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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the UCLA Ziman Center for Real Estate and UCLA Anderson Forecast, anticipates what the Trump administration will mean for economic policy.

This Economic Letter is the companion article to David Shulman’s presentation at the UCLA Anderson Forecast’s December 6, 2016 Economic Outlook.

Trumponomics: Buckle-Up for Higher Real Growth Ahead of Inflation and a More Aggressive Fed

By David Shulman

Contrary to prior expectations, stocks soared and interest rates surged on the election of Donald Trump. It seems that both the stock and bond markets were pricing in the radical reversal in fiscal policy occasioned by his election while ignoring the negative impacts of his immigration and trade policies. Put bluntly the markets are now anticipating stronger real growth, at least for a while, higher inflation and higher interest rates. We believe that the markets have got it right with respect to direction.

“Recall where we started: We are not assuming a major trade war with our partners around the world. If we are wrong here we are likely wrong everywhere.”
Our first pass at Trumponomics, which still remains quite vague, makes the following policy assumptions:

- $300 billion/year annual, mostly higher-end personal tax cuts effective in Q3.
- $200 billion/year corporate tax cut effective in Q3 with $50 billion of revenues associated with the repatriation of foreign earnings that quarter.
- $20 billion/year infrastructure program effective in Q4.
- $20 billion in higher defense spending in 2018.
- $20 billion/year Medicaid/ACA cuts effective in Q4.
- Relaxed energy, environmental and financial regulation.
- Modest changes to immigration except for border wall.
- Modest changes to trade policy yielding net reductions in food and aircraft exports starting mid-2017.

The net result is a massive fiscal stimulus on an economy at or very close to full employment and is directionally what a host of liberal economists have been advocating for the past five years. To be sure the mix of tax cuts and spending is far different from what they desired, but make no mistake this is real or even reckless fiscal stimulus. How so? The federal deficit will roughly double to over one trillion dollars by 2018. (See Figure 1) Simply put an economy operating at full employment should not have a deficit equal to 5% of GDP; the budget should be in balance or in surplus. Thus in the next recession the federal deficit will make the deficits associated with the financial crisis look small.

In response to higher inflation and the exploding federal deficit the long quiescent Fed will become more aggressive with respect to monetary policy. This month’s expected increase in the federal funds rate will be followed up with many more pushing the rate up to above 2% by the end of 2017 and above 3% by the end of 2018. (See Figure 2) Remember President Trump has two vacancies to fill right away and Chair Yellen’s term expires in January 2018. Because of changes in the composition of the board, the Fed will be quite a bit different from what we are used to.

Similarly the yield on 10-year U.S. Treasury Bonds is forecast to exceed 3% by the end of 2017 and 4% by the end of 2018. We know this sounds aggressive but it looks like we are in for, what economists call, a regime change.
With $500 billion in tax cuts arriving in the third quarter of 2017 we expect economic growth to accelerate from the recent 2% growth path to 3% for about four quarters. Thereafter growth will slip back to 2%. Why so little? First it is hard to stimulate an economy operating at about full employment and second the higher interest rates we foresee will begin to bite. In order to maintain 3% growth or higher the economy will need a productivity miracle. Whether that will come from as the Trump partisans expect the supposed supply side effects of the tax cuts and the proposed regulatory reforms remains to be seen.

In this environment employment will continue to grow with job growth on the order of 140,000 a month in calendar 2017 and 120,000 a month in calendar 2018. But if the new administration follows through with its campaign rhetoric to engage in mass deportations then job growth and the economic activity associated with it would be far slower than what we forecast. The unemployment rate is forecast to fall to around 4.5% by the end of 2017 and remain there through 2018. (See Figure 3) Further, as the labor market tightens, wage growth will accelerate to 4% or more from the middle of 2017 on. (See Figure 4)

With year-over-year core inflation already rising above 2%, it should be no surprise to anyone that this rate will accelerate to at least a 2.5% pace; a forecast we view as conservative. (See Figure 5) As oil prices rebound, headline inflation will approach 3%. Therefore, if we are roughly right about the economy operating at full employment with an unemployment rate of 4.5%, inflation exceeding 2.5% and the prospect of a one trillion dollar annual federal deficit, interest rates will be heading much higher.
THE GOOD

The economic growth we envision will be powered by rising consumption, equipment and defense spending. Real consumption spending is forecast to increase at 3% and 3.7% in 2017 and 2018, respectively compared to 2.6% this year. (See Figure 6) Consumption growth will be dampened by an increase in the saving rate as high-end consumers stash some of their tax savings with the rise in interest rates. (See Figure 7) The saving rate rises from 5.7% in 2016 to 7.6% in 2018.

