

Economic Outlook 2017

**Milwaukee Rotary
January 31, 2017**

Michael M. Knetter

President and CEO

Wisconsin Foundation and Alumni Association

Trends Entering 2017

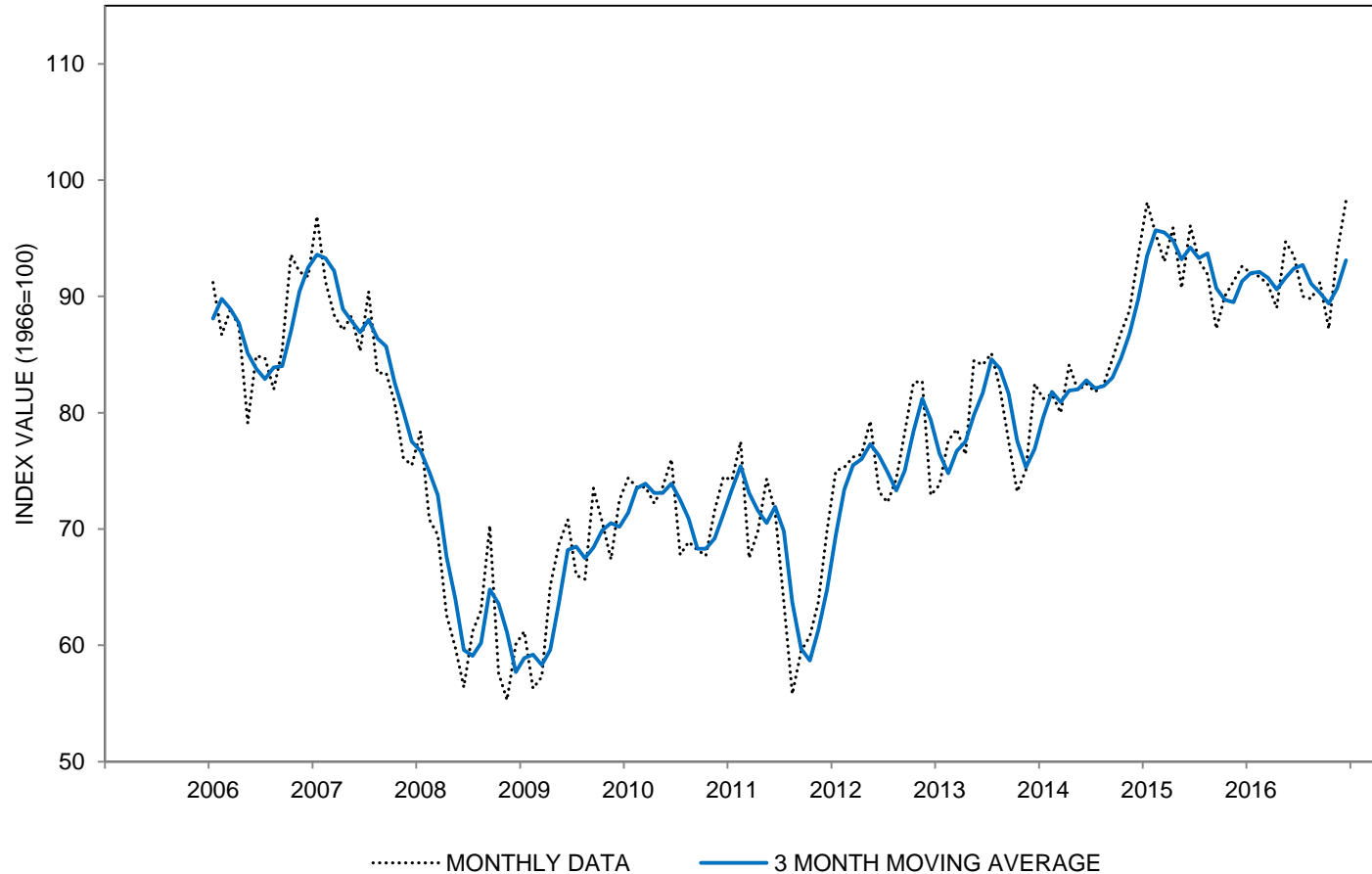
- Increase in consumer confidence
 - Expectation of pro-business regime
- Potential policy changes in 2017:
 - Tax reform
 - Infrastructure spending
 - Border policy – expect slowdown or reversal in globalization
 - The Fed's reaction to changes in the economy and the administration will tilt more hawkish
- A new President whose agenda is coming into focus and whose style is markedly different than anything we have seen

