Economic Viewpoint

Desjardins Economic Studies
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November 4, 2016

The November 8 elections and the U.S. economy

Part three: Economic and financial consequences

The electoral promises made during the presidential campaign set out different paths for the U.S. economy, the Canadian economy and the financial markets. The markets have been closely monitoring this election and the outcome could affect them in the short and medium terms. This third *Economic Viewpoint* on the 2016 presidential election examines the principle economic and financial consequences that could follow the election of either Hillary Clinton, the Democratic candidate, or Donald Trump, the Republican candidate. The net effect of the proposals made by Hillary Clinton is fairly modest. However, the consequences of a Donald Trump victory could be huge if he manages to fulfill his promises. The protectionism of the Republican candidate represents a significant risk to the Canadian economy.

ECONOMIC CONSEQUENCES

The big difference between Hillary Clinton's economic proposals and those made by Donald Trump are based on taxation. The democratic candidate is calling for substantial tax increases on the richest people while the Republican candidate is instead calling for massive tax cuts across the board, but which would benefit the wealthiest taxpayers the most. The spending initiatives of both candidates are also at opposite ends of the spectrum.

The proposals are such that the economic consequences of both plans could also be just as divergent. For the Democrats, the net effects should be especially modest, much like the net budgetary effects of the measures put forth by Hillary Clinton. While the tax increases should put the brakes on growth, the measures to assist families and small businesses and new infrastructure spending should all make positive contributions. The few long-term consequences on the federal government's deficit suggests that the net effect on interest rates would be equally modest.

For the Republicans, tax cuts for individuals and business and increased spending on infrastructures and the federal military should support economic growth in the very short term. The promise of reducing the federal government's discretionary spending, excluding defence, could weigh on growth. Other factors in Donald Trump's proposals could also have destabilizing—clearly negative even—impacts on the U.S. economy. A big increase in the deficits, in cases where the economy is not growing at a good enough clip to offset the shortfalls in government revenues, could sooner or later trigger a faster rise in interest rates than the basic scenario calls for. Households and businesses could also expect a potential tax hike. In addition, immigration reform could hinder economic growth in the short and medium terms by restricting the labour supply.

One of the main economic concerns about Donald Trump is his protectionist instinct. Republicans argue that renegotiating trade agreements and taking a stronger arm approach to anything involving international trade would boost growth. The complete opposite is far more plausible. Closing the borders would work against consumers, import companies, exporters and the broader economy by weakening productivity. The uncertainty of Donald Trump's trade policy could also affect the economy and international markets. Under these circumstances, seeing the positive net effect of Donald Trump's proposals is difficult. Most economic analysts also envision a negative impact. The Tax Policy Center believes the impact on the real GDP over a 20-year horizon would be between -3% or -4%, while the range would be in the area of -0.5% to +0.6% for Hillary Clinton. According to Moody's, Donald Trump's program would trigger a recession that would slash the real GDP in the U.S. to 2.4% between 2018 and 2020, while this same firm assesses that Hillary Clinton's program would boost the real GDP by 1.7% by 2020, compared with the basic scenario. In contrast, the team behind Donald Trump

François Dupuis
Vice-President and Chief Economist

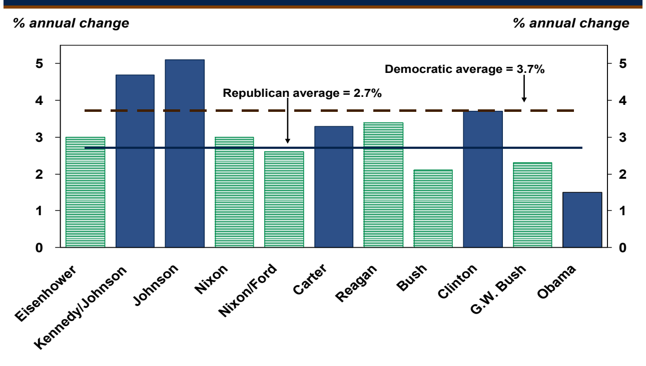
Francis Généreux
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

believes that their candidate's election and the adoption of his program would boost the annual real GDP growth in the U.S. by 3.5%—or even 4%.

