

The Changing of the Guard

Examining the effects of a rapidly changing landscape

February 2017

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NORTHERN TRUST

THEMES

Animal Spirits

- Optimism in the Face of Uncertainty

Fuzzy Math

- Policy Ambition vs. Budget Discipline

The Trials and Tribulations of Trade

- Does “America First” Mean Closing Borders?

Voice of Reason

- Central Banks and Economic Stability

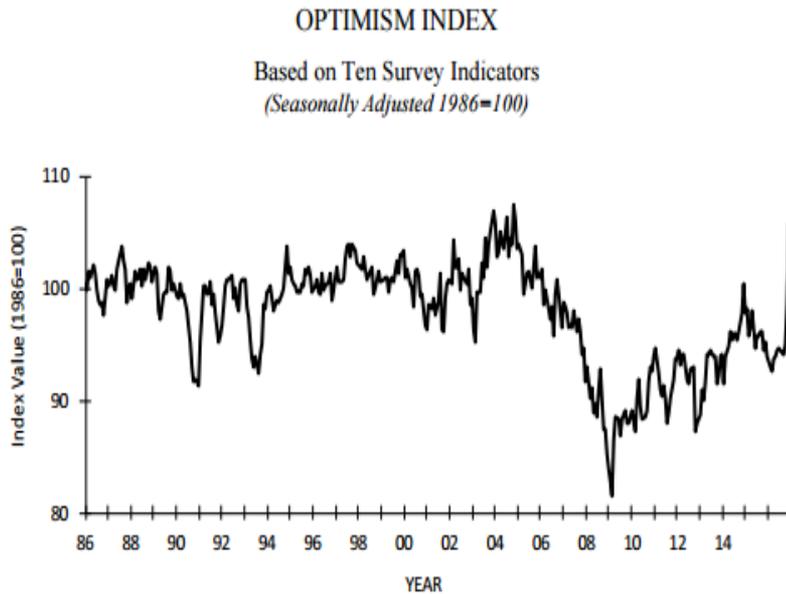
Keeping Calm And Carrying On



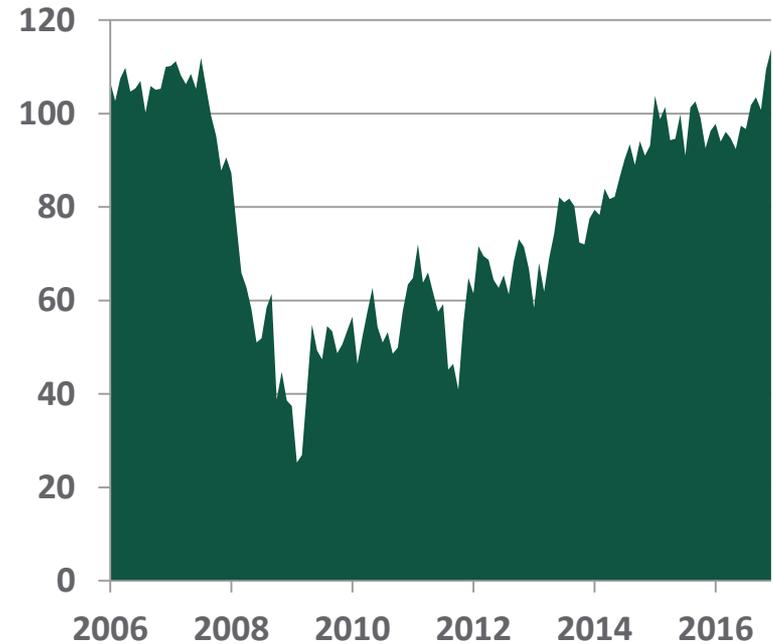
LOOKING UP

- *Business and consumer confidence have soared since the election*
- *Sentiment does not always presage economic trends*

OVERVIEW - SMALL BUSINESS OPTIMISM



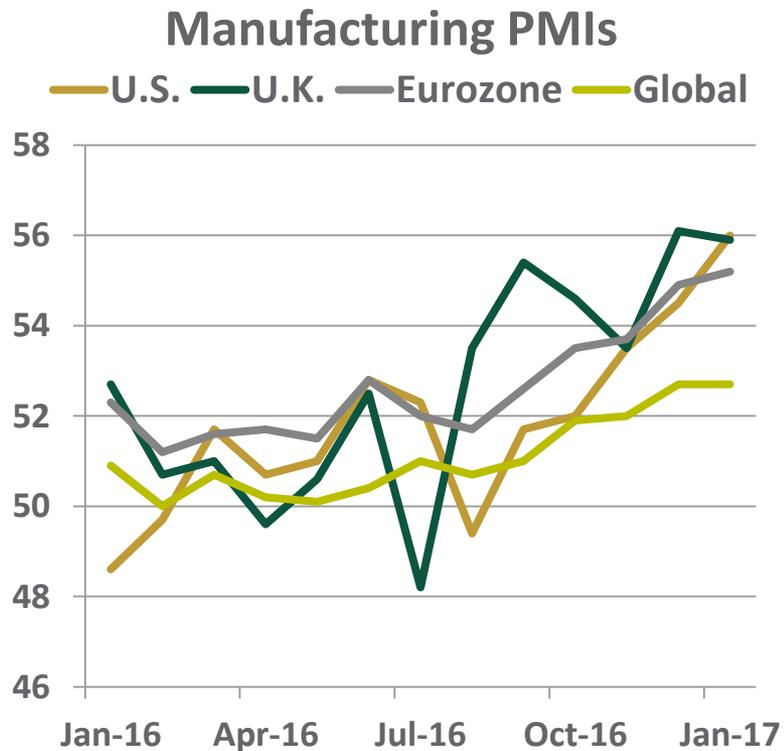
Consumer Confidence



Sources: NFIB, Conference Board

GAINING MOMENTUM

- *Leading indicators are heading up*
- *Incoming data is surprising on the up-side*



