

THIS MONTH'S TOPIC

Estimating the impact of US fiscal policy on growth, fixed-income markets and the dollar

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The essential

US fiscal policy raises many questions about its impact (on the economy, on monetary policy, on long-term interest rates, the dollar and more generally the US fixed income market). The US authorities have indeed decided to stimulate an economy that is close to full employment, something that has never been seen in American history. This will boost growth and inflation (in the short term) and at the same time lead to an increase in bond supply, just as the Fed is raising its key rates and reducing the size of its balance sheet. We return here to the different scenarios that can be considered on public spending. Ultimately, we find that the economic impact will be substantial but temporary and that it (1) it will have a limited impact on the yield curve, (2) a mixed on credit and (3) could ultimately weigh on the USD.

Introduction

After the Tax Cuts and Jobs Act of 2017 (TCJA), a major tax overhaul approved just before the end of the year that introduced significant tax cuts for both individuals and corporations, in early February the U.S. Administration passed the Bipartisan Budget Act of 2018 (Budget Act) that would add increased government spending on top of the fiscal stimulus. Immediately after, the White House presented the President's Fiscal Year Budget 2019 (President's Budget) further pushing, among other actions, for increased infrastructure spending. All these measures would add upside risks to our base case economic projections for growth and inflation for which we provide estimates herein.

The policy mix, in brief

The TCJA is estimated to add approximately \$1.456 trillion to the budget in the 2018-2027 decade (or \$1.071 trillion, after taking into account the expected positive macroeconomic effects); the Federal deficit would increase by \$136bn and \$280bn respectively in 2018 and 2019 (\$104bn and \$246bn when dynamically scored)¹.

The Budget Act is estimated to add approximately \$60bn and \$140bn to the deficit in 2018 and 2019, respectively (CBO assumptions), due to a widening gap between revenues and spending and increased appropriations caps².

The President's Budget, which was drawn up before the Budget Act and released with an Addendum to take into account some discrepancies in domestic spending that Congress authorised with the Budget Act, would, among other provisions, promote another key topic of the presidential campaign – the Infrastructure plan. Despite much debate and criticism, including by the President himself, the plan is a cornerstone of the Trump administration's budget and, if the President's intentions come to fruition, should lead to \$200bn in federal spending over the next 10 years to be matched by other private and public funds, in order to total the promised \$1.5 trillion. The Budget Act already earmarks approximately \$20bn in total for 2018-2019, half of the amount of federal spending included in the President's budget³.

¹ <https://www.jct.gov/publications.html?func=startdown&id=5055>

² <https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/bipartisanbudgetactof2018.pdf>

³ <https://www.whitehouse.gov/wp-content/uploads/2018/02/budget-fy2019.pdf>

Estimating the macroeconomic impact

Base Scenario: On the macro front, we have already priced into our base case the estimated impact of the TCJA. Thanks to the support provided to corporate profits and consumers' disposable income and some increase in government discretionary spending (which we already anticipated would materialise independently from the Budget Act), growth is expected to remain above potential for the next eight quarters, thus lifting core inflation up to the Fed's target. A gradual removal of monetary policy accommodation from the U.S. Federal Reserve would inform careful management of the economic impact, without moving into overtightening and at the same time avoiding overheating. In this context, we expect growth to average 2.7% on an annual basis in 2018, with CPI at 2.3% and Core PCE at 1.8% on average.

Table 1 / **Assumed scenarios for Government Spending**

USD Billions						
Additional Spending on Baseline Govt. Expenditure	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	Total (2018/2023)
Scenario 1 Estimated Outlays by CBO	56	171	64	15	5	310
Scenario 2 Estimated Full Authorizations	143	153				296
Scenario 3 Estimated Authorizations + Infrastructure	193	203				396

Source: CBO, Amundi Macroeconomic Research

Assessing Risks: In order to estimate the risks to our economic outlook posed by the implementation of the two additional measures (Budget Act and Infrastructure Plan from the President's Budget), we assessed the impact of different government spending scenarios through our economic model.

- The selected scenarios range from a gradual implementation over a few years, in line with the CBO estimates (Scenario 1), to a more aggressive pace of implementation (concentrated in 2018 and 2019), where the full appropriations are spent in 2018 and 2019 (Scenario 2); finally, in Scenario 3 we add a partial implementation of the infrastructure plan. For 2018, the three scenarios represent increasing levels of expenditure and therefore allow us to estimate a range of macroeconomic responses.

