Global Market Strategy

Jefferies

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Trumponomics, The Honma Accord & JGB Bondfire

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The Trump policy equation

Summarizing The Trump Policy Effect On Expected Real Returns to Capital

Fiscal & Regulatory + **Trade & Immigration** = **Net Trump Effect**

Source: Jefferies

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The Trump policy equation – positive effects

⬆ Fiscal Policy

Lower corporate and individual tax rates, immediate depreciation of capital investment, and an end to deductibility of interest on corporate debt should easily net to a positive effect on after tax expected real returns on capital. Further, deficit financed infrastructure spending will stimulate aggregate demand and further boost expected real returns on capital.

⬆ Regulatory Policy

Faster drug approval processes, relaxed environmental rules, a new laissez-faire vice-chair for financial stability at the Fed, a reduced role for the Consumer Financial Protection Board, and an unwinding of Dodd-Frank will take the regulatory shackles off many businesses. The reduced need for large scale compliance and legal functions will free resources which can be used to improve expected real returns to capital.

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The Trump policy equation – negative effects

🡇 Trade Policy

A rise in trade barriers hinders the free mobility of capital. Thus, the opportunity set with which to generate a return on capital shrinks, which in turn reduces the expected return on capital. While capital mobility restrictions, tariffs and border adjustments can temporarily boost returns to some sectors of the domestic economy by reducing foreign competition, retaliatory actions will eventually create long run negative returns on capital for the economy as a whole.

🡇 Immigration Policy

A large proportion of the 10 million illegal immigrants in the US actually provide labor market services - many in the retail, hospitality, construction and farming sectors. If these people leave the labor market wage pressures will surely rise. Given that total economic production consists of a payment to either capital or labor, if labor costs rise, then all else equal expected returns on capital must fall.

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The Trump policy equation – net effects

⬆ Net Effect

- Trade policies will be highly controversial and difficult to pass in a Republican controlled Congress.
- Trade and immigration policies involve sizable logistical complexities.
- A trade war is a highly unlikely outcome.
- Immigration reform, while reducing efficiency and returns on capital, should have a partial simulative offset through domestic job creation, excess labor slack reduction, and aggregate demand stimulus.
- Deregulation policies and tax reform are not contentious for a Republican controlled Congress.
- Tax reform requires only small and simple changes in key rates and brackets.
- Regulatory reform can be accomplished in large part via executive order.
- The estimated benefits to capital holders from deregulation and tax reform are likely to be orders of magnitude larger than the estimated costs from trade and immigration policies

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How will monetary policy respond?

⬆ Monetary Policy

- When the FRB/US model is run with lower taxes, higher spending and less regulatory burden, the estimates for potential growth and actual growth will rise. The prescribed path for interest rates would in turn rise.
- When the FRB/US model is run with higher tariffs and less immigration, the estimate for potential growth will fall, but the estimate for inflation risks will rise. The prescribed path for interest rates would also likely rise given how close the current economy is to full employment.
- Away from the models there are also political considerations. In 2016 politics led to the “Dollar Détente/Shanghai Accord”. The Fed pivoted dovishly in order to keep the peace in markets pre-election. This year there are no such considerations, and further the Fed is much more likely to have a political agenda which runs counter to that of the new Administration.

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Real rates headed higher

- ⬆ Expected real returns on capital
- ⬆ Risk-free real rates
- ⬆ Overall real rates

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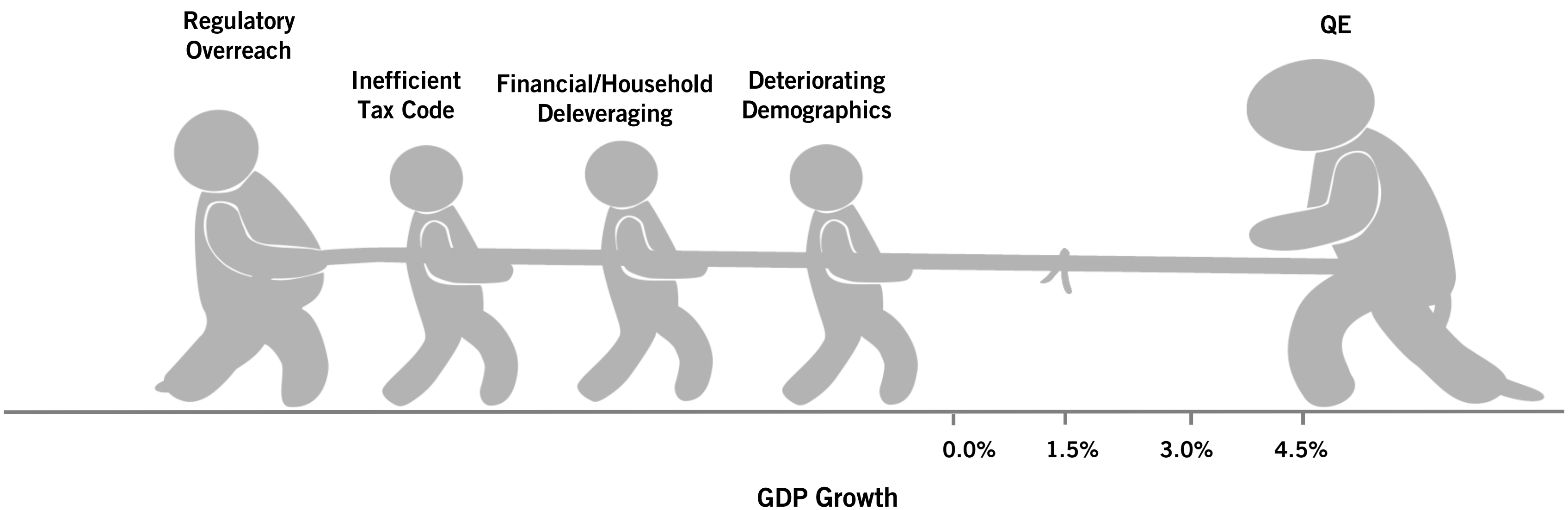
Tug of war pre-Trump