Source: Bloomberg

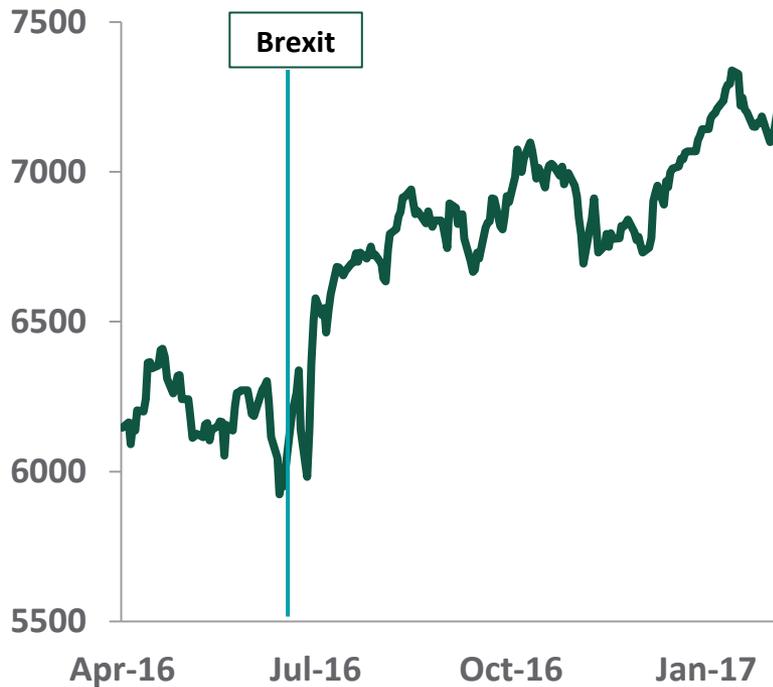


Source: Citigroup, Morgan Stanley Research

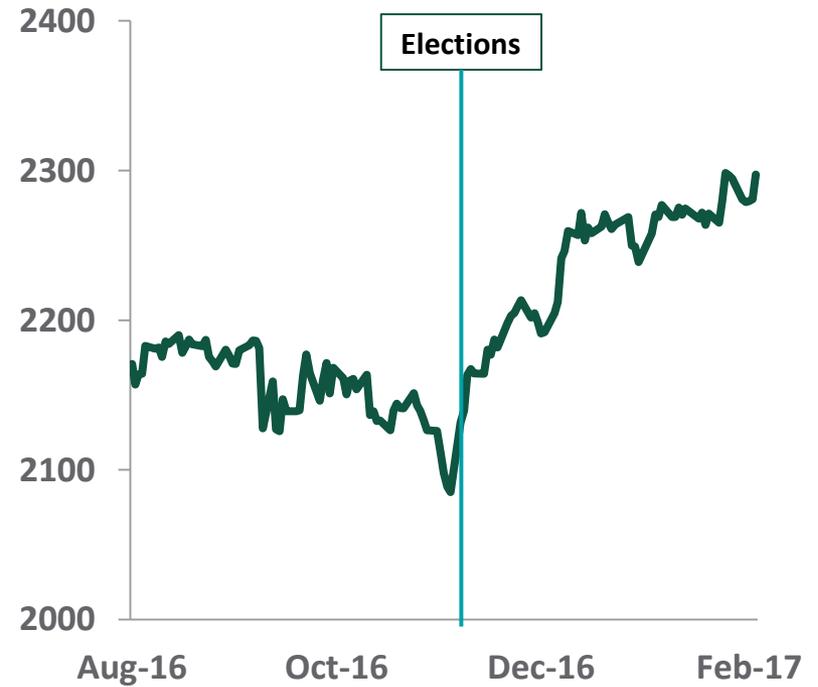
EQUITY ECSTASY

- *Despite dire predictions, equities have moved ahead to record levels!*

UK: Stock Price Index



US: S&P 500

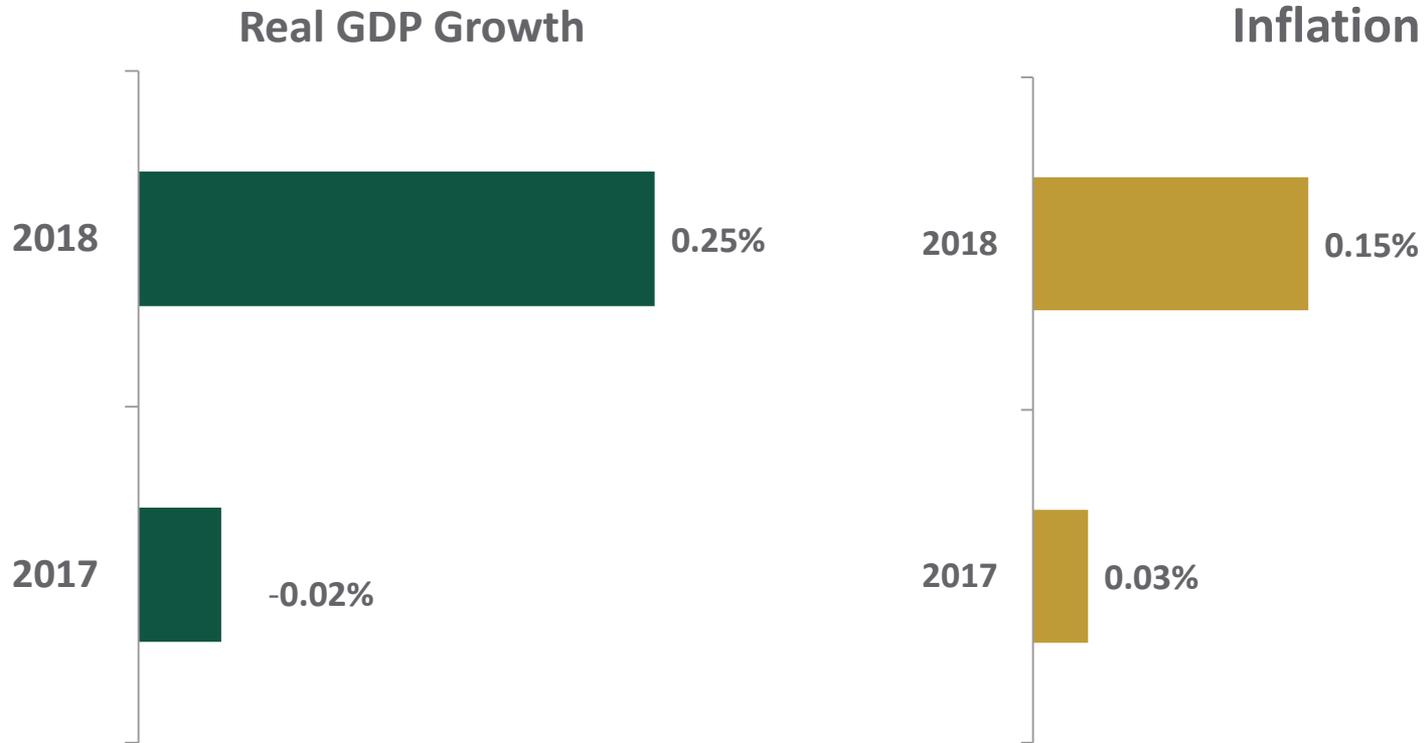


Source: Bloomberg

POST-ELECTION FORECAST REVISIONS

WALL STREET JOURNAL SURVEY

- *Few are expecting a significant lift from fiscal policy*
- *The feedback loops could be significant*

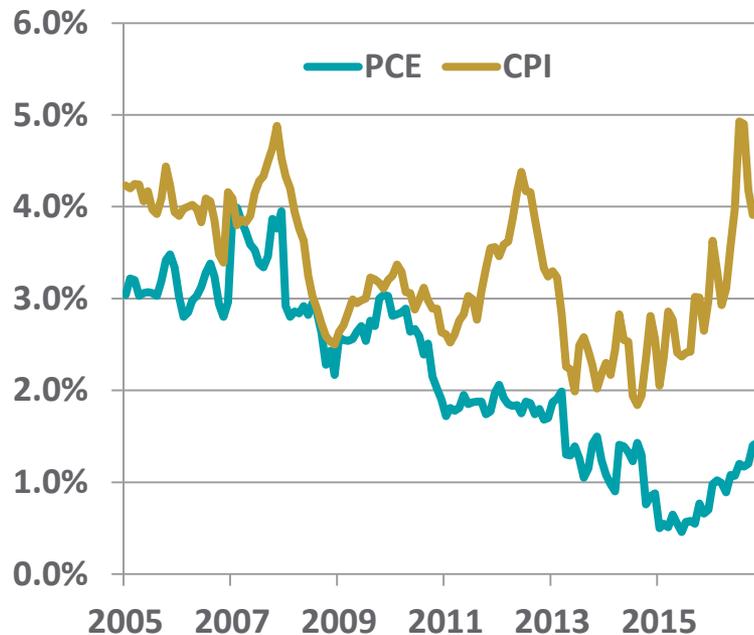


Fuzzy Math

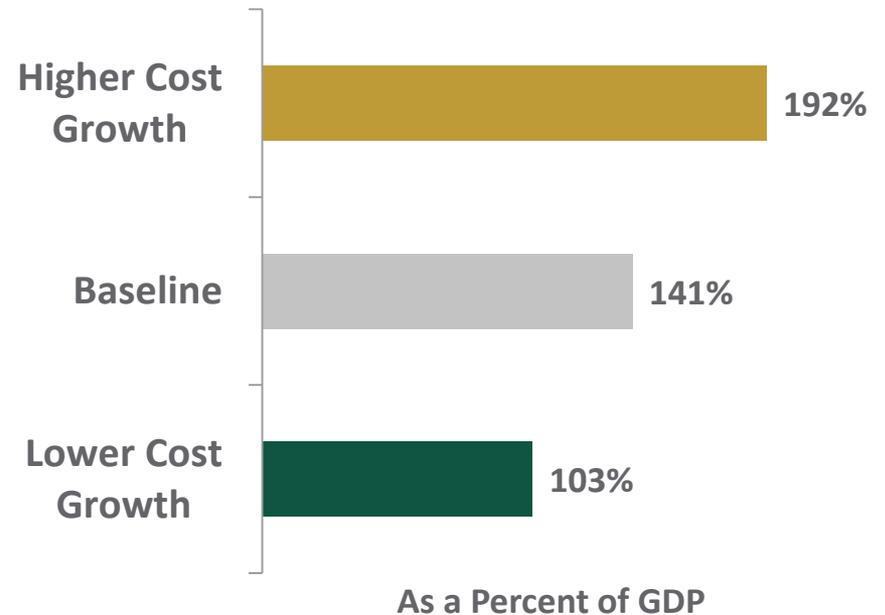
BENDING THE CURVE

- *Health care costs are rising more rapidly*
- *Sustaining cost discipline is critical*