Among the three scenarios, we attribute the highest probability (70%) to Scenario 1, while we equally weight the likelihood of Scenarios 2 and 3 (15%).

Table 2 details the estimated impact on growth and allows for comparison with the base scenario.

Table 2 / **Impact on economic projections**

US Macroeconomic Forecast		base scenario		scenario 1 ex ante		scenario 2 ex ante		scenario 3 ex ante		scenario 1 feedback	
CY	2017	2018	2019	2018	2019	2018	2019	2018	2019	2018	2019
Q4/Q4	2.5	2.5	2.3	2.9	2.4	3.1	2.3	3.3	2.3	2.7	2.4
GDP & Components											
GDP (QoQ Ann)	2.3	2.7	2.2	2.9	2.4	3.1	2.5	3.2	2.6	2.8	2.4
Personal Consumption Expenditures	2.8	2.6	2.4	2.7	2.6	2.9	2.7	2.9	2.6	2.7	2.6
Government Consumption Expenditures	0.1	1.4	1.7	2.2	3.2	3.6	3.3	4.0	3.3	2.2	3.2
Fixed Investment	4.1	4.8	2.7	4.8	2.0	4.5	1.8	4.5	1.7	4.4	1.8
Non residential	4.7	5.6	3.1	5.5	2.4	5.2	2.1	5.1	2.0	5.0	2.2
Residential	1.7	2.0	1.0	2.0	0.4	2.1	0.3	2.1	0.3	1.8	0.1
Exports	3.4	4.6	4.2	4.3	4.0	4.2	3.9	4.2	3.9	4.8	4.3
Imports	3.9	4.9	3.4	5.0	3.6	5.4	3.7	5.5	3.7	4.5	3.5
GDP Contributions											
Net trade	-0.2	-0.2	0.0	-0.3	-0.1	-0.4	-0.1	-0.4	-0.1	-0.1	0.0
Inventories changes	-0.1	0.0	-0.2	0.1	-0.2	0.1	-0.1	0.1	0.0	-0.1	-0.2
Trend Variables (YoY average)											
Consumer Prices Index	2.1	2.3	2.2	2.5	2.2	2.6	2.2	2.6	2.2	2.5	2.2
Core PCE	1.5	1.8	1.9	1.9	2.0	2.0	2.0	2.0	2.1	1.8	2.0
Nominal GDP	4.4	5.0	4.4	5.4	4.5	5.6	4.6	5.7	4.8	5.3	4.6

Included in the forecasts: changes from the Fiscal Bill Approved by the US Congress in December 2017.

As expected, increased government spending would further support growth by boosting domestic demand, likely generating supply-side adjustments; as resource utilisation moves higher prompting further tightening of the labour market, the path of inflation is lifted as the economy keeps growing above potential. However, while domestic demand and GDP are supported by incremental government expenditure, the underlying growth drivers (consumption, investment and the trade balance) show changing dynamics as we move through the three scenarios.

With reference to Scenario 1, we also computed the feedback impact or “ex post” effects when interest rates, exchange rates and the equity market reprice according to the new economic and deficit projections. Rising interest rates and a depreciating dollar would somewhat moderate the upside on growth, while they would have a lesser offsetting effect on the upside inflation risk (due to weaker USD impact).

But all that glitters is not gold: increased widening of the Federal Revenues vs. Expenditure gap, with little offsetting from improved growth dynamics, is likely to lead to a wider federal budget deficit (estimated to exceed 5% of GDP in 2019). Stronger domestic demand could increase imports significantly, thus widening the trade balance deficit. The removal of monetary policy accommodation via balance sheet normalisation, plus the increase in target rates in a context of rising inflation, would lift long-term interest rates, increasing debt service costs; the current account balance would suffer as well.

Some of these consequences are already being seen in the revival on the twin-deficit theme, which is expected to remain a hot topic in the months to come.

Estimating the impact on fixed-income markets and on the dollar

To assess the impact of tax reform and the potential infrastructure spending plan on the markets, we have to take into account two important factors: (1) the end of global QE and (2) the lag between the US cycle and the rest of the world.