Regulatory overreach, an inefficient tax code, household and financial deleveraging & deteriorating demographics have been holding back the economic activity post-crisis. QE has been the only meaningful offset.

Source: Jefferies,

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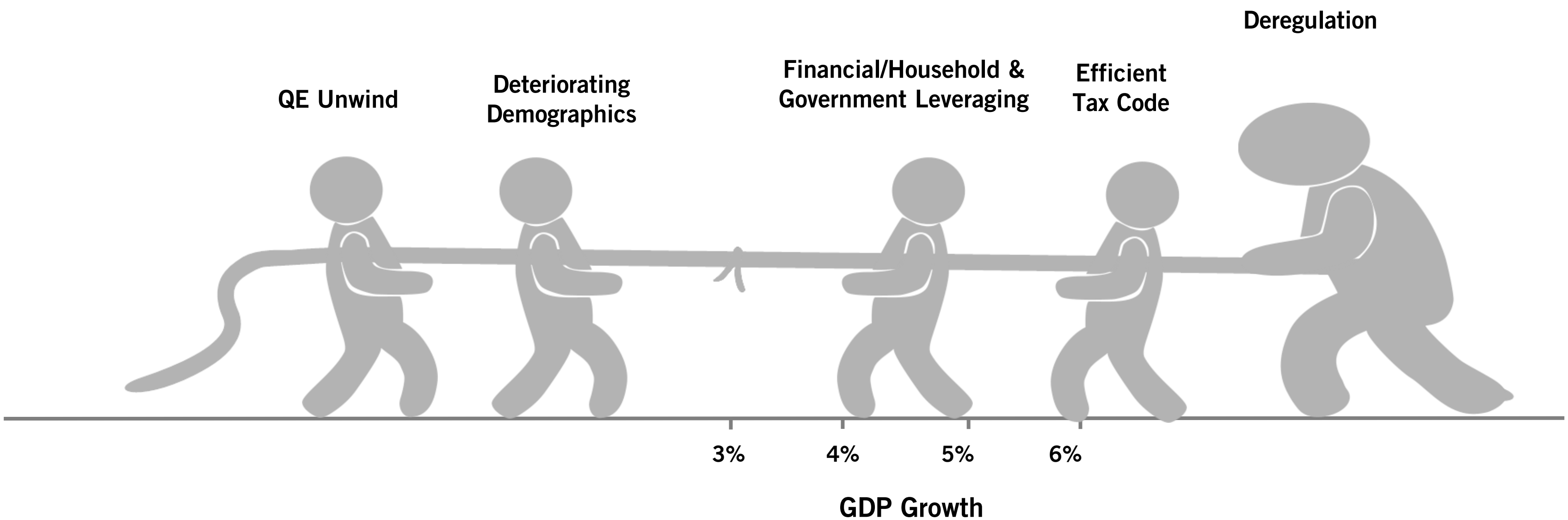
Tug of war post-Trump



Deregulation, lower taxes, and a leveraging of government, household and financial institution balance sheets should easily outweigh a modest reduction in monetary stimulus and poor demographics.

Source: Jefferies

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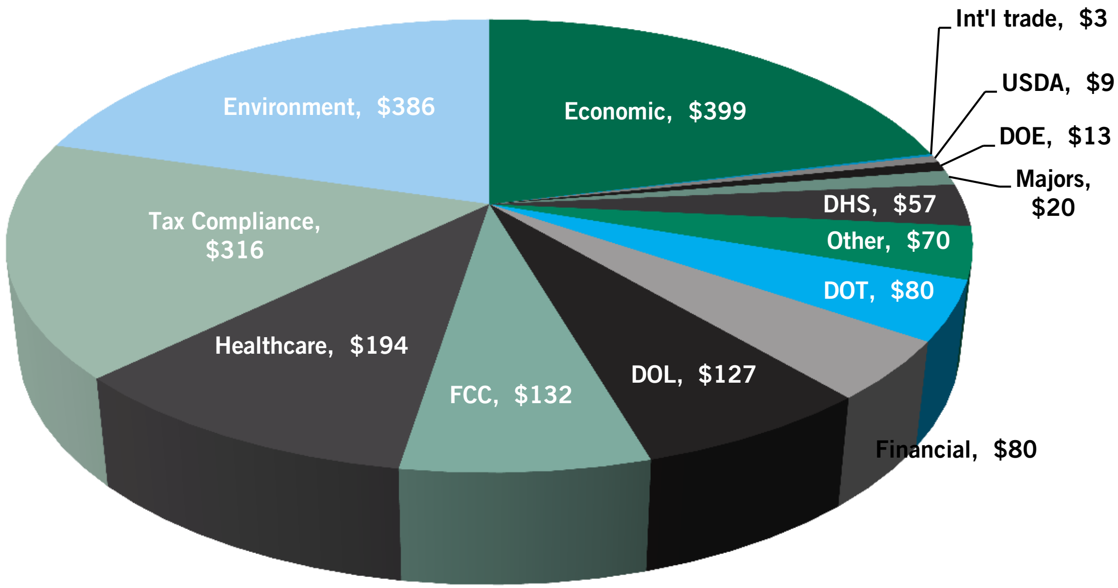
Federal regulation & intervention – YUGE!