U.S. Health Care Inflation



U.S. Federal Debt in 2045 Given Alternative Paths of Medicare Costs

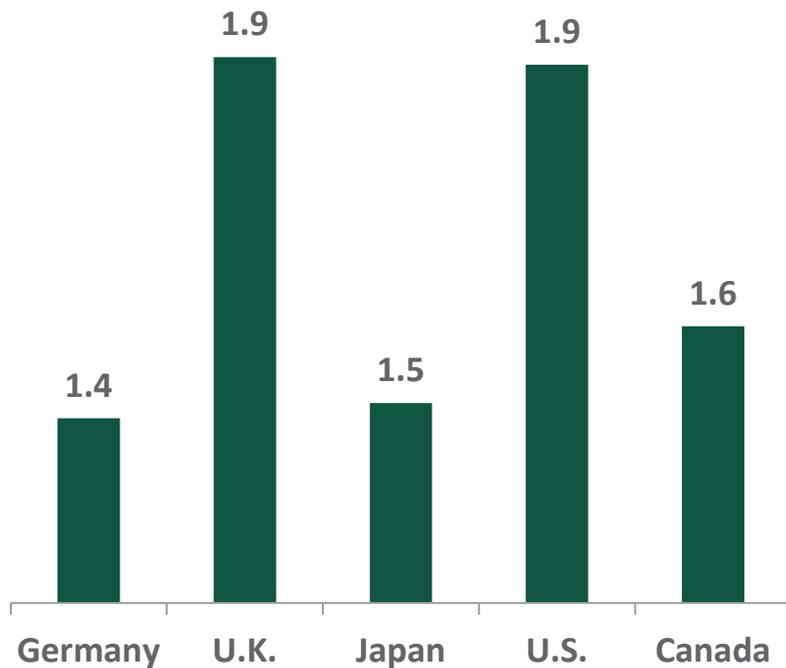


Sources: Haver Analytics, Congressional Budget Office

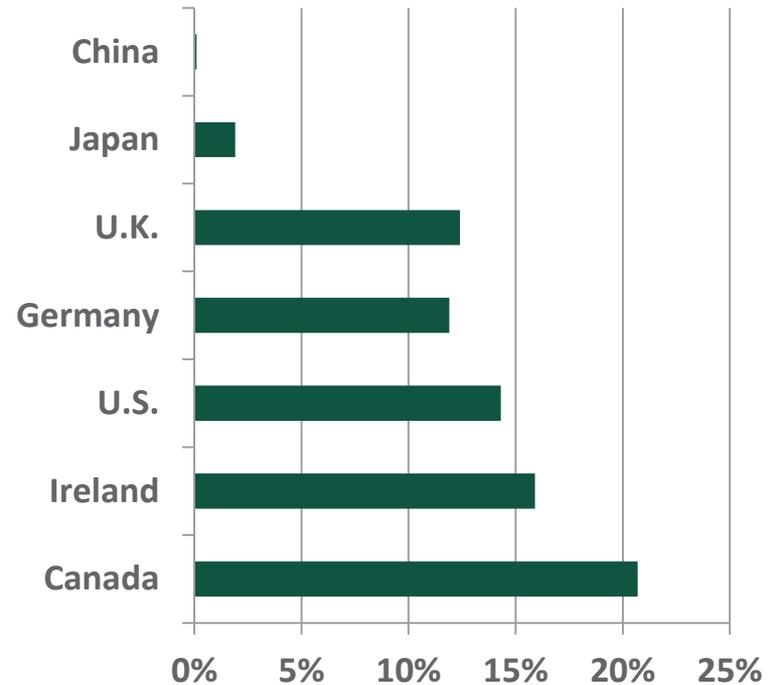
SUSTAINING POPULATION

- *Promoting fertility rarely works*
- *Accepting new entrants successfully is key*

Fertility Rates Per Woman, 2015



Immigrant Population, 2013

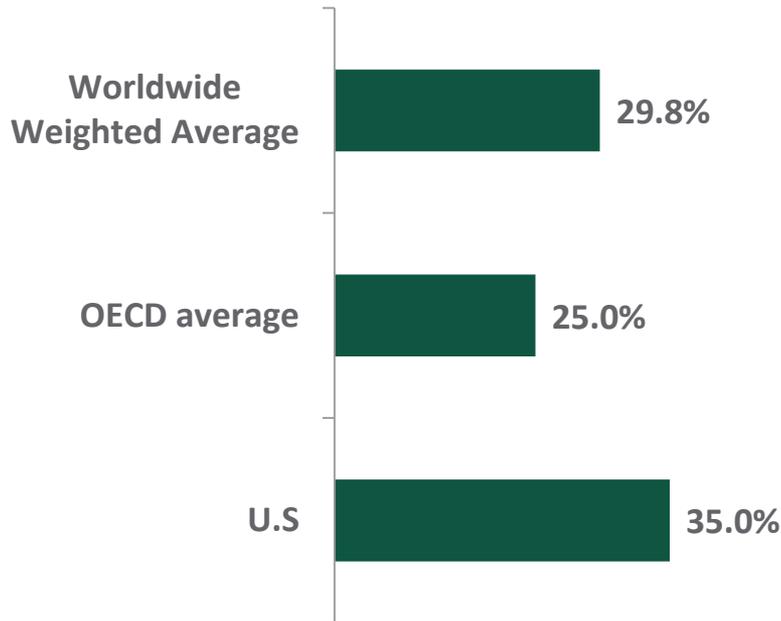


Sources: CIA, United Nations

REVENUE REFORMS

- *Corporate tax rates push activity away*
- *Individual reform may be too complicated to complete*

Corporate Tax Rates



Source: Haver Analytics

HOUSE GOP SIMPLIFIED TAX REFORM PROPOSAL

SIMPLE, FAIR "POSTCARD" TAX FILING

1	Wage and compensation income	1	
2	Add 1/2 of investment income	2	
3	Subtract contributions to specified savings plans	3	
4	Subtract standard deduction OR	4	
5	Subtract mortgage interest deduction	5	
6	Subtract charitable contribution deduction	6	
7	Taxable income	7	
8	Preliminary tax (from tax table)	8	
9	Subtract child credit	9	
10	Subtract earned income credit	10	
11	Subtract higher education credit	11	
12	Total tax	12	
13	Subtract taxes withheld	13	
14	Refund due / taxes owed	14	

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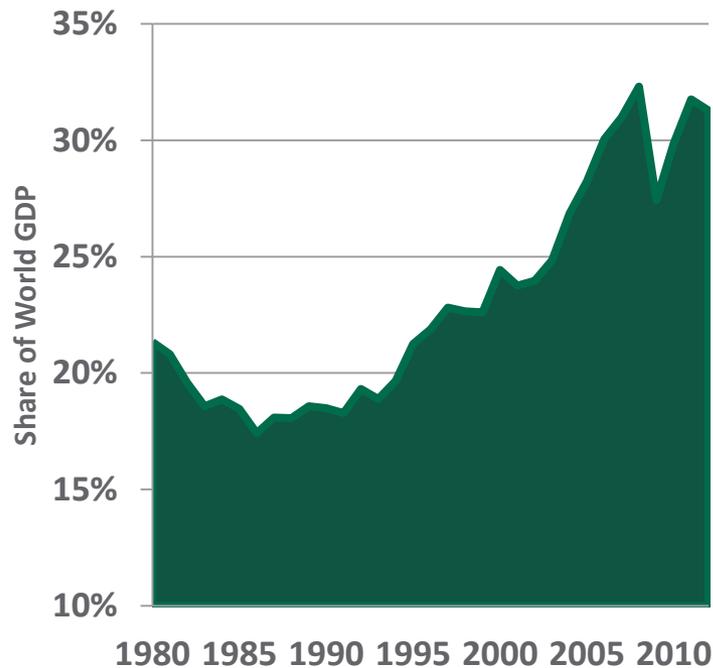
Source: House Ways & Means 'A Better Way Forward' Tax Proposal