I - The end of global QE will change the landscape of the fixed-income market in the coming years

Since the financial crisis, developed market (DM) central banks have provided substantial support to the fixed-income market through two important channels:

(1.) Unconventional monetary policies. These measures have aimed to stimulate activity and inflation in a context where key rates were close to their low limit and have consisted of bank loans and, more specifically, asset purchase programmes. Especially:

- **The major central banks have aggressively bought government bonds.** A large part of the public debt is now held by the central banks of these countries: the United States (20% or \$2.432 trillion), Europe (20% or €1.913 trillion) and Japan (30% or JPY 10.46 trillion).
- **The ECB has also become a major player in the Euro Corporate bond market.**

(2.) The “global search for yield”. Monetary policies have contributed significantly to pushing sovereign bond yields down, especially in Europe and Japan where negative rates were used to stabilise the economy. The United States was the first to emerge from the crisis and raise key rates. The US fixed-income market has since been considered as an oasis in this yield desert. 10% of all debt is still negative yielding. The result:

- **Strong demand for US assets by foreigners and domestic investors.** USD corporate securities held by foreign residents have increased by 45% since 2012 and foreign investors currently account for 40% of the USD corporate bond market.
- **Strong demand for Investment Grade products.** Investors motivated by the search for yield have treated IG corporate bonds as a rate product.

In this low inflation and very accommodative monetary policy environment, corporate bond spreads and sovereign yields tightened to near record low levels. The trade-weighted dollar jumped 25% between 2014 and 2016.

2018 marked a turning point as the global economy is enjoying a significant synchronised upswing allowing DM central banks to pull back collectively.

(1.) In the United States, the Fed has begun to gradually reduce the size of its balance sheet by not reinvesting some of the securities that are maturing in addition to its cycle of rate increases.

(2.) In the euro zone, we expect the ECB to end its QE next September. The ECB is already buying assets at a rate of €30bn per month, which is half that of 2017.

(3.) In Japan, the BoJ's balance sheet continues to increase but at a slower pace. In practice, purchases are now around 50trillion yen annually compared to 80 trillion previously.

The peak of liquidity is behind us. The size of the Fed, ECB and BoJ balance sheets will increase +\$220bn this year versus \$1.1tr in 2017, \$1.5tr in 2016 and \$1.2tr in 2015. Fed is reducing its portfolio while the ECB and BoJ are still increasing it. At a global level, net issue volumes of government bonds will no longer be absorbed by central bank purchases as was the case in the last three years.

The upswing in global growth expectations and the reduction in the accommodative stance in monetary policy has already led to an increase in Fed funds expectations, a rise in sovereign bond yields, some outflows on the corporate bond market and a decline in the trade-weighted dollar.

II- What impact will there be on rates, the dollar and credit?

Rates: rates could move around 3%, not as much could be expected from a steepening.