2016 Annual Cost Estimate = $1886 Billion



Source: Competitive Enterprise Institute

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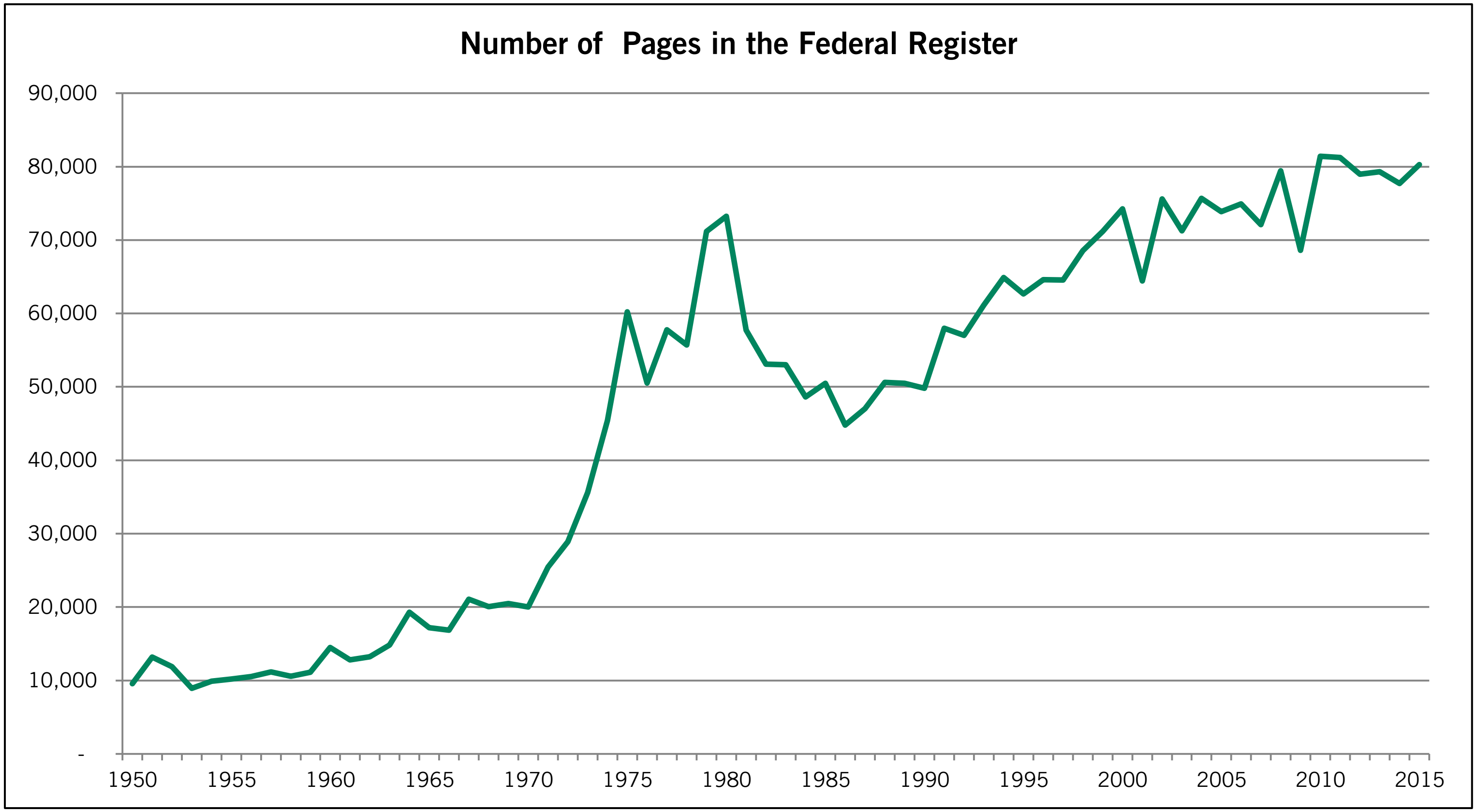
Expanding government overreach.....