Boundary Conditions

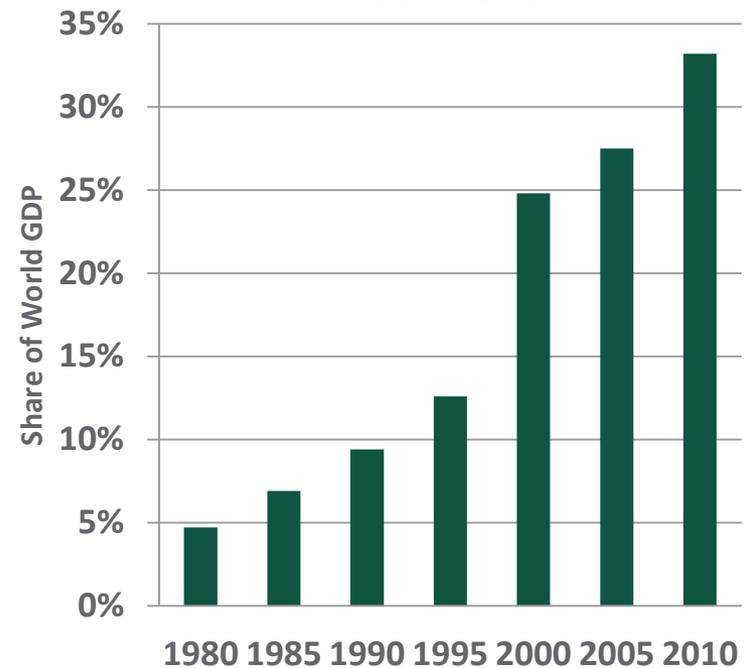
TRADE

- *Free trade and open markets bring important benefits*
- *More adjustment assistance for those who are displaced?*

World Exports



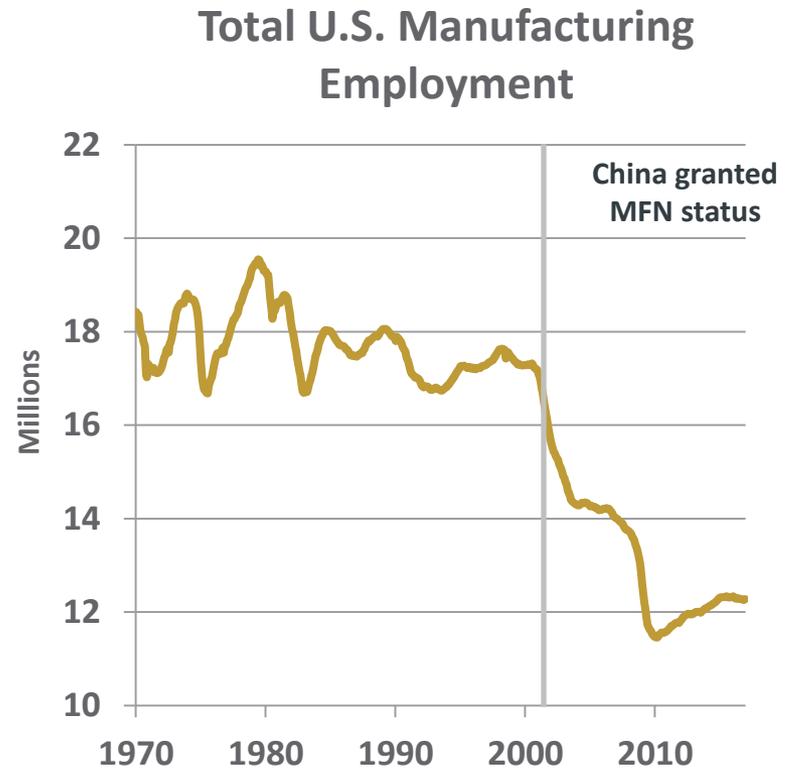
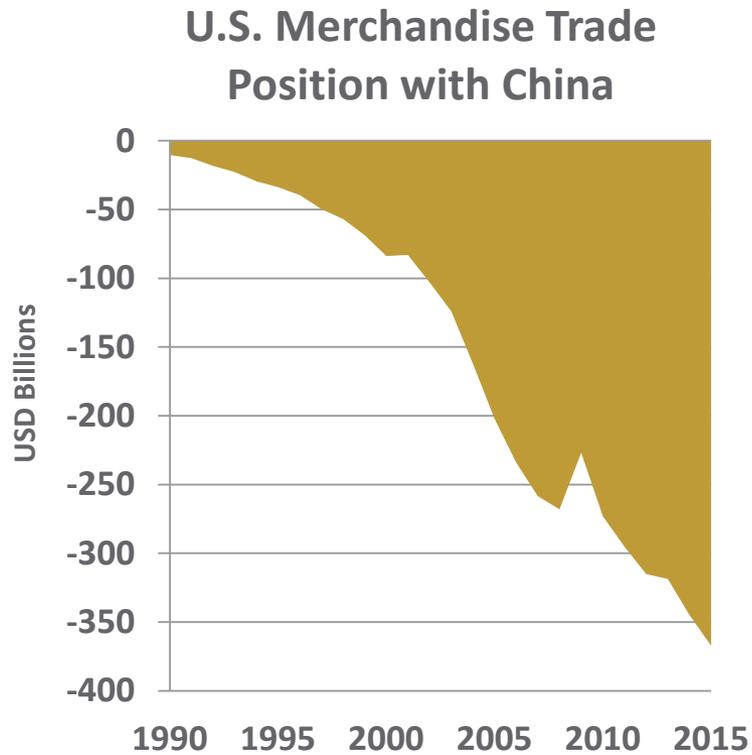
Outward Foreign Direct Investment



Sources: International Monetary Fund, United Nations

IS FREE TRADE FAIR TRADE?

- *A renewed desire to level the playing field*
- *Each side has important leverage*