Historically, growth is stronger when a Democrat is in the White House (graph 1). Since the beginning of the 1950s, the average real GDP growth has been 3.7% under Democratic presidents, while it falls to 2.7% when a Republican is in office. This 1.0% difference is mostly due to the solid performance of the U.S. economy during the Kennedy and Johnson administrations in the 1960s and when Bill Clinton was president in the 1990s. They all took office at the beginning of economic cycles. The cyclical lows hurt the Republican outcomes the most—and Barack Obama, a Democrat.

Graph 1 Real GDP growth based on the parties



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

CONSTRAINTS

As always, implementing either candidate's full program will not be seamless. Many political, cyclical and structural constraints will remain, meaning that the new administration will have to make compromises and choices. There is a chance that the majority of members in either of the Chambers of Congress won't belong to the new president's party. Even if it is the case, the political process could be halted by the lack of a Senate supermajority, which would hand the minority party the chance to obstruct the political process by filibuster. Hillary Clinton could suffer the same fate as Barack Obama, who saw his projects thwarted at every turn by the Republican-controlled House of Representatives. It would be surprising if Hillary Clinton succeeded in raising taxes as she has proposed. For his part, Donald Trump may have to deal with a Republican or Democratic Congress that will be reluctant to adopt his more extreme proposals, due to budgetary prudence in the case of tax cuts, or political beliefs on trade agreements or divergent opinions on the place of immigrants in American society. The economic situation could also tip the scales if the conditions do not lend themselves to adopting a proposed policy or if it calls for a change in priorities. The different measures that the financial crisis imposed on the Obama administration in its early days come to mind. The structural trend of the economy and factors such as the aging of the population, new technologies, globalization and the increasing importance of the services industry are also factors that could skew both candidates' forecasts, especially in terms of potential economic growth. When growth hovers at around 2%, it is hard to imagine any measures that would lead to 4% growth in any sustainable way.

A RISK FOR CANADA

For Donald Trump and, albeit to a much lesser extent, Hillary Clinton, the issue of international trade could cause considerable turmoil outside the United States. For Canada, the revival of U.S. protectionism is a major risk and terminating NAFTA (North American Free Trade Agreement) would be detrimental to our economy. Given the importance of the U.S. to Canada's industry, increases in U.S. trade tariffs and closing off certain markets would deal a blow to most of Canada's exporters. A unilateral decision by a U.S. president to trigger an abrupt end to NAFTA (with six months' legal notice) could possibly plunge Canada into a recession. The impact would be particularly brutal in the more manufacturing-heavy provinces such as Quebec and Ontario. The resources sector would also be affected, but a protectionist stance could spare Canada's oil industry. The consequences are already being felt on Canada's softwood lumber; according to Chrystia Freeland, the federal minister of international trade, the protectionism that is wading into the U.S. election campaign is hindering Canada's efforts to reach an agreement in this conflict.

China and Mexico are the primary targets of Donald Trump's protectionist stance and any increase in tariff and non-tariff measures would also hurt the economies in these countries—and the global economy by extension. The risk of a trade war and its impact on jobs, living standards and the financial markets cannot be overlooked.

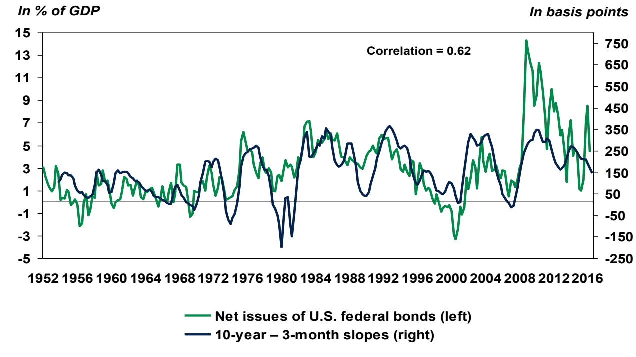
THE BOND MARKET

Despite the deterioration in public finances during the crisis and the current absence of credible plans to balance them, bond yields remain at depressed levels, reaching a low point in the summer of 2016.