Source: US Census Bureau

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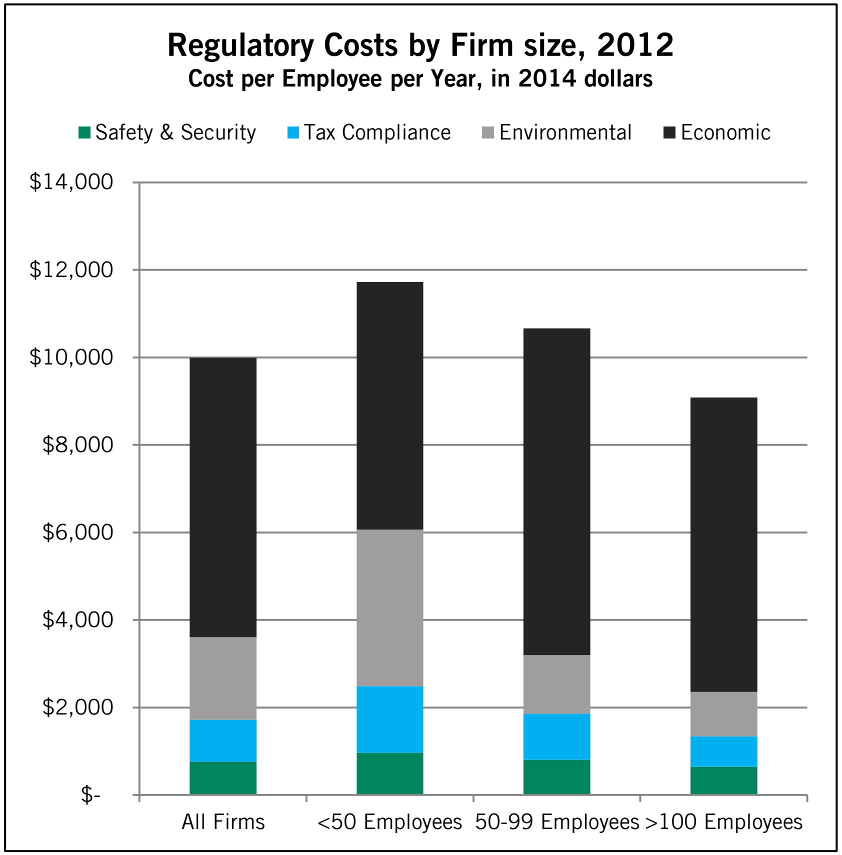
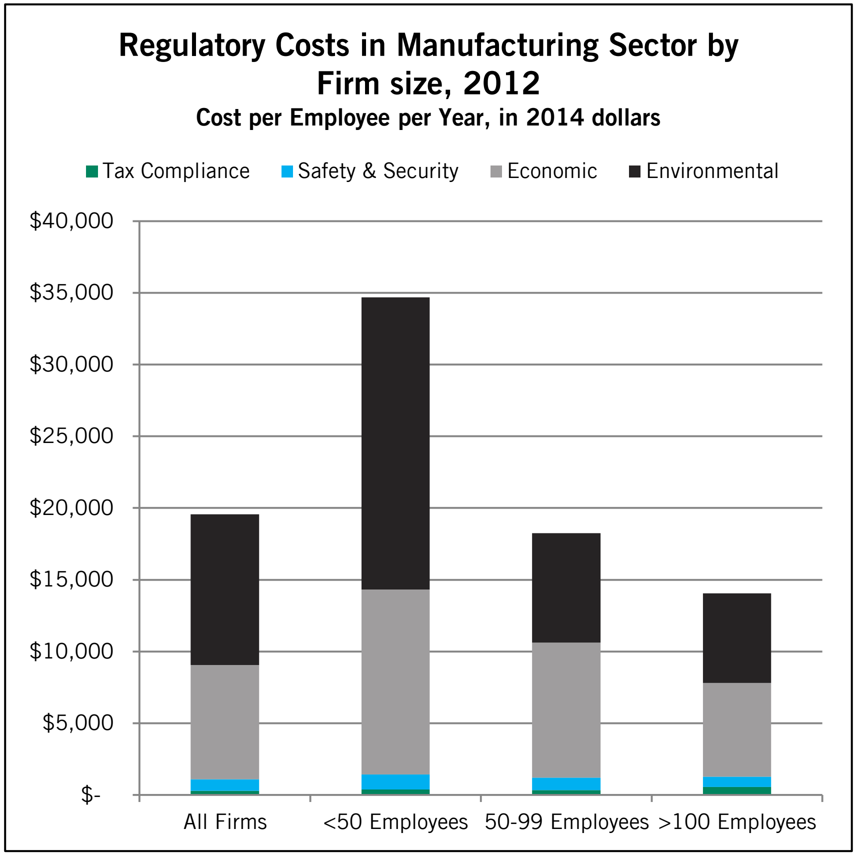
...which is not evenly distributed