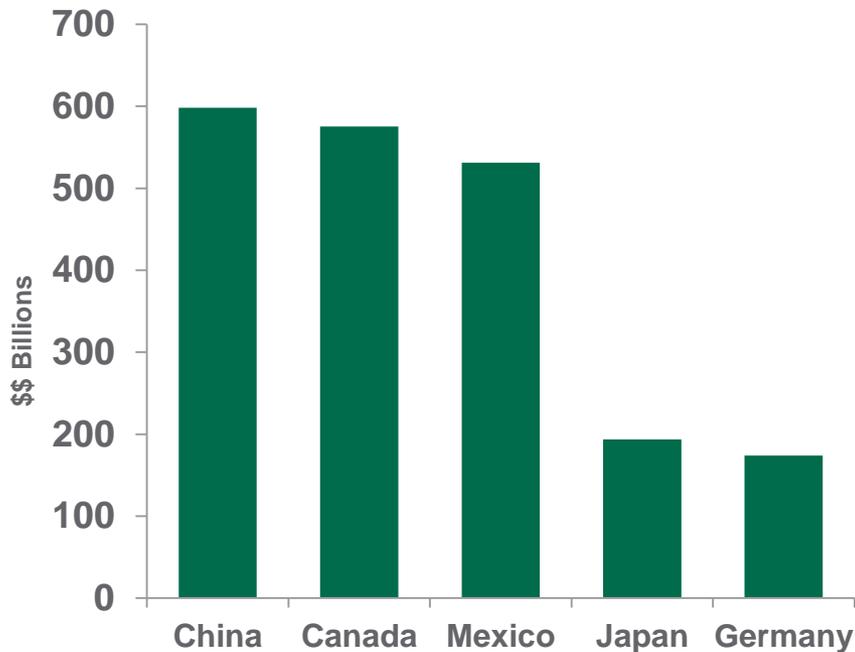


Source: Haver Analytics

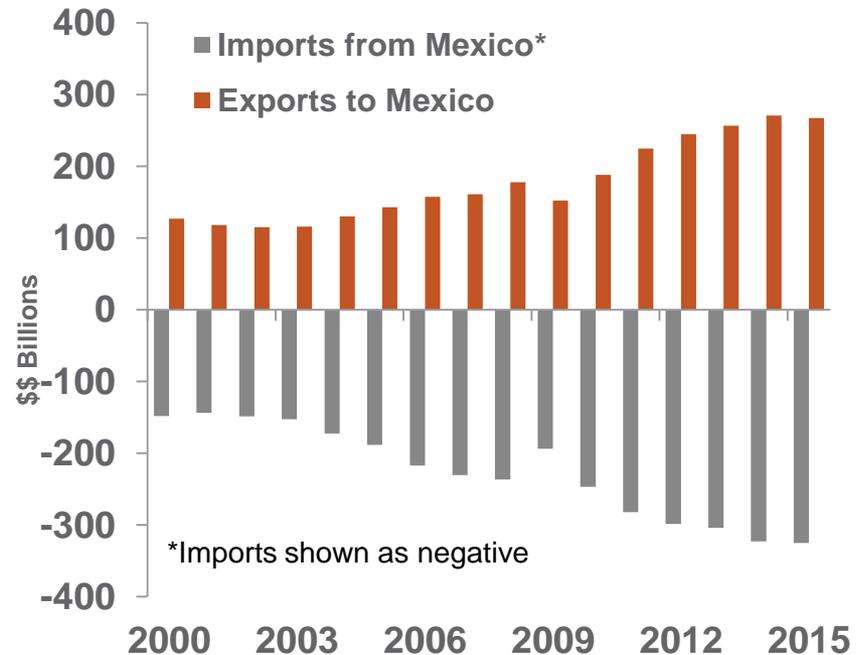
NORTH AMERICAN NEIGHBORS

- *Continental trade is immense*
- *NAFTA has accelerated merchandise flows*

America's Total Trade with Major Partners



U.S. Trade History



Source: US Census Bureau, Haver Analytics

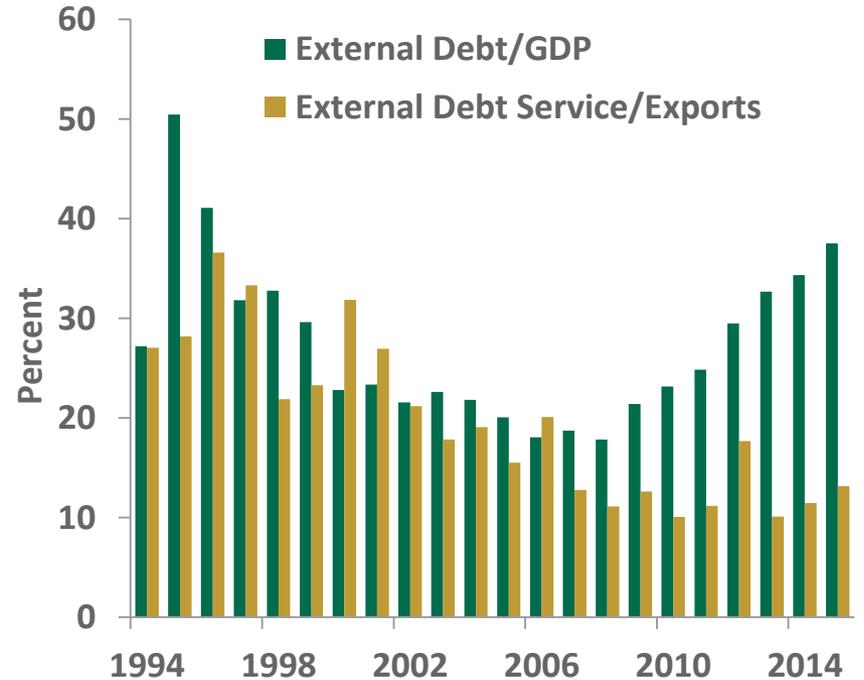
NO MORE TEQUILA

- *Important risk of financial and political stability in Mexico*
- *No one wants a re-run of 1994*

Mexican Currency & Yields



Mexican External Debt Profile

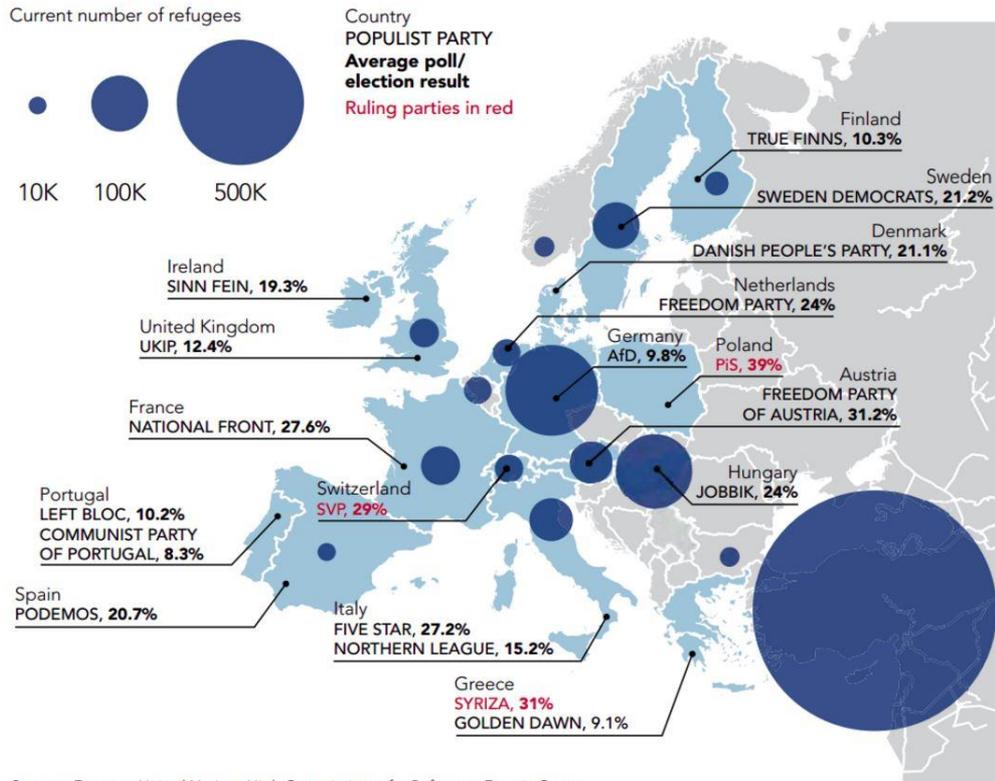


Sources: Haver Analytics, World Bank

EU DECISION DATES

- *The rise of populism is closely correlated with the flow of immigration*

Populism is surging as refugees bring increased political pressures



Sources: Eurostat, United Nations High Commissioner for Refugees, Eurasia Group

Upcoming Milestones

- *Brexit negotiations begin: March 2017*
- *Dutch parliament: March 2017*
- *French Presidential contest: April/May 2017*
- *German parliament: September 2017*
- *Italian elections: ?*

The Last Line of Defense?

ISSUES FOR THE FED

Renewed risk of inflation

- A marked change from last summer

Macroprudential risks

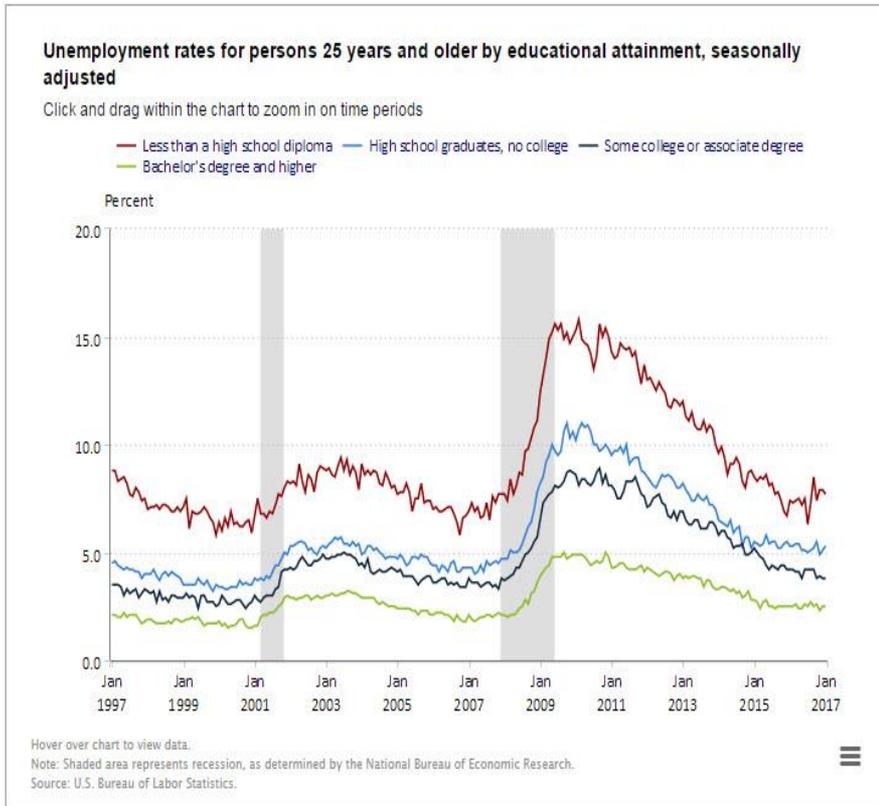
- Low rates may be feeding rising asset valuations