The choice Americans make could affect the bond market. Hillary Clinton's proposals will do little to change overall public finances vs. the Congressional Budget Office's basic scenario. Her election would not have much impact on stakeholder expectations for the bond market. The impact of Donald Trump's election would be far more consequential. First of all, increasing the deficits and the federal debt by cutting taxes would substantially increase the supply of securities. Normally, this would lead to higher yields, especially for longer-term bonds (graph 2). Second, the protectionist measures being considered, aimed mostly at Mexico and China, could trigger price hikes for imports, production and consumption. Inflation expectations would rise, pushing nominal interest rates higher. Lastly, price increases could put pressure on the Fed to normalize key rates, and see bond yields rise higher at a faster pace than what the base scenario is calling for—or if the Democratic candidate is elected. These effects would obviously be magnified if Donald Trump seems to have the political heft to set his electoral promises in motion. This type of relative deterioration would contrast with the results of other Republican presidents, since the bond market tends to perform better with a Republican in the White House rather than a Democrat (table 1), even if the debt tends to shrink in step with the GDP under the Democrats (with the noteworthy exception of Barack Obama) (graph 3).

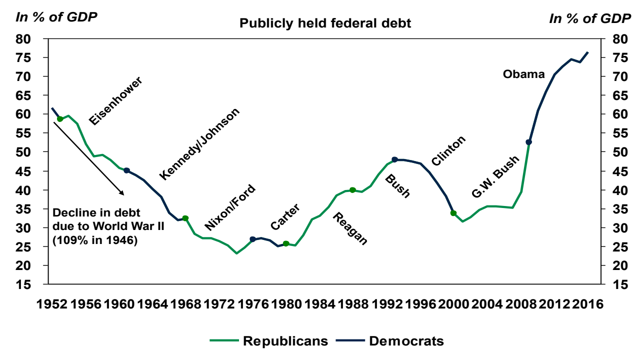
The markets' perception as election day approaches will also have an influence on very short-term shifts in the bond market. During most of the campaign, the surveys have pointed to a Clinton victory. Market expectations have gone in this direction. The tightening of surveys over the last week, however, has shaken this belief and the markets reacted accordingly. It is therefore clear that the surprise election of Donald Trump could trigger temporary

Graph 2 A deterioration in the fiscal situation should steepen the yield curve



Sources: Federal Reserve Board and Desjardins, Economic Studies

Graph 3 Apart for Obama s presidency, the public debt tends to improve under the Democrats



Sources: Congressional Budget Office, U.S. Treasury and Desjardins, Economic Studies

Table 1
American presidents and bond market performance

	Party	Period of office	Total average annual return of federal 10-year bonds	
			In current $	In constant $
T. Roosevelt	Republican	1901-1909	3.0	0.7
T. Taft	Republican	1909-1913	3.2	0.4
T. Wilson	Democrat	1913-1921	2.4	-9.9
W. Harding/C. Coolidge	Republican	1921-1925	8.3	11.0
C. Coolidge	Republican	1925-1929	5.0	5.3
H. Hoover	Republican	1929-1933	3.9	9.7
F. Roosevelt	Democrat	1933-1945	4.1	1.1
H. Truman	Democrat	1945-1953	1.7	-4.5
D. Eisenhower	Republican	1953-1961	2.2	0.8
J. Kennedy/L. Johnson	Democrat	1961-1965	3.5	2.3
L. Johnson	Democrat	1965-1969	1.3	-2.1
R. Nixon	Republican	1969-1973	7.0	2.1
R. Nixon/G. Ford	Republican	1973-1977	7.7	-1.6
J. Carter	Democrat	1977-1981	-0.5	-12.6
R. Reagan	Republican	1981-1989	24.2	19.2
G. Bush	Republican	1989-1993	15.9	11.5
B. Clinton	Democrat	1993-2001	10.5	7.8
G. W. Bush	Republican	2001-2009	9.9	6.8
B. Obama	Democrat	2009-2016 (jusqu'au 31 oct.)	4.0	2.4
Average since 1901			**6.2**	**2.7**
Republican average			**8.2**	**6.0**
Democratic average			**3.4**	**-1.9**

Sources: Global Financial Data, Datastream, Bureau of Labor Statistics and Desjardins, Economic Studies uncertainty that would give a short-term boost to less risky and highly liquid assets like U.S. bonds. Lower yields in the very short term are therefore in the cards, even if Mr. Trump's policies appear to go against the bond market.

