at least imprecise and in most cases assume a negative output gap for too long. The reason is that growth of production potential is estimated too high.

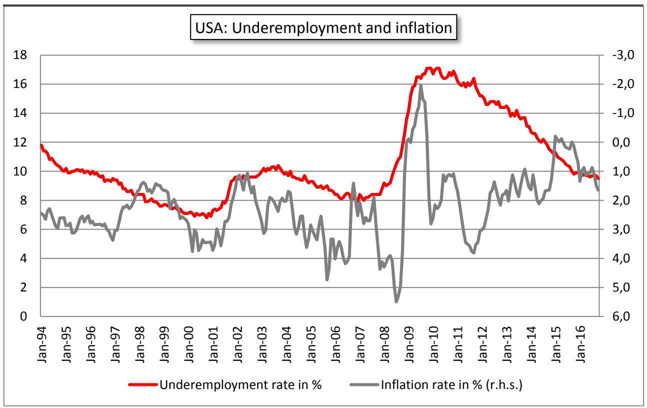
A look at capacity utilization in the United States shows still underutilized reserves. Current capacity utilization is at 75.3% and hence below the average since 2001 of 76.6%. It is difficult to determine what exactly the normal value is from which inflation risks multiply, but it is presumably between 77% and 79%. However, given the significant improvement of recent data, the US economy should be able to achieve a value in this range again in 2017 even without additional stimulation from Donald Trump. The latest surveys of purchasing managers from diverse regions suggest a marked advance of growth momentum.



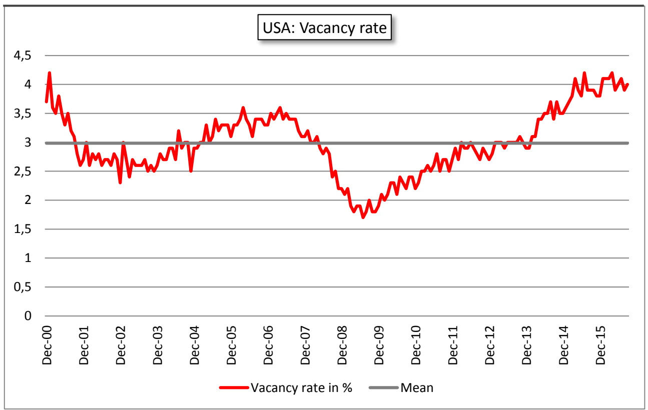
An alternative approach focuses on the labor market. The concept of the output gap is closely tied to another technical notion, the non-accelerating inflation rate of unemployment (NAIRU). This is the unemployment rate up to which the inflation rate does not rise. According to the OECD, the NAIRU should now stand at about 4.9%. The official unemployment rate of 4.6% is thus already below the OECD NAIRU and even more noticeably below the average of the last 25 years. Accordingly, stronger wage increases would have to become evident soon and then lead to higher inflation.



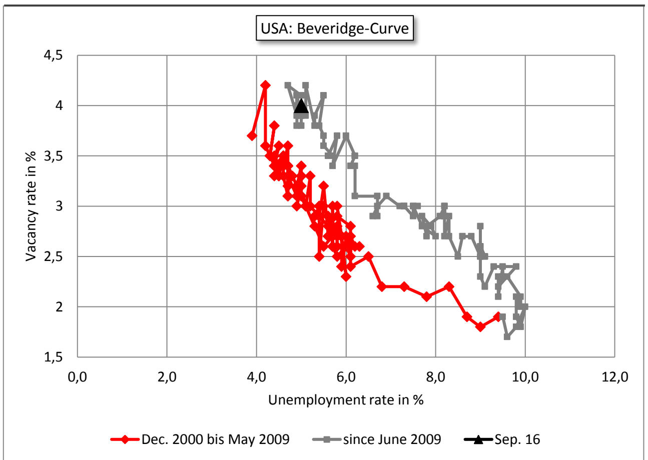
However, it is often noted that the official unemployment rate obscures the extent of underemployment because many Americans have turned away the labor market, frustrated because they are unable to find work. The underemployment rate is therefore probably a better indicator of emerging inflation risks. It now stands at 9.5% and, based on historical comparison, should thus gradually reach the phase of faster-rising prices. Here, too, the trend does not point to any necessity of economic stimulus measures, even though it has slowed somewhat lately.