2017 Forecast

- S&P 500: +5%
- Real GDP growth: +2.25%
- Unemployment rate remains low, participation rate and wages rise
- Inflation: 2.3% core
- US\$ remains strong through balance of the year
- Very high degree of uncertainty in any 2017 forecast due to change in agenda *and* style

Trend #1: Consumer Confidence

THE INDEX OF CONSUMER SENTIMENT



Trend #1: Consumer Confidence

- Economy near full employment
- Trump administration trusts competition and consumers more than regulators
 - Financial services and energy industries have benefitted most
- Confidence or animal spirits can create a self-fulfilling positive dynamic
- Early policy actions from Trump administration will determine sustainability of this cycle—first 100 days

Trend #2: Tax Reform

- Will be difficult to pass so my expectations are low to modest here
- Reduction in corporate taxes might keep more production in the U.S.
 - If corporate taxes were cut in half, corporate profits would rise by 7% while federal revenue would fall by 5%
- Shifting toward consumption tax vs. income tax or simplifying tax code would be great, but unlikely to happen

Trend #3: Infrastructure Spending

- Could boost demand in the short term and expand the economy's long-term supply capability
- Roads, bridges, rail systems, ports and airports are in need of improvements
- And now, walls must be built!
- Might be the one policy that can truly boost employment for Trump's blue collar base
- Potential for public-private partnerships

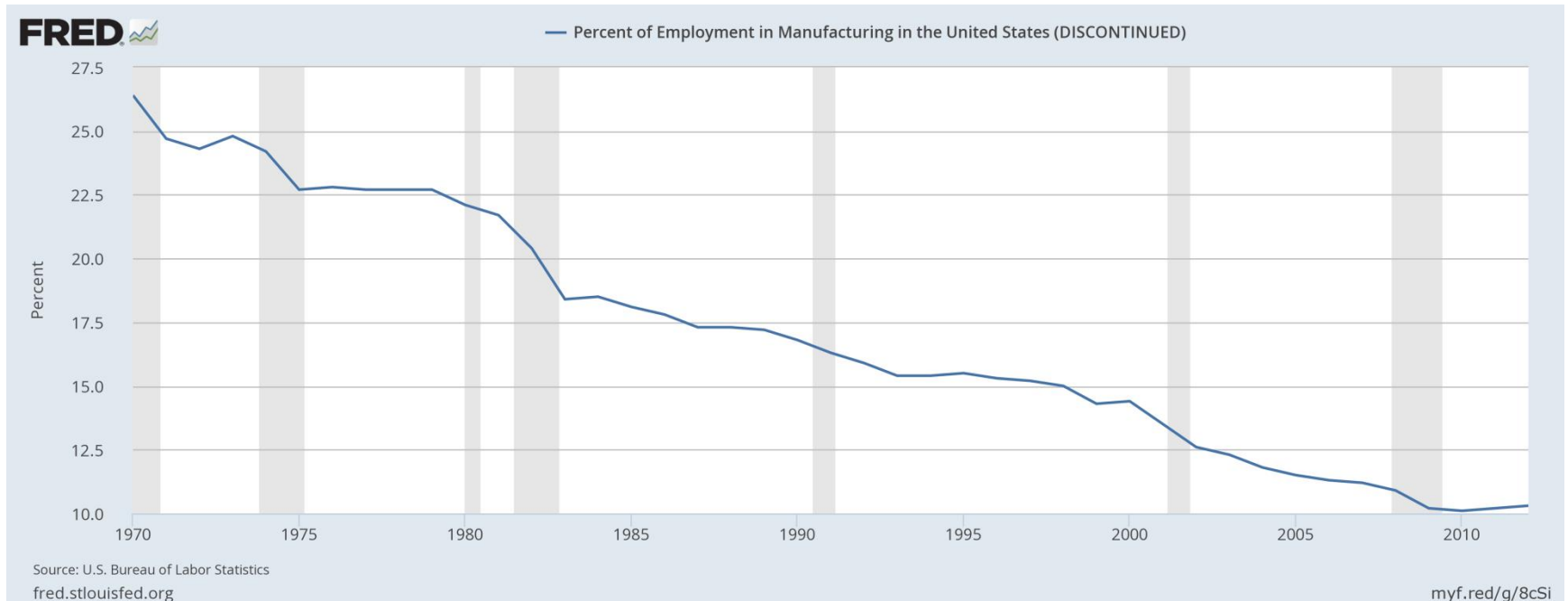
Trend #4: Border Policy

- More aggressive trade policy is popular with many Trump voters, but would be a negative supply shock to the economy
- Short term:
 - Prices would go up with little change in supply (stagflation)
- Long term:
 - Domestic production replaces imports at higher prices and this crowds out production of things we currently export (technology intensive goods and services)

