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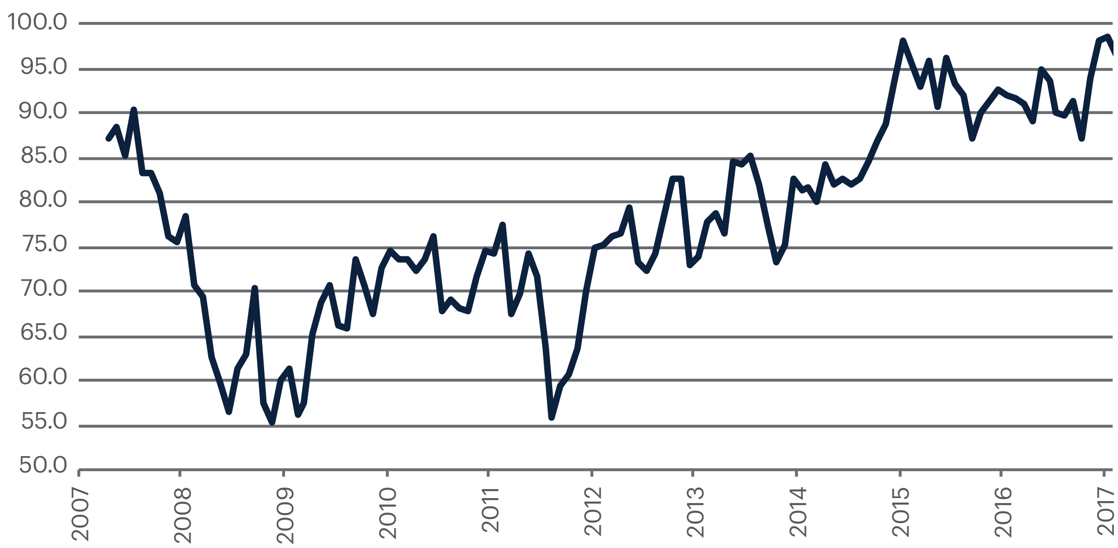
The Trump Administration and the Consumer

Key economic developments, including continued job growth, low unemployment, rising wages, and continued home price appreciation, converged in 2016 to the benefit of the U.S. consumer. The average consumer has also benefited over the past few years by becoming a savvier spender, demanding more value for each dollar spent. The composition of spending has evolved as well, with consumers favoring experiences such as travel and restaurants over material purchases like clothing and appliances.

As the divisive U.S. election cycle drew on, the willingness to consume by most Americans took a pause until Donald Trump's election late in the year. As shown in the chart below, while consumer sentiment reached a 10-year high in January 2017, more recent readings have moderated, particularly at the middle-income levels.

"Trump-onomics" may result in bittersweet outcomes for various cohorts of the U.S. consumer economy. For now, tempered optimism remains though its sustainability is dependent on many of President Trump's policy outcomes.

Consumer Sentiment Soars, Then Retreats



Source: Federal Reserve Bank of St. Louis; University of Michigan: Consumer Sentiment©, Index, Monthly, Not Seasonally Adjusted. Data as of April 30, 2017

Administration policies and potential outcomes

President Trump's policy agenda includes individual and corporate tax rate cuts, infrastructure spending, and trade protectionism. While this may lead to a better tomorrow for many consumers, the current tax reform proposal by House Republicans may benefit top income earners and corporate America more than middle-income earners.

The Republican tax reform proposal, which the Trump Administration backs in principle, includes the collapsing of seven tax brackets to three. The top bracket of 39.6% would decline to 25%, effectively reducing the highest tax payers' bill by 30%. In contrast, the lowest income households would receive a 1% tax cut while middle-income households would receive a 5% cut. The proposed repeal of estate and gift taxes would also disproportionately benefit consumers in the higher income brackets.

The lessons of the Reagan and Bush tax cuts suggest that these marginal tax rate cuts could boost retail sales if they are immediate and permanent. A look back at the Bush tax cuts from 2001–2003 showed retail sales and personal consumption expenditures (PCE) accelerated shortly thereafter. But if the tax cuts currently envisioned are phased in over several years, and border taxes or tariffs are implemented, there is a risk of economic stagflation.

Trade protectionism and border adjustability—friends or foes?