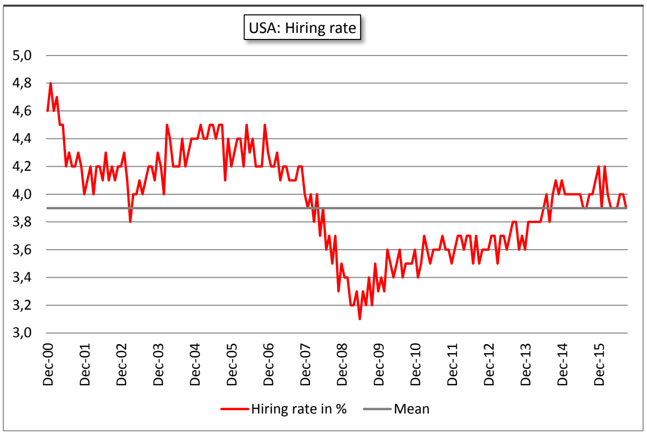
By itself, the number of job vacancies provides the strongest indication that the labor market does not need any further support. The job vacancy rate is now about 4%, already far above the 3.5% of the 2006-2007 boom phase.



However, the connection between job vacancies and the unemployment rate shows a clear shift compared with the time before the financial market crisis. There are probably structural reasons for this. Job seekers' qualifications evidently match available jobs less well now than they did about ten years ago. Increasing digitalization might be partly responsible for that.



That also explains the finding of a comparatively low hiring rate of 3.9%, which, unlike job vacancies, is only at the historical average.



However, in that case, measures to stimulate the economy will provide only limited help. Instead, the necessary adjustment of workers' qualifications might only be delayed, so the rude awakening will not come until the next crisis. Moreover, the need of protectionist measures is rising, since only by sealing off markets can obsolete and unprofitable jobs be maintained at least temporarily. Consequently, Trump has a consistent position of lobbying for a growing group of workers left behind by digitalization or other structural changes.

The analyses have yielded an overall picture of an economy very close to the threshold of higher inflation rates. In other words, the US economy has already reached a normal level or should be able to reach it in the course of 2017 even without stimulation from Trump. This means conversely that the new US president's "crowd-pleasing" policies will probably stimulate the economy only temporarily, with the primary result being higher inflation rates. The Federal Reserve will have to react to that eventually by tightening monetary policy. Even though current sentiment at the Fed might still allow inflation rates to overshoot its target temporarily, the end could come at the latest with the extension of Janet Yellen's term (or be brought about by her successor in case she is not reappointed) in 2018.

However, rising interest rates are the death knell for an economic upswing. The signal ending this one, among the longest ever at almost eight years, is thus being given. It is likely that no large interest rate hikes will be necessary to choke off the upswing given the fragile state of the world economy. Investors should perhaps become more cautious already towards the end of 2018, but at the latest in 2019. Until then, there is still enough time to benefit from rising corporate earnings and to build up a cushion for worse times to come. Investors should therefore overweight their stock positions now.

Weekly outlook for December 19-23, 2016

	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Release
DE: Ifo business climate index	106.3	109.5	110.4	110.4	110.4		December 19
DE: Ifo current conditions	112.9	114.7	115.1	115.6	115.9		December 19
DE: Producer prices, m/m	-0.1%	-0.2%	0.7%	0.4%			December 20
DE: Producer prices, y/y	-1.6%	-1.4%	-0.4%	0.2%			December 20
DE: GfK consumer climate	10	10.2	10	9.7	9.8	10.0	December 23

MMWB estimates in red

Chart of the Week: Can Santa Trump make Christmas great again?

The Chart of the Week this time comes from our colleagues Lasse Heitmann (drawing) and Gabriela Rieks (text), whose contribution we greatly appreciate.

This year, the United States has selected a new First Citizen in charge of gift-giving, Donald Trump, who has quickly assumed his function as Santa Claus. With the slogan "make Christmas great again," Santa Trump has called his helpers from the banking and petroleum industries together to make holiday preparations. A number of presents have been promised for 2017, including increased government spending on infrastructure, tax cuts for businesses, and deregulation in the banking sector. But will Santa Trump save the world economy, or will he end the age of globalization? And who will feel the sting of Bad Santa's rod? China may become the first victim, while Europe still waits in suspense. How will he deal with conflicts and crises when diplomatic skills are needed? And how substantial will the announced gifts be? How will high government debt, Trump-style protectionism, and the new climate policy affect the United States and the world economy? At least one thing is certain: Santa Trump will not be able to make all wishes come true.

We wish all our readers happy holidays. We are glad you have stayed with us in 2016 and appreciate your comments and suggestions. Please feel free to contact us again next year. The next issue of Economic Situation and Strategy will appear on January 5, 2017.