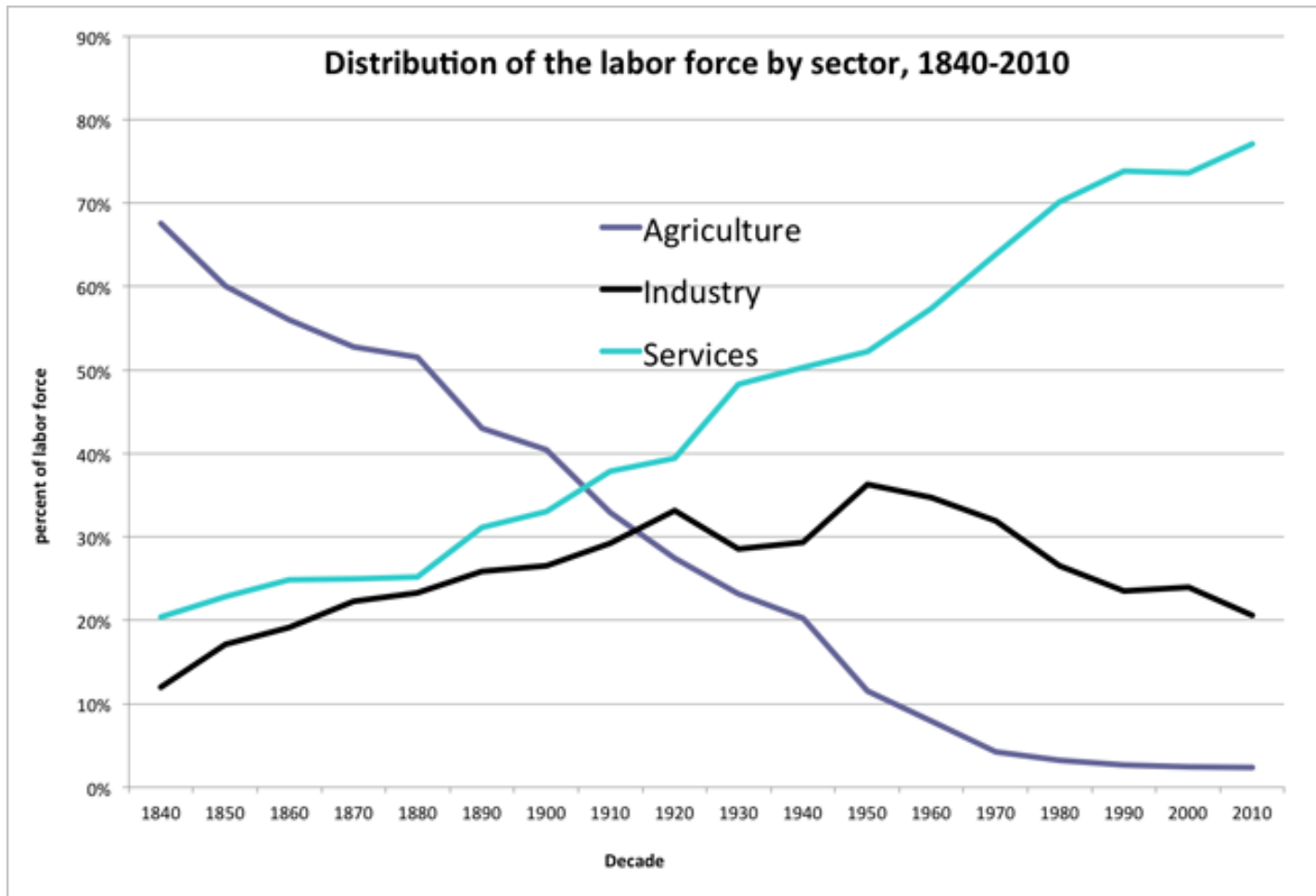
Some Arguments *Against* Trade

- Free trade has hurt U.S. manufacturing and blue collar jobs
- Trade isn't fair, as other countries have cheap labor, fewer environmental protections, and subsidies
- U.S. companies are moving production abroad, hurting U.S. employment