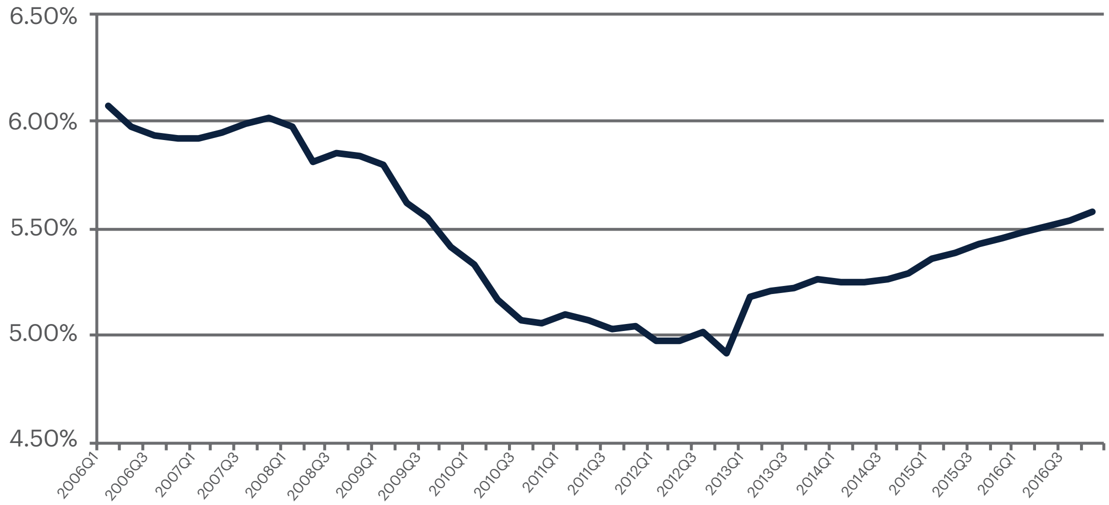
President Trump has been clear about his goal of implementing greater trade protectionism. Furthering this goal may entail revisions to the North American Free Trade Agreement (NAFTA) or adoption of a Border Adjustability Tax (BAT). The BAT system stems from U.S. House Speaker Paul Ryan's tax plan to effectively pay for proposed corporate and individual tax cuts with taxes on imports to avoid increasing the U.S. budget deficit. The concept of a border adjustability taxation system is not new, as it exists in numerous countries around the world.

However, it is important to understand the effects of such a system on the U.S.'s net import economy and, ultimately, the end consumer. Companies are likely to pass higher costs to U.S. consumers, which could drive up prices and create inflation. By taxing imports to pay for tax cuts and/or infrastructure spending, prices on most everyday goods could rise by 10–20%.

Theoretically, the U.S. dollar should appreciate, offsetting price increases on imported goods resulting from implementing the BAT. However, the magnitude and timing of the potential U.S. dollar spike is not clear. The net result could still be to reduce the spending power of the average U.S. consumer. With consumer spending currently at 70% of U.S. GDP growth, this would in turn create headwinds to economic growth.

The U.S consumer outlook for 2017 remains mixed to positive with low unemployment and positive wealth effects from rising home values and stock prices, offset by rising consumer debt levels for the average American, as shown in the chart on the next page.

Consumer Debt Service Ratio



Source: Federal Reserve, Consumer debt service ratio, seasonally adjusted, percentage. Data as of December 31, 2016.

The outcome of President Trump's policy proposals—tax cuts, infrastructure spending, and trade—may provide an additional boost to consumer spending as early as 2018 if consumers expect lower taxes, rising wages, and continued job growth.

But the fly in the "Trump-onomics" ointment may be the proposition to use trade policies to fund dramatic tax-code revisions which could create an uptick in inflation. Rising inflation could reduce the spending power of the average American, leading to lower sales at the cash register. Furthermore, recently announced executive orders on immigration restrictions could have a negative impact on U.S. labor force growth. Immigration currently accounts for almost half of U.S. population growth. Significantly reducing this pace of growth poses a risk to U.S. Gross Domestic Product (GDP) growth and increased consumer spending.

Conclusion

The new Administration and Congress are tasked with implementing a variety of policies President Trump has proposed, and engaging in subsequent negotiations on a new fiscal budget. Meanwhile, consumer confidence has improved and wealth effects are building. Together, these developments may bode well for increased earnings of consumer-reliant stocks. However, at the same time, the current tax-cut proposals and protectionist policies of the new Administration may spawn inflationary pressures which could continue consumers on the "save, not spend" track record of recent years.

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