Political activism

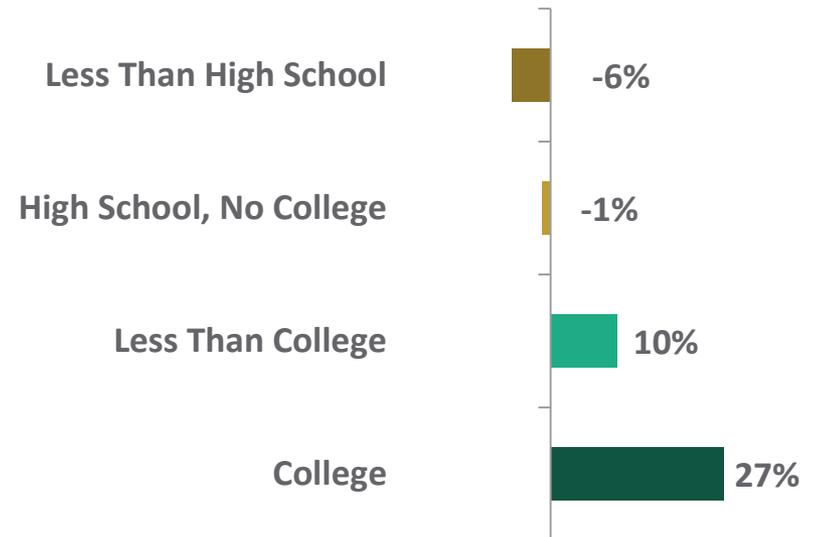
- Can the Fed retain its independence?

TWO LABOR MARKETS

- *Education gaps explain differences in outcomes*
- *Monetary policy may not be the best tool to address this*



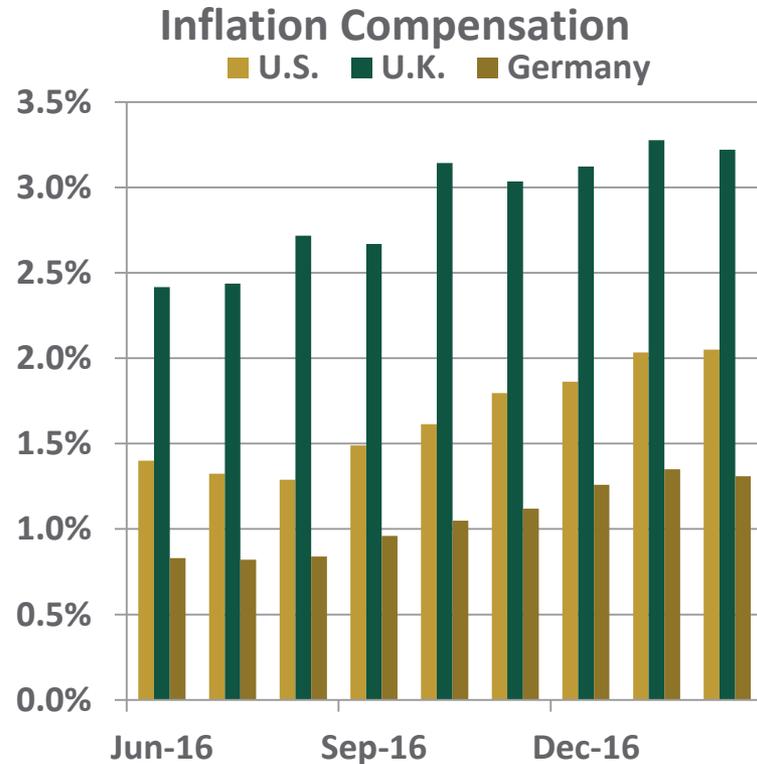
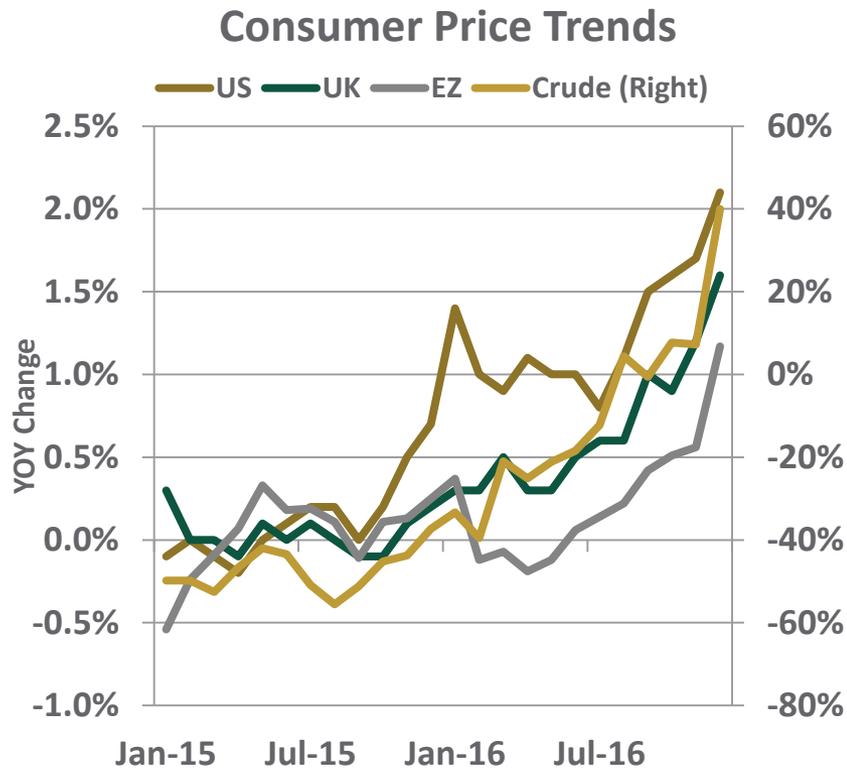
U.S. Change in Hourly Earnings by Educational Attainment, 2009-2016



Sources: BLS, Haver Analytics

INFLATION AND INFLATION EXPECTATIONS

- *Price levels are advancing across markets*
- *Inflation expectations are also higher*

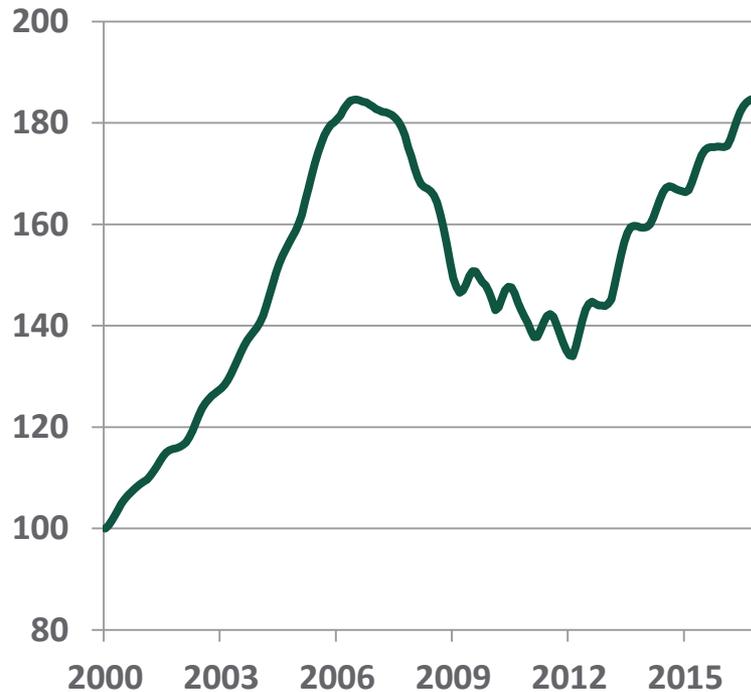


Source: Bloomberg

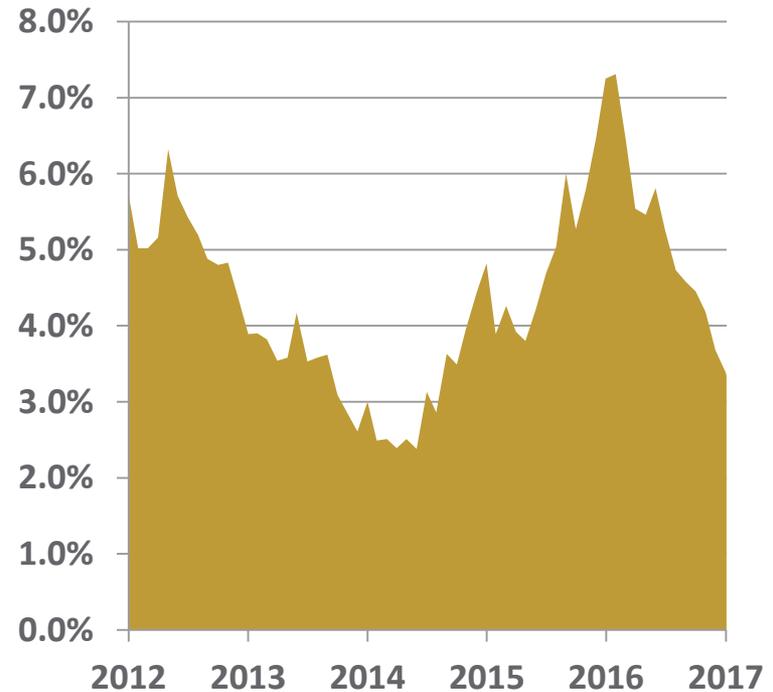
FROTHY?