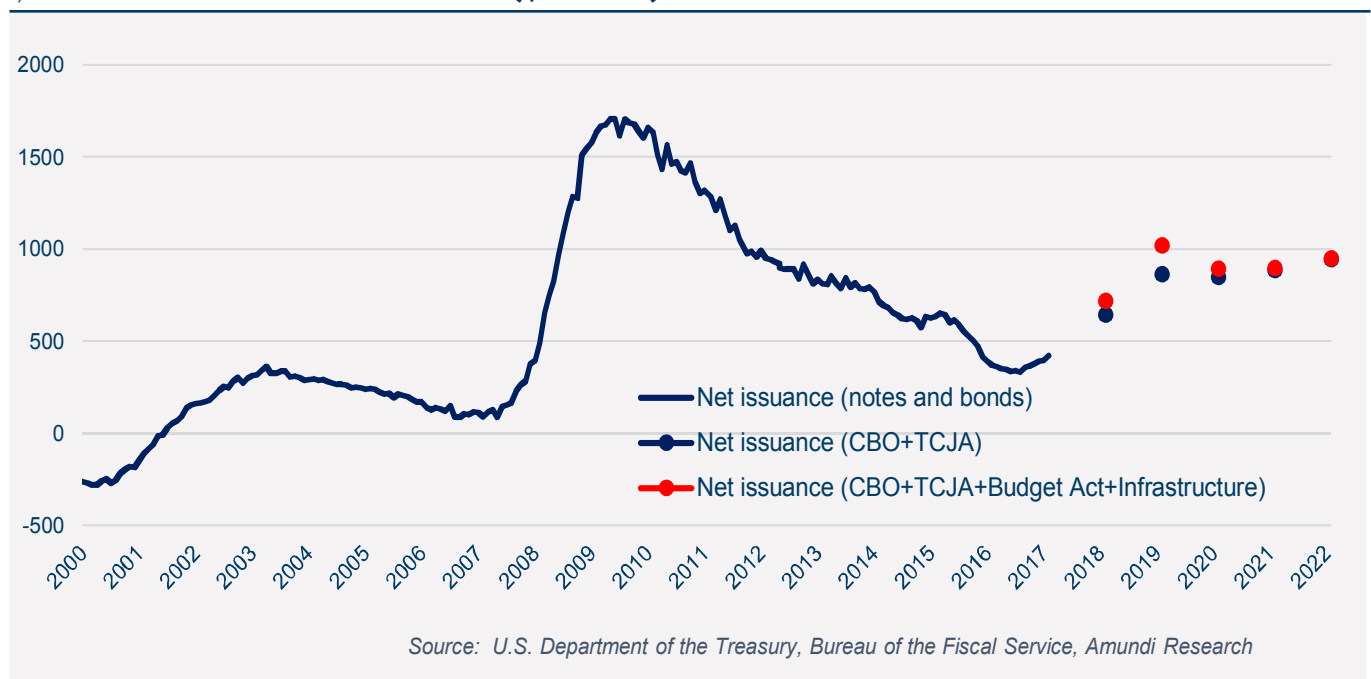
The increased deficit projections in the budget pose questions on how funding needs are going to evolve in the US over the next few years. The tax reform approved at the end of last year (TCJA) would increase the net issuance of long-term treasuries to about \$649bn in 2018 and \$867bn in 2019. If enacted, such a scenario would have to be increased with the inclusion of the Budget Act effect and the infrastructure plan, which would lift the net issuance to \$724bn in 2018 and \$1022bn in 2019. The aforementioned set of projections include the Fed's SOMA redemptions, according to the official schedule, and Amundi's estimates.

(1.) Despite being a considerable increase relative to the 2016-2017 figures, **non-Fed investors have been able to absorb similar amounts in the recent past** (i.e. net purchases by non-Fed investors accounted for \$1 trillion in 2012).

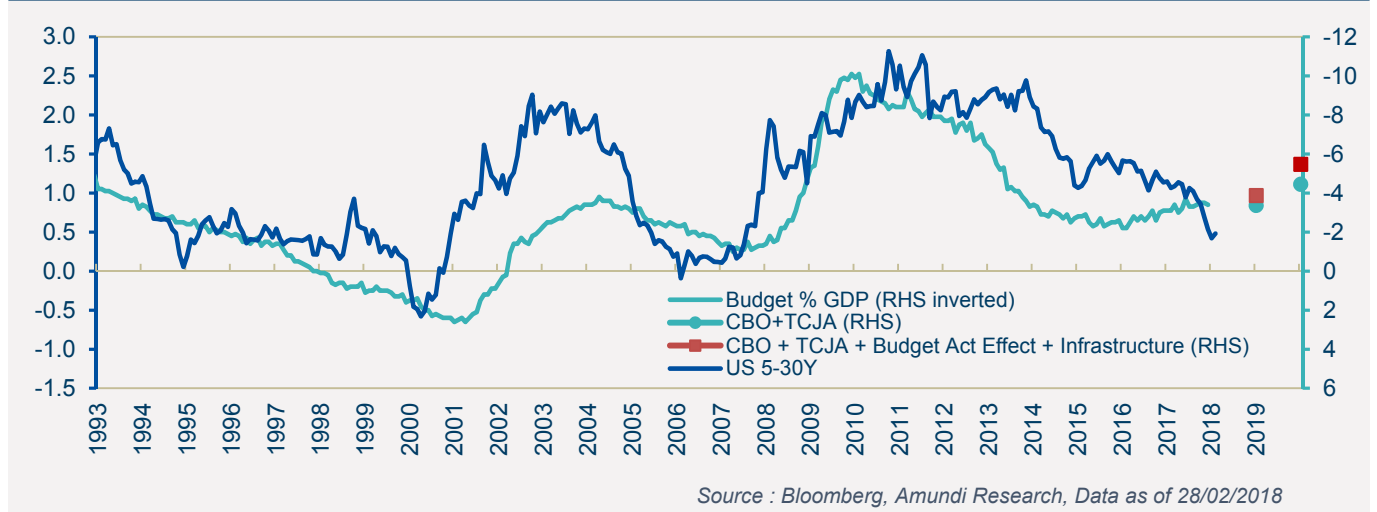
(2.) **Historically the US curve has steepened on increasing budget deficits, as the back end tends to price in a higher term premium.** A scenario that accounts for the TCJA would indeed imply a deficit on GDP of -3.36% in 2018 and -4.45% in 2019, which could generate steepening pressures, all other things equal.

