

Inside Washington: A Global Market Perspective



Kevin McCreadie – Economic Summary

The relationship between politics and financial markets is ever-changing, and what transpires in Washington is felt far beyond U.S. borders. The impacts of U.S. fiscal and monetary policy must be considered in making global investment decisions.

How high does the Fed go?

- A decade following the great financial crisis, economic conditions are finally returning to 'normal', with central banks beginning to wind down easing measures and increase interest rates in some regions.
- The U.S. Federal Reserve (Fed) is expected to apply an additional rate hike before year-end, followed by three more in 2018. Telegraphed plans suggest continuation of higher rates until reaching the 3% range.

It's not just the U.S. increasing rates

- The Bank of Canada (BoC) implemented two quick rate hikes in Q2 after leading all G20 economies with the fastest pace of growth over the last three quarters.
 - The BoC has since come off this stance to a degree, now cautioning over NAFTA, currency strength, housing concerns, and other overhanging issues.
 - After spiking over the summer in response to the rate hikes, the Canadian dollar has broken back down in a short timeframe.
- The European Central Bank has also announced that they too will further reduce stimulus in a move towards 'normalized' conditions.

What will impact markets?

- Interest rates: We expect 'normalized rates' to look far different than what history tells us. In previous cycles, this equated to 5% levels, or even higher. Should the Fed pause around 3%, as projected, the economic backdrop would still be considerably accommodative for growth.

- Geopolitics: This is one major risk that cannot be modeled. U.S. relations with the likes of North Korea, Russia, Iran, Mexico, even Canada, could flare up at any time.
- Tax cuts: Have been hanging over the Trump administration for some time, with pressure mounting.
 - If implemented to the extent proposed, could add an estimated \$10 of earnings per share, spurring further market growth.
 - Tax cuts, as well as infrastructure spending, will be necessary sooner than later to help offset the effects of higher interest rates.
 - There is widespread agreement that there will be a significant cut in the top corporate tax rate. This is great news for small-cap companies.

Greg Valliere – The Impact of Politics in Financial Markets

In talks with associates in Washington as well as meetings across North America, six themes have been prevalent.

Could there be failure on tax reform?

- Some concern Corker, McCain and others could vote against what is proposed, but it seems there should be just enough votes for the Republicans to get something done.
- Several amendments are to be expected. Depending to what length, they could delay progress further. Final enactment does not seem likely until late in the winter, at best.

The budget deficit

- Washington has shown little concern over its spending discipline and the upward trajectory of the deficit.
 - And worse, the proposed tax cut could cost US\$1.5 trillion over the next ten years.

Unknowns related to the next Fed Chair

- Expectation is that Janet Yellen will be replaced. The candidate most closely aligned with Yellen's views is Jerome Powell, who is said to be one of Trump's finalists for the role.
- John Taylor has also emerged as a leading candidate. Taylor, an economics professor, has bluntly expressed his view that the Fed has been too accommodative and would threaten a faster pace of rate hikes.
- The Fed has increasingly become consensus-orientated, so regardless of who assumes the position going forward, a dramatic spike in rates is not expected. Still, anyone other than Yellen represents unknown risk to some degree.

NAFTA: Could the U.S. be careening towards trade protectionism?

- With little progress made thus far, there is increased concern that the U.S. may eventually pull out of the NAFTA deal as originally threatened.
- President Trump could view ending the agreement as means to improve his favourability amongst those negatively impacted by free trade deals.

Political noise

- Trump's Twitter outbursts have continued, both internally towards fellow GOP members as well as a variety of other public figures.
- Positively, markets have displayed an ability to remove noise from fundamentals, though there is no certainty this will continue.

Threat of a geopolitical incident

- Chance of an all-out war is still fairly slim, yet Trump may be boxing himself into a corner.
 - Trump has threatened a response should North Korea keep pushing. If they continue to do so, inaction from Trump could be viewed as an empty threat, while at the same time, declaring war seems like something the U.S. does not want to engage in.
- While most media attention has turned toward disputes with North Korea, tensions with Iran are brewing
 - The U.S. is attempting to end the Iran Nuclear deal, and relations will likely be hostile for some time.



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Greg Valliere is the Chief Political Strategist at Horizon Investments and has nearly 40 years of experience following Washington issues for institutional and retail investors. He also is widely quoted in U.S. media. Greg specializes in coverage of the Federal Reserve, tax and spending issues, and – of course – politics.

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