Source: National Association of Manufacturers

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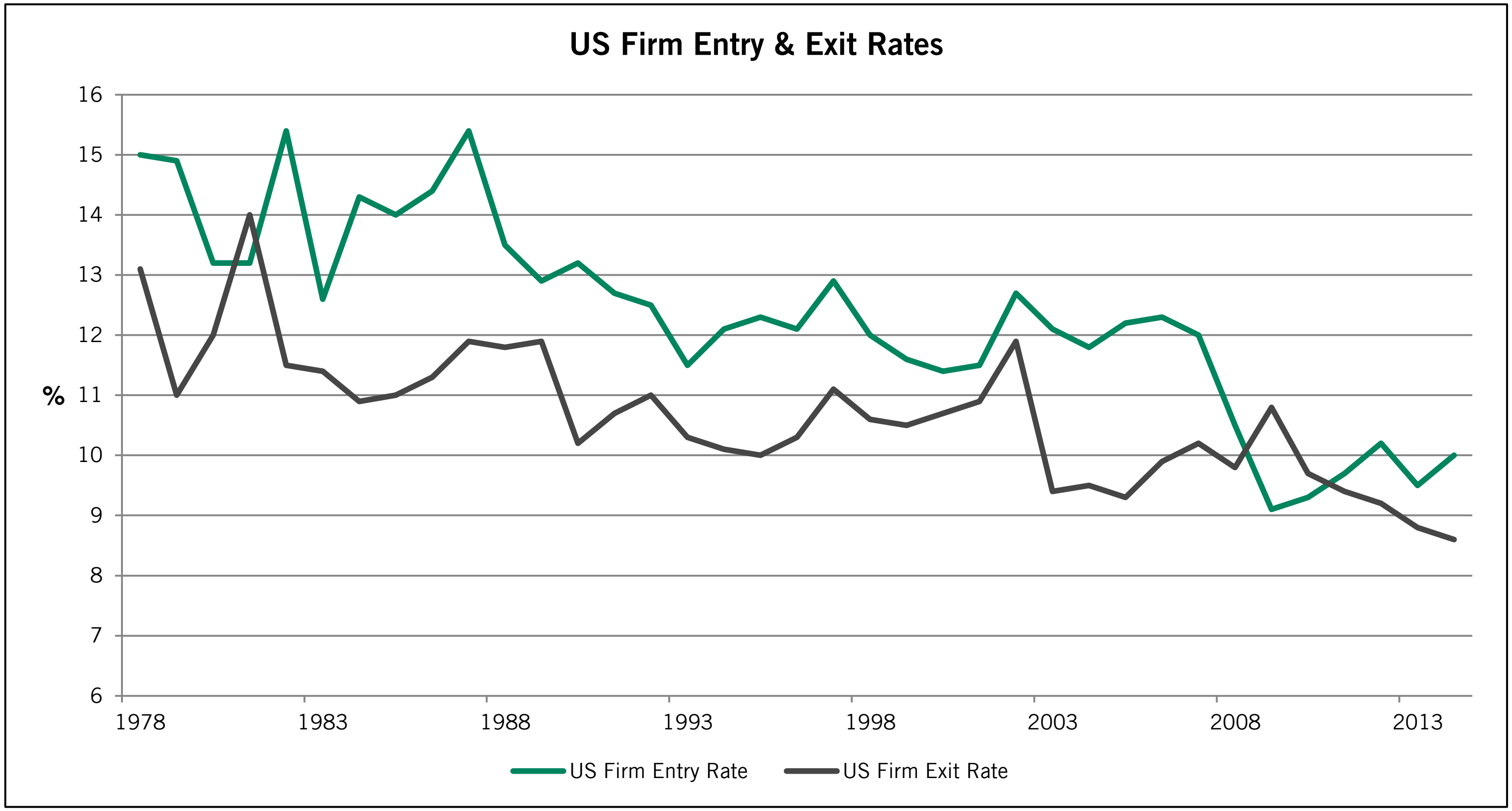
US business expansion - decelerating