- *Markets have done very well...too well?*
- *Are the makings of market instability accumulating?*

Case-Shiller House Price Index



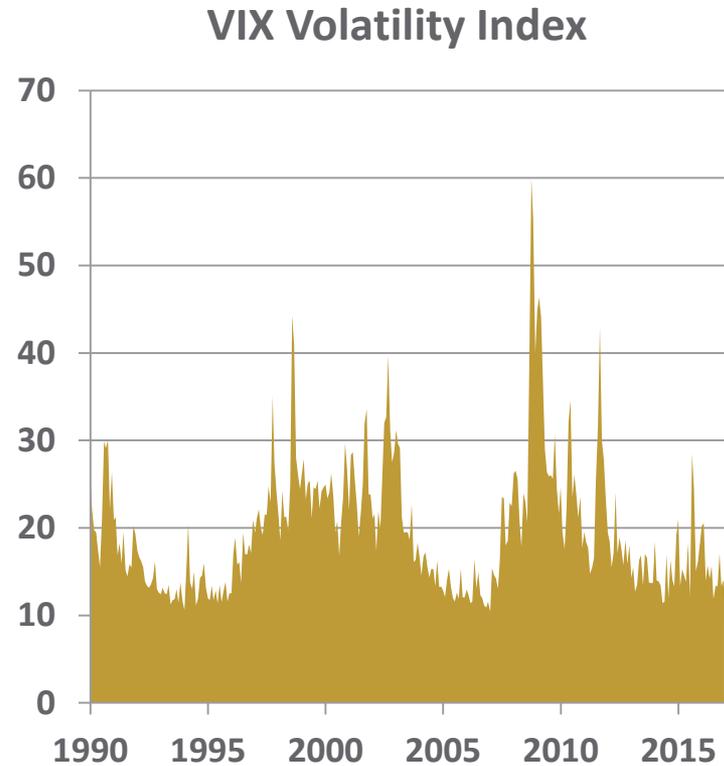
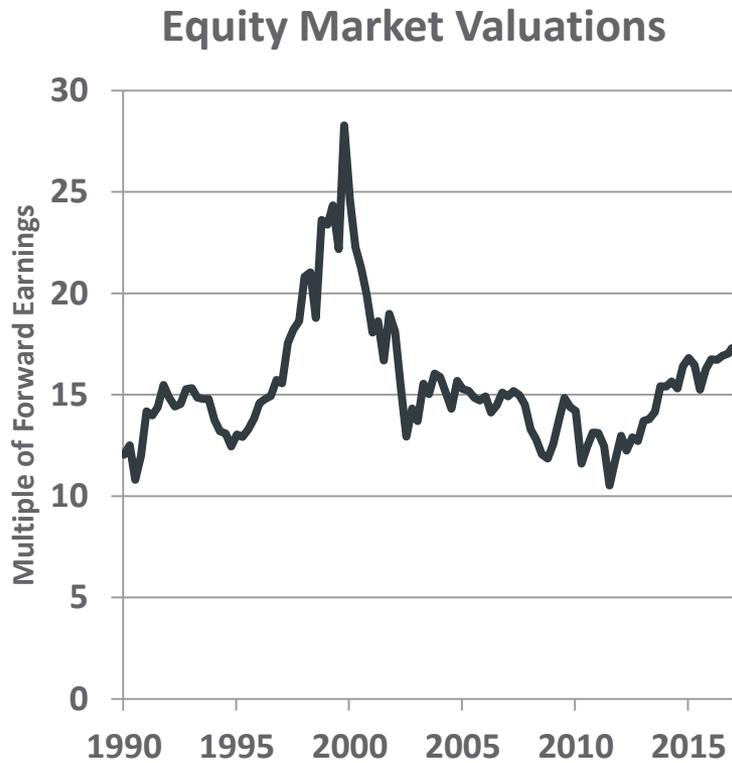
High Yield Bond Spreads



Source: Bloomberg

PRICED FOR PERFECTION

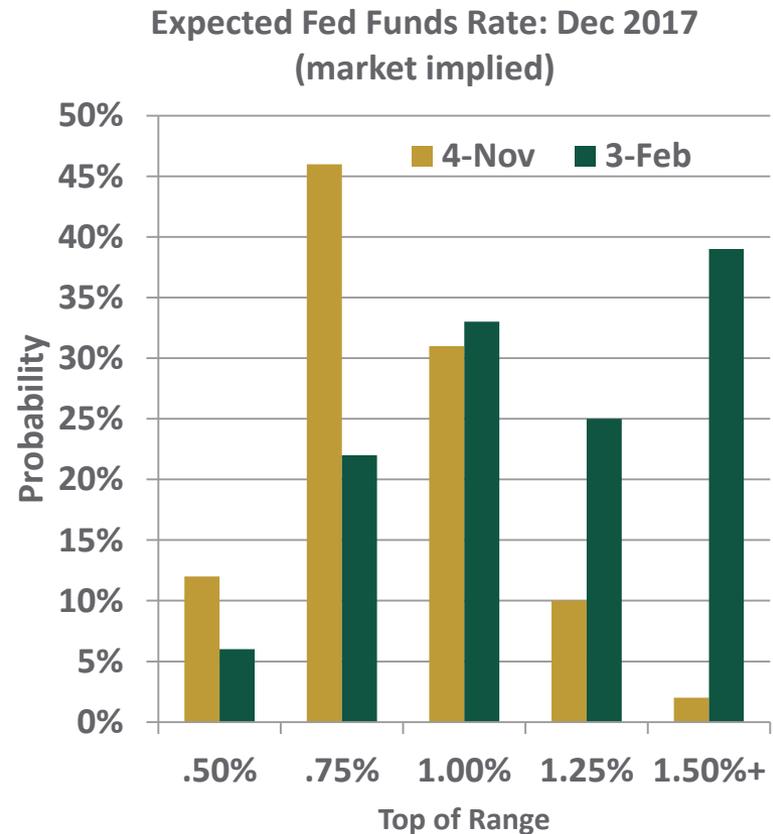
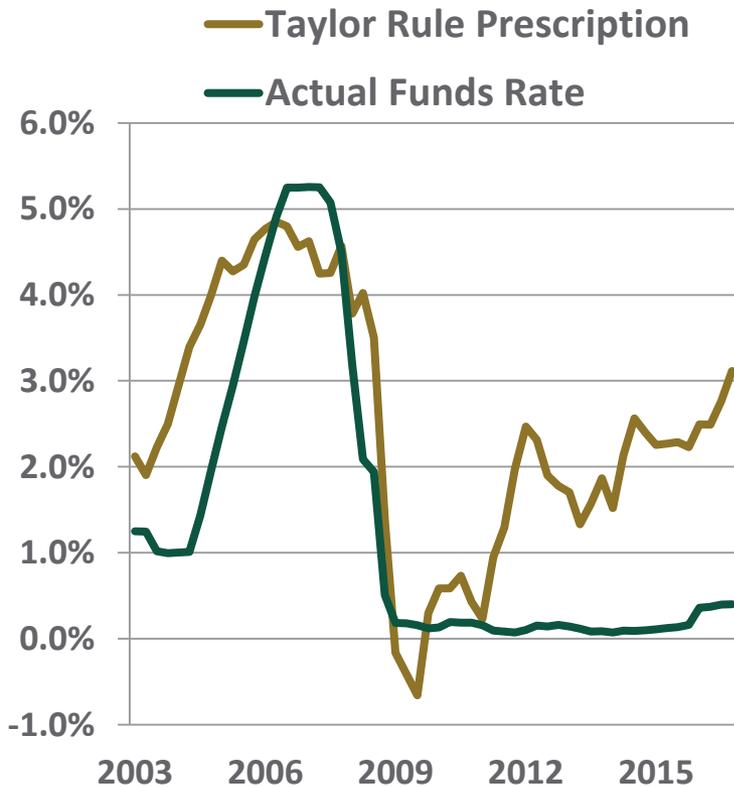
- *Equity valuations may be assuming policies that won't come to fruition*
- *Market volatility is at a historical low*