![Figure 6. Real Consumption Spending, 2007 -2018F, Percent Change, Annual Data](image6)

**Sources:** U.S. Department of Commerce and UCLA Anderson Forecast

![Figure 7. Saving Rate, 2007 – 2018F](image7)

**Source:** U.S. Department of Commerce and UCLA Anderson Forecast

We have been forecasting a turnaround in defense purchases over the past two years. With the election of President Trump it is upon us. After declining six years in a row, real defense spending is forecast to increase by 0.8% and 3.2% in 2017 and 2018, respectively. (Figure 8) This is one spending priority that is expected to achieve broad support.

![Figure 8. Real Defense Purchases, 2007 – 2018F, Percent Change, Annual Data](image8)

**U.S. Department of Commerce and UCLA Anderson Forecast**
THE BAD

Housing activity will likely be a casualty. The speed of the recent spike in long-term interest rates and the prospect of further increases will dampen housing production. Instead of the 1.4 million level of housing starts that we were previously looking for in 2017 and 2018, we are now looking for a far more modest level of starts in the 1.2 million - 1.25 million range. (See Figure 9) This is an increase from 2016’s estimated 1.17 million starts, but far below the underlying demand of 1.5 million units per year.

![Figure 9. Housing Starts, 2007Q1 -2018Q4F](image)

Sources: U.S. Bureau of the Census and UCLA Anderson Forecast

THE UGLY

Although President-elect Trump raged against imports and the trade deficit during the campaign, it looks like he will come up woefully short. Why? The consumer boom that his tax cuts will ignite will inevitably suck in imports. Further, the change in policy mix from monetary policy to fiscal policy will trigger a rally in the dollar making imports cheaper and exports more expensive.

Recall where we started, we are not assuming a major trade war with our partners around the world. If we are wrong here we are likely wrong everywhere. We are assuming that there will be minor tweaks to trade policy that would modestly reduce imports (mostly in the auto sector) and trigger modest retaliatory actions affecting aircraft and farm exports. As a result imports will continue to rise and exports flat-line.

The slowdown in trade we envision is, unfortunately, only the beginning as the broad postwar consensus favoring open markets has broken down. The bi-partisan collapse of the Trans Pacific Partnership (TPP) and the Brexit vote signaled that we are moving to a more protectionist world and the age of ever-increasing globalism is over, at least for now. The world will be a poorer place for it.

A NOTE ON INFRASTRUCTURE SPENDING

Trump is proposing $137 billion in tax credits for private investors to fund major infrastructure projects. But this requires a revenue stream, and there aren’t any major revenue streams associated with highway, bridge and tunnel, wastewater and transit maintenance. Thus, we anticipate a more traditional infrastructure program amounting to a modest $20 billion dollars a year of direct taxpayer funding. We could very well be low here, but it will take time for an expanded infrastructure program to ramp up.
CONCLUSION

The election of Donald Trump signaled a major regime change in economic policy. We are transitioning from a reckless monetary policy to a reckless fiscal policy. In the short run that will bring with it more real growth and inflation along with higher interest rates. However, because the economy is operating at or close to full employment, the growth spurt will be short-lived and we will return to the 2% growth economy of the past seven years.

However, we will be left with mega-deficits that will make it more difficult to fund the retirement and health programs voters expect. And the real risk is that a more aggressive Trump Administration trade policy would trigger a growth-killing trade war. Thus we would caution that because there are so many ill-defined moving parts there is higher degree of uncertainty in this forecast compared to prior ones.