Source: US Census Bureau

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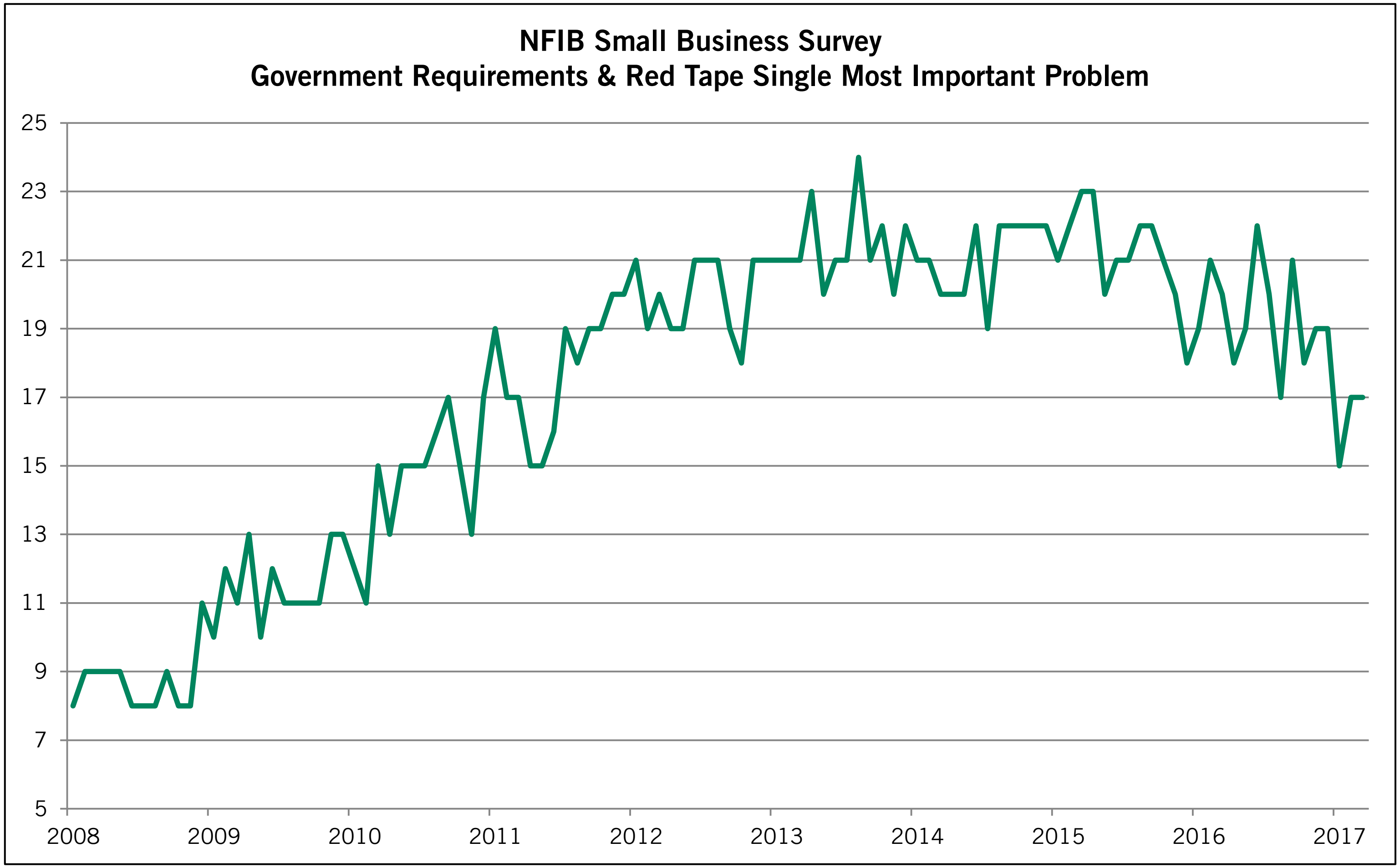
Small business in regulatory pain



Source: Bloomberg

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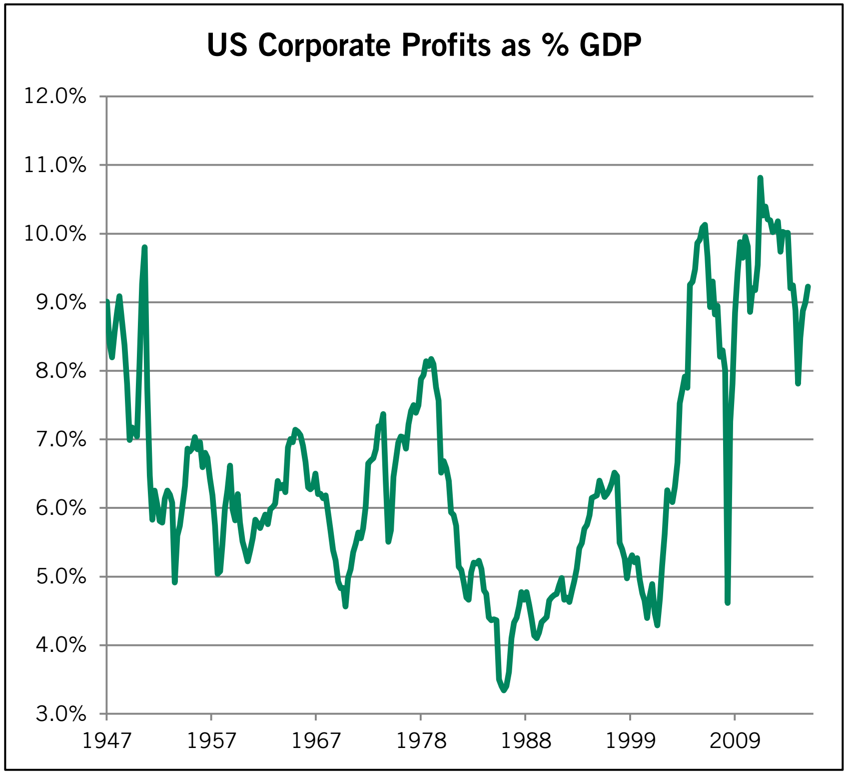
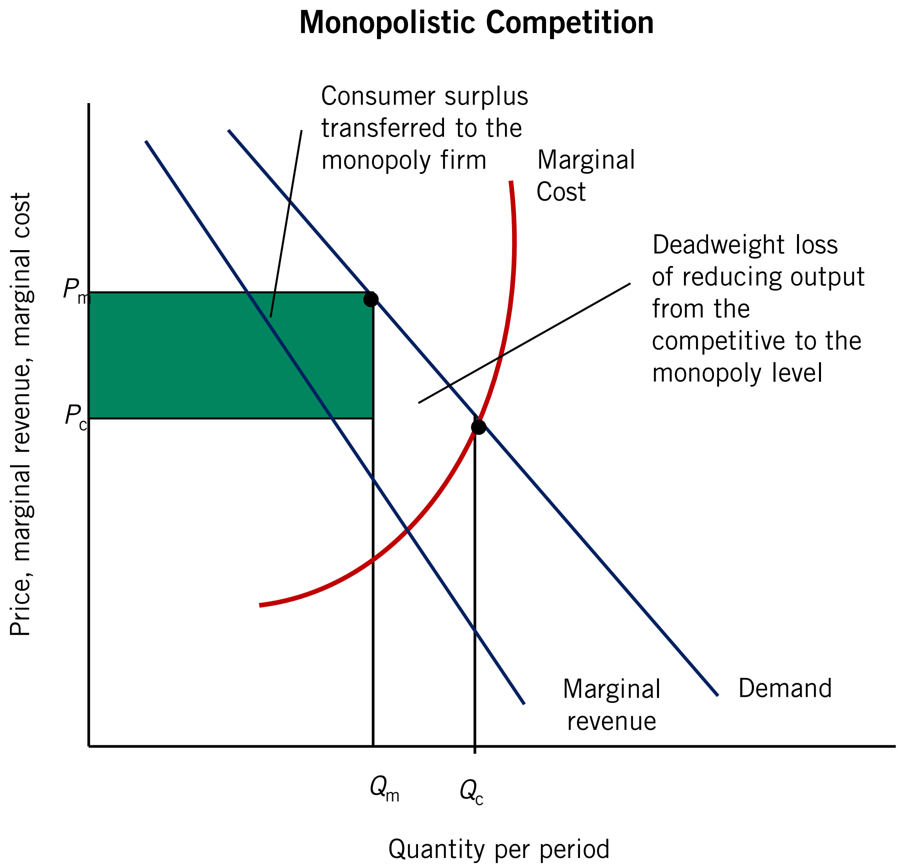
Has regulatory burden stifled competition?? YES!