(3.) A caveat to the above is that this time around the increase in the deficit is happening at the unusual time of a late-cycle phase, while the FED is normalising rates. Therefore, **the steepening effect could be mitigated by the sell-off of the front-end** which would continue to price in additional tightening from the Central Bank.

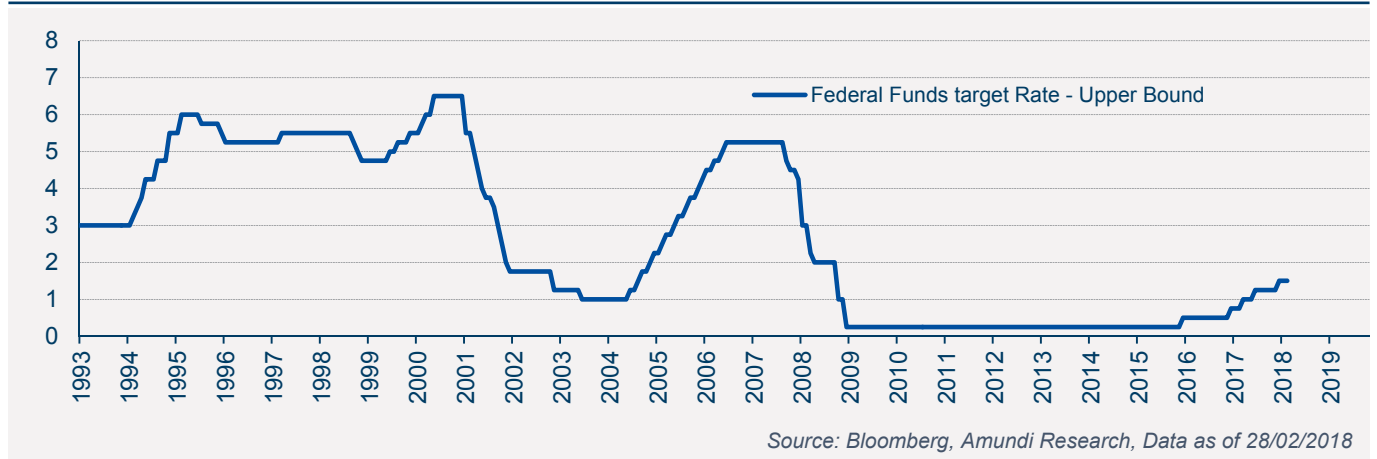
1/ Net Issuance of Notes and Bonds (\$ billions)