Source: Bloomberg

THE ROAD AHEAD

- *Does the administration prefer low rates or high rates?*
- *Market expectations for the Fed have moved higher*



Sources: Federal Reserve Bank of Atlanta, Bloomberg

CHANGING OF THE BOARD



Janet Yellen, 70
Chair: January 2018
Governor: January 2024



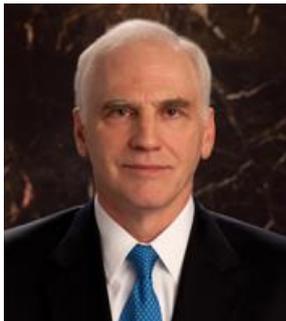
Jerome Powell, 64
January 2028



Stanley Fischer, 73
Vice Chair: June 2018
Governor: January 2020



Lael Brainard, 55
January 2026



Daniel Tarullo, 64
Departing April 2017

Two Seats Open



Bradd Jaffy ✓

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President Trump says he plans to roll back Dodd-Frank financial regulations because so many friends of his in business can't borrow money



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VICE CHAIRMAN,
COMMITTEE ON FINANCIAL SERVICES

January 31, 2017

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chair Yellen:

I am writing regarding the Federal Reserve's continued participation in international forums on financial regulation. Despite the clear message delivered by President Donald Trump in prioritizing America's interest in international negotiations, it appears that the Federal Reserve continues negotiating international regulatory standards for financial institutions among global bureaucrats in foreign lands without transparency, accountability, or the authority to do so.

This is unacceptable.

Continued participation in international forums such as the Financial Stability Board, the Basel Committee on Banking and Supervision, and the International Association of Insurance Supervisors is predicated on achieving the objectives set by the new Administration. That will likely require a comprehensive review of past agreements that unfairly penalized the American financial system in areas as varied as bank capital, insurance, derivatives, systemic risk, and asset management.

It is incumbent upon all regulators to support the U.S. economy, and scrutinize international agreements that are killing American jobs. Accordingly, the Federal Reserve must cease all attempts to negotiate binding standards burdening American business until President Trump has had an opportunity to nominate and appoint officials that prioritize America's best interests.

Sincerely,


Patrick McHenry
Vice Chairman
Financial Services Committee

Congress of the United States
House of Representatives
Washington, DC 20515-3310

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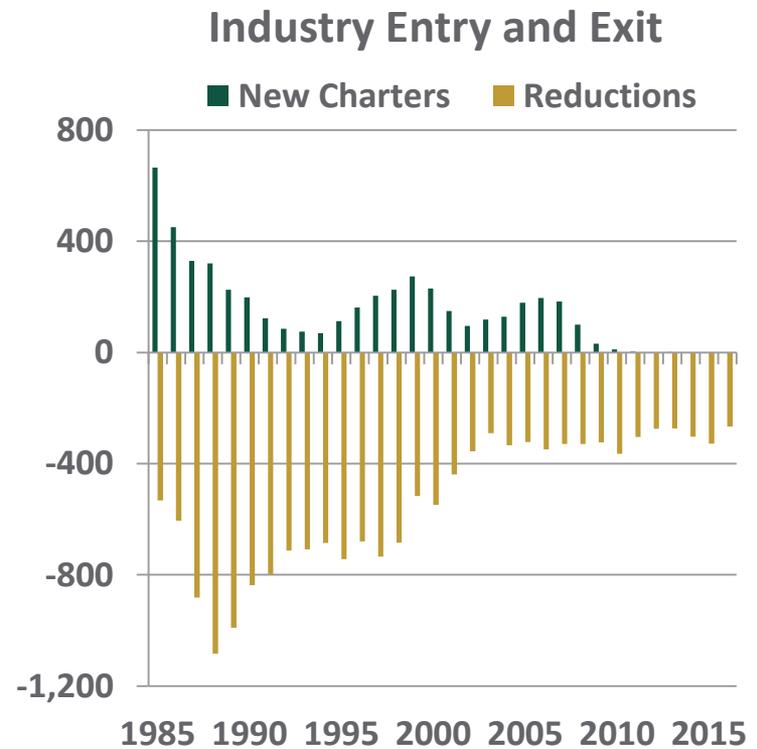
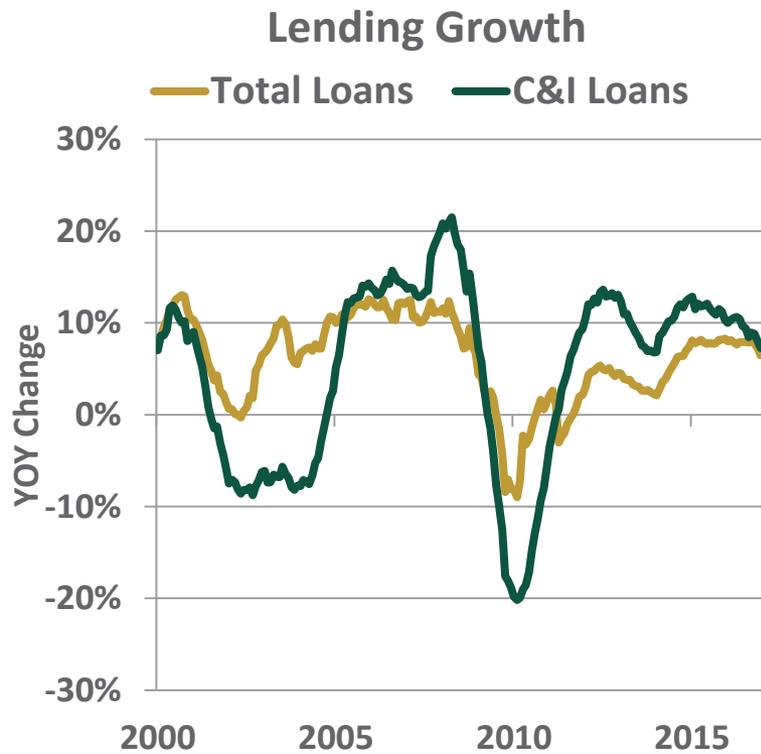
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BANK REGULATION AND CREDIT

- *The economy hasn't been starved for credit*
- *New bank formation hindered by more than new rules*



Sources: Haver Analytics, FDIC

NOT RULES, BUT PRINCIPALS



Janet Yellen, FRB
January 2018



Mary Jo White, SEC
Stepped Down



Thomas Curry, OCC
April 2017



Timothy Massad, CFTC
Stepped Down



Martin Gruenberg, FDIC
November 2017



Richard Cordray, CFPB
July 2018...or sooner?

TWEETS I DON'T WANT TO SEE



Donald J. Trump @realDonaldTrump ·



The Fed's interest rate increases reward investors and foreign banks, but HURTS ORDINARY AMERICANS! #ByebyeYellen

↩ 20K ↻ 39K ❤ 164K



Donald J. Trump @realDonaldTrump



The Fed's regulation is KILLING small banks and small businesses. Wait until you see who I appoint to fix that! #RandPaul

↩ 20K ↻ 39K ❤ 164K



Donald J. Trump @realDonaldTrump



The markets are a HUGE reflection of all the great things we're going to be doing. What is the Fed doing RUINING things? #Savethepunchbowl

↩ 20K ↻ 39K ❤ 164K

PARTING THOUGHTS

We need to recall why international commerce is so beneficial

- Nationalism is damaging to global markets

We'll need to get used to a new leadership style

- Policy formulation and communication are being done very differently

Checks and balances remain important

- Congress, the Fed, and the courts may be called upon to be more active

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