Source: St. Louis Fed, Flat World Knowledge

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And it has done the same thing to productivity

Source: Bureau of Labor Statistics

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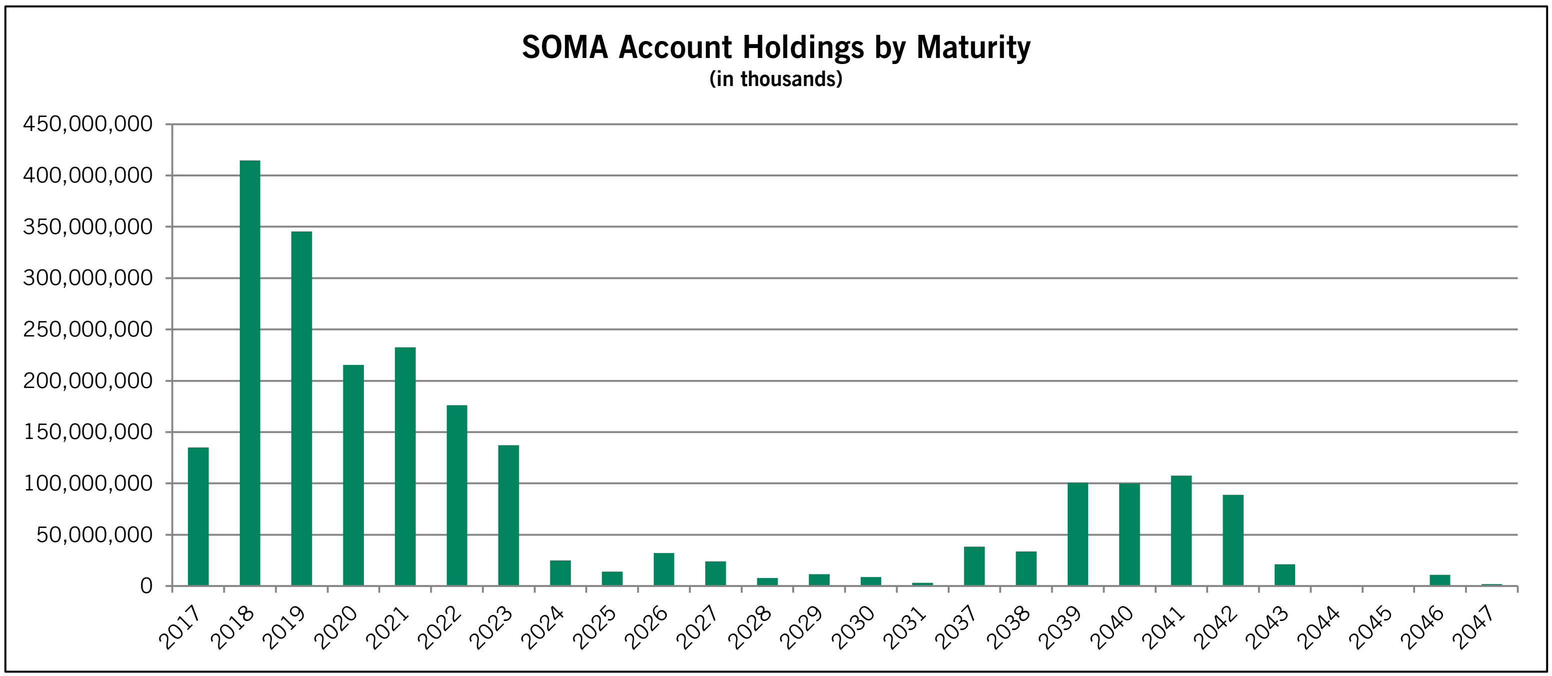
Deregulation + Demonetization