Furthermore, the markets may view the uncertainty unleashed by the election of Donald Trump as a factor that will prevent the Fed from increasing key rates at its upcoming meetings. Over the longer view, Mr. Trump's attacks on the Fed's monetary policy would put the central bank in an uncomfortable position if he becomes president. It would be surprising if the new Republican president were to renew Janet Yellen's term, which ends in early 2018. Replacing the most influential and one of the most dovish members of the monetary policy committee and nominating, sooner or later, governors who are more in line with Mr. Trump could shift the Fed's balance and change expectations on movements in key rates. Appointed to lead the Federal Reserve by Barack Obama, Janet Yellen would have a greater chance of having her term extended if Hillary Clinton were to reach the White House.

THE CURRENCY MARKET

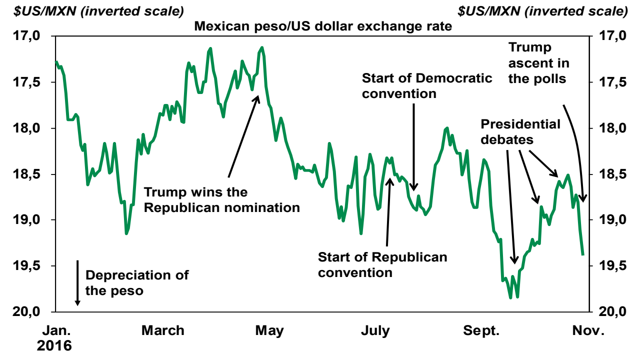
As a safe haven currency, the U.S. dollar is influenced by the overall degree of uncertainty felt on the global markets. Donald Trump's election in a surprise victory could be good for the greenback in its role as a safe haven currency. For example, the financial crisis, which was rooted in the United States, did not prevent the U.S. dollar from increasing in value compared with most other currencies. However, changes in the short-term expectations on monetary policy movement could see the greenback fall against the other main currencies. The net effect in the short term is not crystal clear.

The protectionist measures that may be implemented would then raise questions about the economic health of the United State's main trading partners—mainly the emerging countries—but Canada as well. Canada's loonie and to a greater extent, the Mexican peso, would clearly suffer if Mr. Trump were to win the election. The peso, already a good indicator of the Republican candidate's chances of winning the White House, has been shifting in recent weeks with the ebb and flow of the events in this election campaign (graph 4).

THE STOCK MARKET

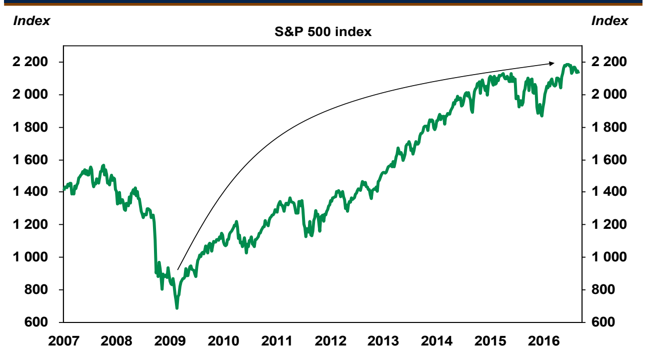
The stock market has had a good run under the Obama administration (graph 5), which adds to its solid showing under previous Democratic presidents (table 2 on page 5). The fact that the stock market reached a trough during the financial crisis a few weeks after Barack Obama's inauguration invites easy comparisons.

Graph 4 The Mexican peso depreciates when the news favours Donald Trump



Sources: Datastream and Desjardins, Economic Studies

Graph 5 The stock market has generally done well under Obama



Sources: Datastream and Desjardins, Economic Studies

In addition, the Fed's monetary policy during and after the recession generally supported the price of assets such as equities.

The tax policies put forth by both candidates could have important implications for developments in the stock market. Both candidates are calling for reform of business taxes, but Donald Trump's plan goes further. The tax relief he intends to put through—including slashing the business tax rate from 35% to 15%—could support after-tax profits. The measures he proposes for personal income taxes are also more favourable to the stock market, and are more beneficial to the wealthy who are generally more inclined to invest in the market. In contrast, the income tax increases suggested by Hillary Clinton work against the wealthiest households.