2/ **US Deficit on GDP vs Interest Rates Curve**

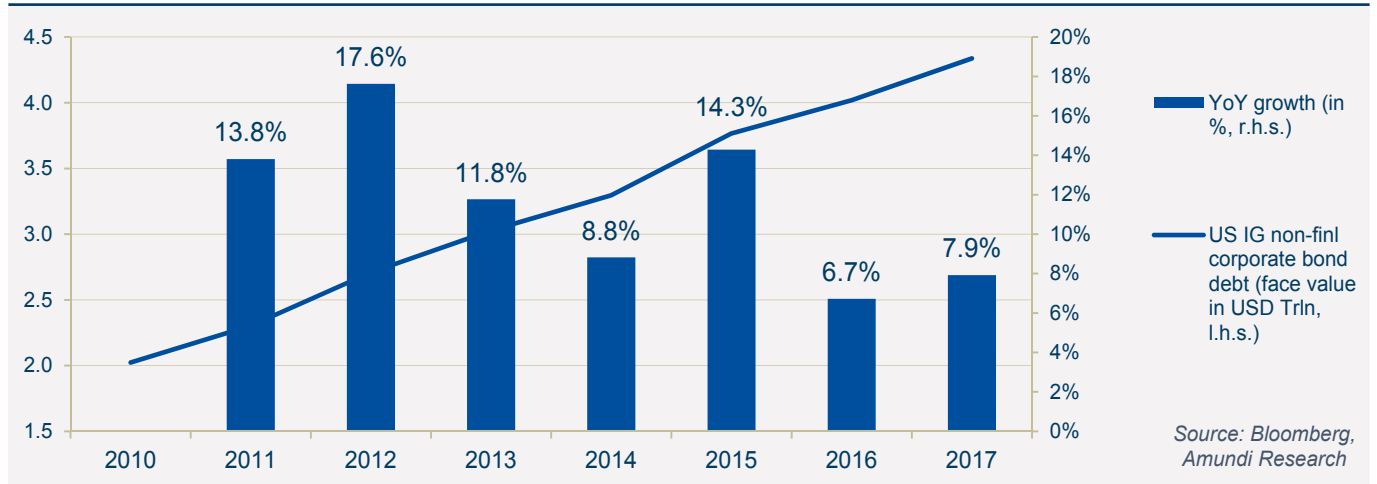


3/ **Fed funds**

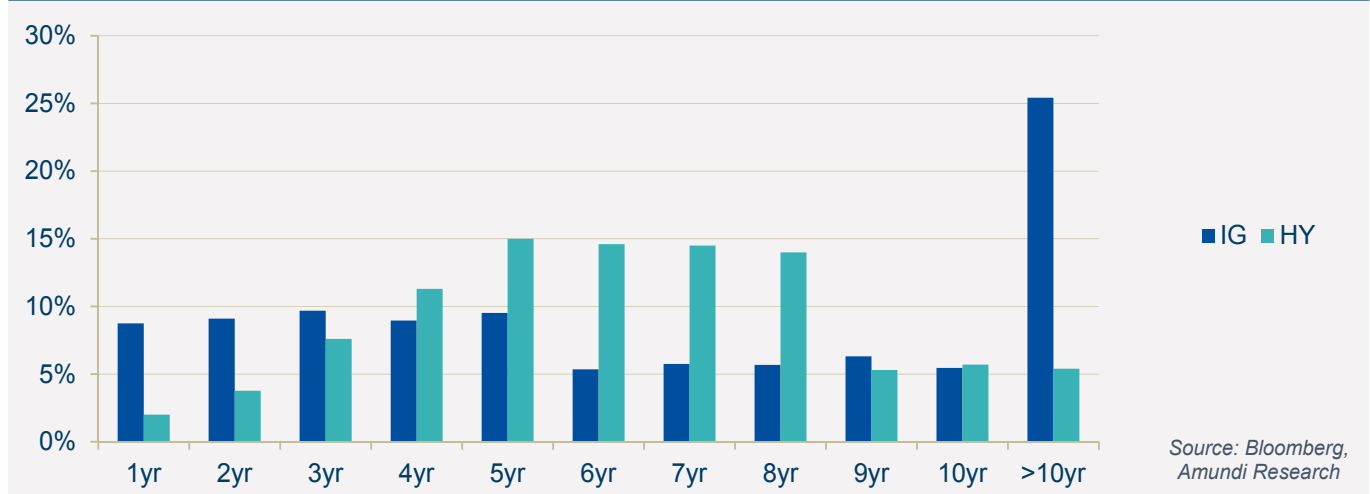


Credit: improving fundamentals but technical aspects seem more challenging in the medium term. The fundamentals are improving thanks to the global economic upswing and a more cautious stance by businesses. Leverage at US companies is stabilising or even decreasing in some cases. This trend is likely to improve further on the back of the tax reform. Higher revenues and profits are going to be coupled with a more limited use of debt financing among funding channels.