- Fed vs Administration politics could force an aggressive monetary policy countermove to the coming deregulation and fiscal easing
- Balance sheet tapering looks set to begin in 2017
- Large scale deficit spending could start to unhinge longer term rates



Source: NY Federal Reserve

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But significantly higher rates are not a material risk

We have the Honma Accord

A gift from Abe. The Honma 5-star Driver. Retail Price ¥540,000

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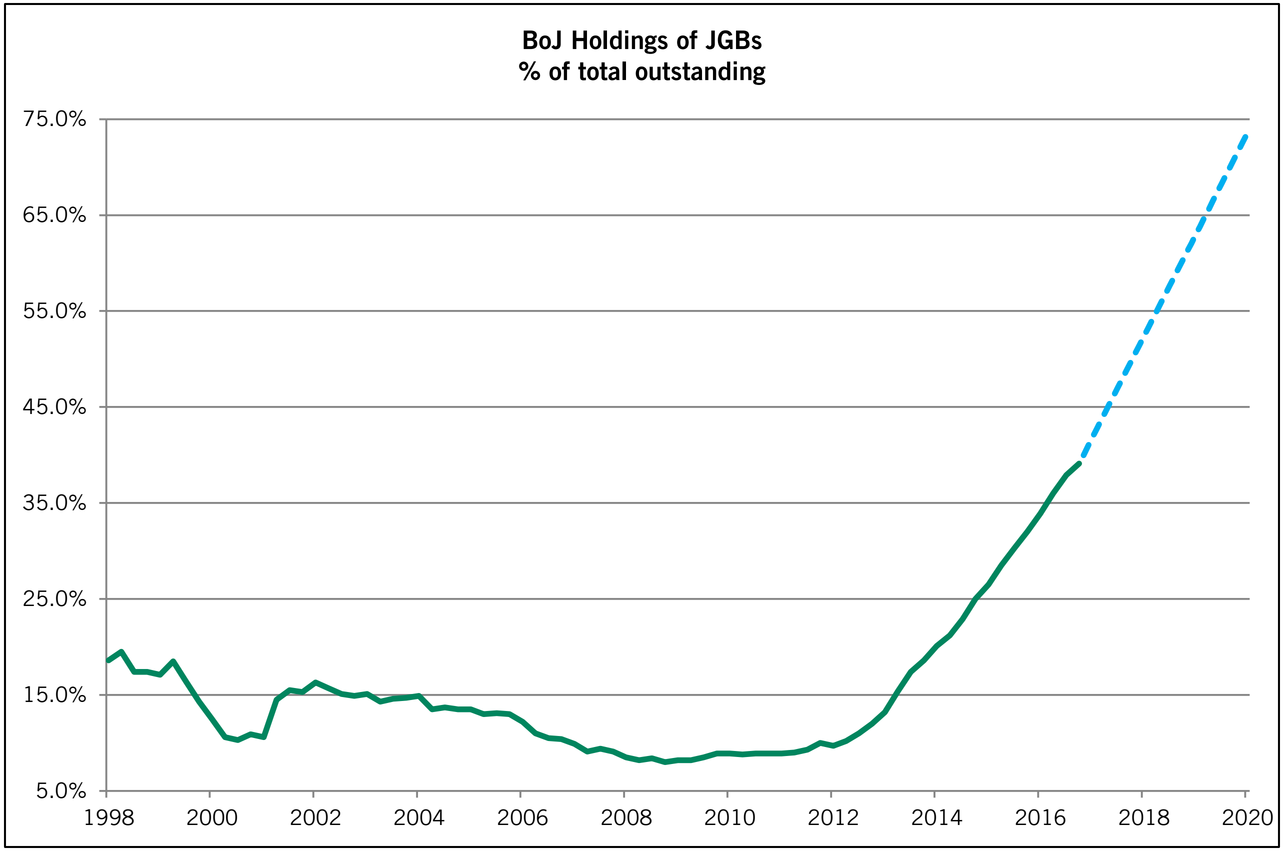
The BoJ yield cap will keep US rates in check



Source: Bloomberg/Jefferies

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This all leads to a Japanese BONDfire of the vanities

Source: Jefferies

Which leaves us with the following trading themes

- Higher US real rates support USD strength
- The Honma Accord supports a weaker JPY
- So....higher USDJPY...125/128 target
- 30y real rates back to 2% – up 100bps from here
- US equites remain tricky – higher expected real returns on capital and higher GDP growth are a positive, but a stronger USD and higher discount rates make outsized gains in equities unlikely. Further, lower regulation and less incumbent firm market power could start to cause corporate profits to decline as a percentage of GDP.
- As for Europe, its sadly all about politics. Our latest thinking suggests the new administration in the US will actually bring Europe closer together. It's a tricky call, but we could easily be looking a European risk-on trade and higher EURJPY by year end.

Source: Jefferies

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