Some industries will see upsides and downsides, depending on how the electorate votes. The biggest difference lies in the resources industry, especially energy. On one hand, Hillary Clinton's program clearly goes against the oil and gas industry, which would be subject to more regulatory pressures to respect stricter environmental standards,

Table 2
American presidents and stock market performance

	Party	Period of office	Ann. var. in average of S&P 500			
			Without dividends		With dividends	
			In current $	In constant $	In current $	In constant $
T. Roosevelt	Republican	1901-1909	3.9	1.6	10.3	8.0
T. Taft	Republican	1909-1913	1.0	-1.8	6.3	3.5
T. Wilson	Democrat	1913-1921	-3.4	-15.7	2.1	-10.2
W. Harding/C. Coolidge	Republican	1921-1925	13.0	15.7	22.9	25.6
C. Coolidge	Republican	1925-1929	33.8	34.1	45.7	46.0
H. Hoover	Republican	1929-1933	-17.9	-12.1	-16.3	-10.5
F. Roosevelt	Democrat	1933-1945	7.7	4.7	21.7	18.7
H. Truman	Democrat	1945-1953	12.5	6.3	26.9	20.7
D. Eisenhower	Republican	1953-1961	14.8	13.4	25.4	24.0
J. Kennedy/L. Johnson	Democrat	1961-1965	11.5	10.3	16.3	15.1
L. Johnson	Democrat	1965-1969	5.6	2.2	9.7	6.3
R. Nixon	Republican	1969-1973	3.4	-1.5	7.4	2.5
R. Nixon/G. Ford	Republican	1973-1977	-2.2	-11.5	1.7	-7.6
J. Carter	Democrat	1977-1981	6.6	-5.5	13.9	1.8
R. Reagan	Republican	1981-1989	13.1	8.1	23.6	18.6
G. Bush	Republican	1989-1993	14.2	9.8	19.8	15.4
B. Clinton	Democrat	1993-2001	25.4	22.7	32.0	29.3
G. W. Bush	Republican	2001-2009	-3.9	-7.1	-2.6	-5.7
B. Obama	Democrat	2009-2016 (up to Oct. 31.)	17.3	15.5	22.8	22.1
Average since 1901			**8.2**	**4.7**	**15.2**	**11.8**
Republican average			**6.7**	**4.4**	**13.1**	**10.9**
Democratic average			**10.4**	**5.1**	**18.2**	**13.0**

Sources: Global Financial Data, Datastream, Bureau of Labor Statistics and Desjardins, Economic Studies

and lose some tax benefits in the process. On the other, a potential Clinton administration would lift the renewable energies industry. Donald Trump promises to spend more energy promoting and increasing opportunities for the U.S. oil, gas and coal industries. Mr. Trump's approach that focuses on deregulation could also help the financial sector. He has already signaled his intention to scrap the financial regulatory policy implemented in 2010 by Congress and the Obama administration. And Hillary Clinton has promised to veto "any legislation that would weaken financial reform." More so, she has proposed a surtax on the biggest financial institutions to be based on size and their degree of risk to the financial system.

Both candidates have put forth measures to support investment in manufacturing, which could be good for profits and returns on stock market shares. That said, Mr. Trump's protectionism could sideswipe this sector. In an attempt to protect and breathe life into the U.S. manufacturing sector, higher tariffs could increase the cost of imports considerably. Additional complications in the supply chains, which are becoming increasingly international, would also drag down profits. In cases of trade retaliation, we would also expect the companies that benefit from international trade to struggle. For the consumer goods sector, more protectionism equals higher costs and slimmer profit margins.

The impact on the stock market is therefore far from clear. At first glance, Hillary Clinton's proposals could be detrimental to investors and the stock market. While major corporations (often international market players) and investors do not seem to like Donald Trump's more populist measures, they also seem to be guarding against his unpredictable character. In the end, the stock market, like the bond and currency markets, is expecting the Democratic candidate to win even though the polls have tightened. As such, a surprise victory by Donald Trump could create more volatility in the short term. Like the election in 2000, the worst probable scenario would be a tight and contested election with no clear winner on the morning of November 9.

Francis Généreux
Senior Economist