4/ **The size of the US market has doubled over the last years**



5/ No wall of maturities



However, the technical aspects seem more challenging in the medium term. After years of low funding needs and high investor appetite, leverage at US companies is near record highs. The refinancing needs of US companies will increase significantly in the coming years. At the same time:

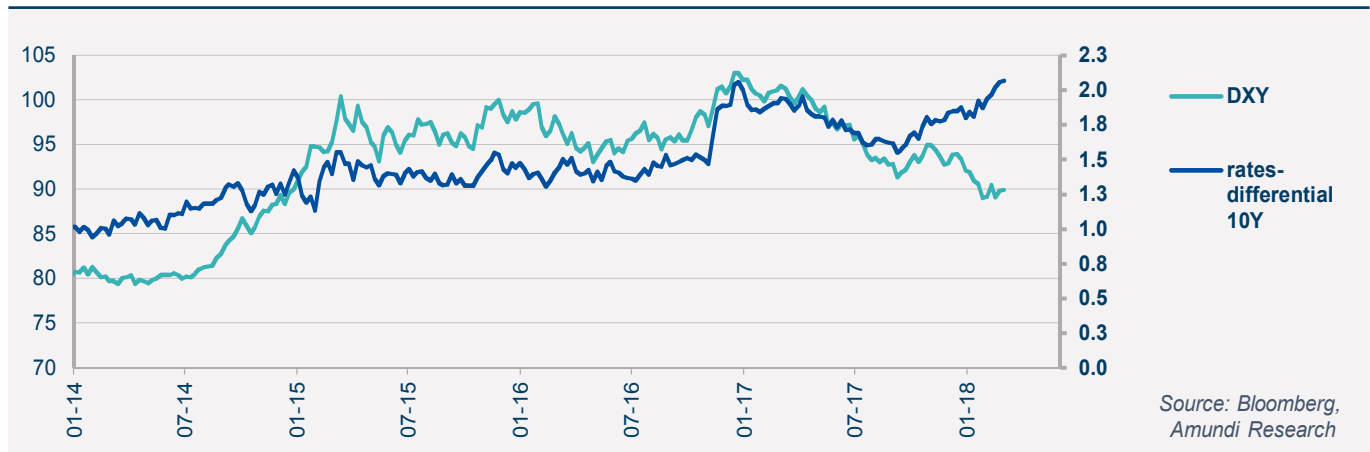
- The growing net supply by the public sector could cause a potential “crowding effect”.
- The need to search for yield may become less apparent if Treasury bond yields continue to move north, finally becoming relatively more attractive vs. corporates, and if in the coming years larger oases appear in the deserts of yield in other jurisdictions on the back of normalising monetary policy.

We remain confident on US IG credit. In the short term, positive factors should keep supply from re-accelerating: cash repatriation, lower M&A and share buyback spending. Challenges on both the technical and fundamental sides seem to be further out than 2018. The risks remain tilted towards higher inflation/higher bond yields and their effects on re-allocation from credit into govies and/or equities.