* tariffs, government debt, climate policy ** deregulation, tax cut, infrastructure

Stock marktes	As of 16.12.2016 14:00	Change versus 22.11.2016 -1 Woche	28.10.2016 -1 Monat	26.08.2016 -3 Monate	31.12.2015 YTD
Dow Jones	19852	4,4%	9,3%	7,9%	13,9%
S&P 500	2262	2,7%	6,4%	4,3%	10,7%
Nasdaq	5369	-0,3%	3,4%	2,9%	7,2%
DAX	11401	6,4%	6,6%	7,7%	6,1%
MDAX	21831	5,4%	3,2%	1,3%	5,1%
TecDAX	1766	1,5%	2,0%	2,5%	-3,5%
EuroStoxx 50	3266	7,3%	6,1%	8,5%	0,0%
Stoxx 50	3003	6,4%	6,0%	5,0%	-3,1%
SMI (Swiss Market Index)	8227	6,3%	4,0%	0,7%	-6,7%
Nikkei 225	19401	6,8%	11,2%	18,6%	1,9%
Brasilien BOVESPA	58596	-5,4%	-8,9%	1,5%	35,2%
Russland RTS	1143	12,4%	15,2%	17,4%	51,0%
Indien BSE 30	26490	2,0%	-5,2%	-4,7%	1,4%
China Shanghai Composite	3124	-3,8%	0,6%	1,7%	-11,7%
MSCI Welt (in €)	1755	4,2%	8,6%	10,0%	10,1%
MSCI Emerging Markets (in €)	859	1,9%	-0,5%	3,0%	12,8%
Bond markets					
Bund-Future	162,36	96	28	-534	444
Bobl-Future	133,12	183	205	-50	245
Schatz-Future	112,32	8	33	31	80
3 Monats Euribor	-0,32	0	0	-2	-19
3M Euribor Future, Dec 2016	-0,31	0	0	0	0
3 Monats $ Libor	0,94	1	5	10	32
Fed Funds Future, Dec 2016	0,53	0	3	-2	0
10 year US Treasuries	2,58	25	73	94	31
10 year Bunds	0,32	17	23	47	-32
10 year JGB	0,08	5	13	15	-17
10 year Swiss Government	-0,09	9	31	42	-2
US Treas 10Y Performance	574,09	0,0%	-3,5%	-4,8%	1,7%
Bund 10Y Performance	612,87	0,4%	-0,2%	-2,4%	5,9%
REX Performance Index	483,36	0,0%	-0,4%	-1,5%	1,9%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,67	-3	10	30	-61
IBOXX BBB, €	1,63	-2	24	44	-64
ML US High Yield	6,75	-3	26	0	-214
JPM EMBI+, Index	763	-0,1%	-4,6%	-6,1%	8,4%
Convertible Bonds, Exane 25	6859	2,8%	1,5%	0,7%	-1,4%
Commodities					
CRB Index	421,14	0,1%	-1,0%	0,8%	11,0%
MG Base Metal Index	305,63	5,8%	16,9%	21,8%	31,6%
Crude oil Brent	54,24	11,5%	8,0%	8,2%	51,9%
Gold	1133,88	-6,3%	-10,7%	-15,0%	6,7%
Silver	16,59	-0,4%	-6,1%	-11,4%	19,8%
Aluminium	1745,00	-1,2%	1,5%	7,2%	16,3%
Copper	5865,75	4,8%	21,4%	27,4%	24,7%
Iron ore	81,00	6,6%	27,6%	33,9%	84,9%
Freight rates Baltic Dry Index	966	-21,6%	15,8%	34,2%	102,1%
Currencies					
EUR/ USD	1,0437	-1,7%	-4,4%	-7,6%	-4,1%
EUR/ GBP	0,8379	-1,7%	-6,9%	-1,9%	13,7%
EUR/ JPY	123,35	4,8%	7,2%	8,8%	-5,9%
EUR/ CHF	1,0740	0,1%	-1,1%	-1,8%	-0,9%
USD/ CNY	6,9561	1,0%	2,6%	4,3%	7,1%
USD/ JPY	111,94	0,7%	6,9%	9,9%	-7,0%
USD/ GBP	0,80	-0,2%	-2,4%	6,0%	18,4%

Carsten Klude +49 40 3282-2572 cklude@mmwarburg.com
Dr. Christian Jasperneite +49 40 3282-2439 cjasperneite@mmwarburg.com
Martin Hasse +49 40 3282-2411 mhasse@mmwarburg.com
Dr. Rebekka Haller +49 40 3282-2452 rhaller@mmwarburg.com