USD - Growth differential is key

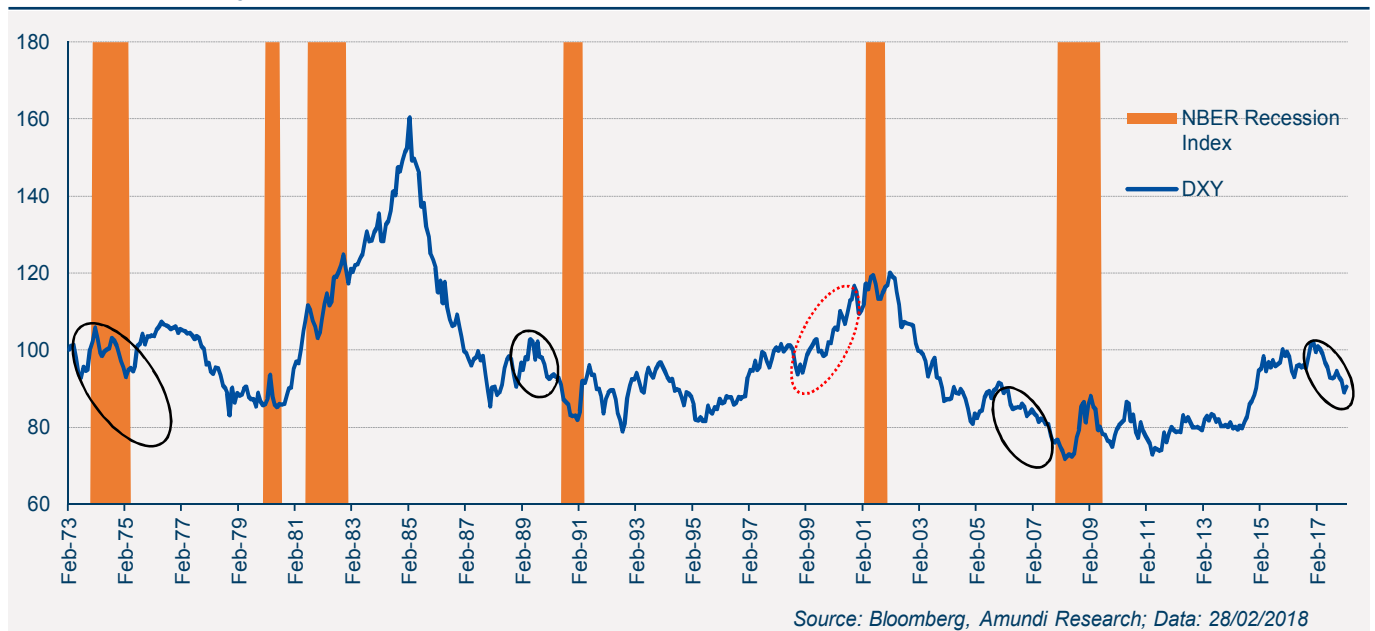
In 2017, the dollar was down 10% against all currencies and has lost 2% since January. This depreciation has even been more pronounced against the euro. This is surprising because the spread between US and European rates continues to grow. The gap at 2 years is 260bp and at 200bp for 10 years. Historically, the USD and the 10y rate spread have been positively correlated (see graph). So, what has happened?

6/ DXY-10Y rates differential



(1.) **The growth differential is no longer in favour of the US.** The global economy is experiencing a recovery, and growth in Japan and Europe in particular has been revised upwards much more strongly than in the United States, which is instead in the last phase of its cycle. Monetary policy surprises may come more from Europe or Japan than from the United States. Central banks other than the Fed are currently on the path to monetary policy normalisation. Thus, a downward correction of the USD was expected, given the strong appreciation the currency went through in 2014-2016.

7/ **DXY and US cycle**



(2.) Regarding the technicals, we note that the cross-currency basis has widened, therefore investing in US Treasuries (on a hedged basis) is not attractive for Japanese or European investors as the dollar hedge is expensive. Moreover, the flattened curve in the US has not helped to keep US Treasuries attractive. It is very interesting to note that the amount of US Treasuries held by foreigners has fallen again since the end of 2017.

(3.) **Financing the new fiscal stimulus may drag down the dollar.** While it has been argued that the current dollar weakness could be related to the US “twin deficits”, the correlation between higher twin deficits and USD weakness is difficult to prove. This could be explained by the peculiarity of the dollar in its role as the largest reserve currency and a safe haven investment. However, investors are now concerned about the major impact of a large fiscal boost so late in the US cycle, which could lead to increasing inflationary pressures and an aggressive response from the Fed.

2018 marked a turning point. The global economy is experiencing a significant synchronized upswing allowing DM central banks to pull back collectively at different speed. The peak of liquidity is behind us. The technical factors of the Fixed Income market will be less supportive in the coming years. In this context, the large US fiscal boost and infrastructure spending plans raise question. Indeed, a fiscal stimulus is completely unusual at the late phase of the cycle. **We expect the tax reform:**

- **To have a positive impact at macro levels.** We revised our US growth and inflation forecasts upward (Real GDP growth :2.7% for 2018 and 2.2% for 2019; Inflation CPI: 2.3% 2018 and 2.2% 2019). We do not expect this plan to result in significant inflationary pressure that will force the Fed to raise rates drastically.
- **To have a limited impact on the US curve.** Historically the US curve has steepened on increasing budget deficits, as the back end tends to price in a higher term premium. But the steepening effect could be mitigated by the sell-off of the front-end.
- **To have a mitigated impact on credit.** The technical aspects seem more challenging in the medium term but the fundamentals are improving thanks to the global economic upswing.
- **To weigh on the dollar.** But we think that the evolution of the dollar will remain guided by interest rate differentials. If we expect no significant change in the Fed’s rate hike path, monetary policy surprises may come more from Europe or Japan than from the United States.

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