Evidence: Share of Employment in Manufacturing Since 1970



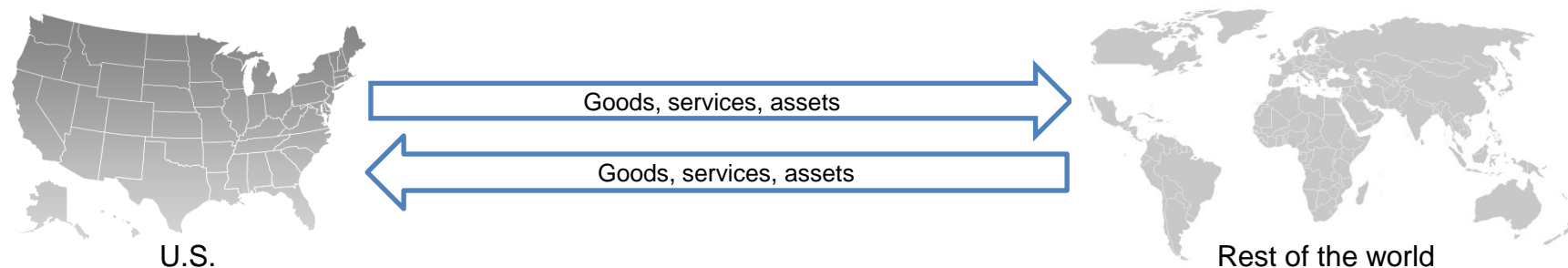
Does Trade Explain This?



The Case *for* Trade: Gains from Exchange

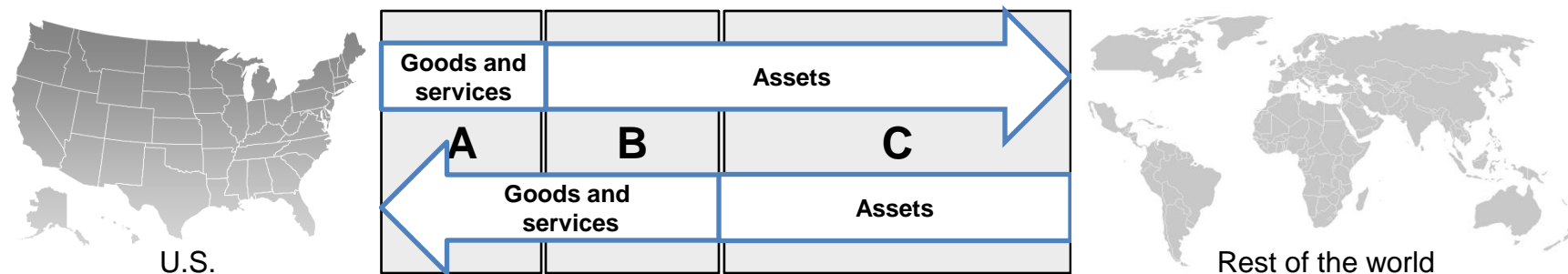
- Countries are comprised of many different decision-making units including households, firms, and governments
- These decision-makers engage in voluntary exchange of goods, services, and assets across borders
- By definition, voluntary exchanges make both parties better off: parties prefer the item they gained to the item they gave up. Otherwise, why do it?

Review of the Gains from Exchange



- Every transaction has a buyer and a seller
- The value of goods, services, and assets exchanged must balance across countries
- Each party got something they value more than the thing they gave up
- How is this bad for a nation? Where is the externality?

Review of the Gains from Exchange



- **Region A:** Balanced trade of goods and services. Specialization and comparative advantage.
- **Region C:** Balanced trade in assets. Diversification.
- **Region B:** U.S. trading our assets for foreign goods and services. This is the “trade deficit.” Is that the problem?

Chronic (but Overstated) Trade Deficits since Capital Markets Opened in Late 70s

- Why would we exchange our assets for foreign goods and services?
- This would be rational if we (collectively) prefer goods today relative to goods tomorrow more than trading partners
- This would be rational if we had relatively more valuable assets than our trading partners
- Having valuable assets is a sign of our strength as an economy and nation
- Trading assets for goods and services is also good for both parties!

My Views on the Impact of Globalization on the U.S. Economy

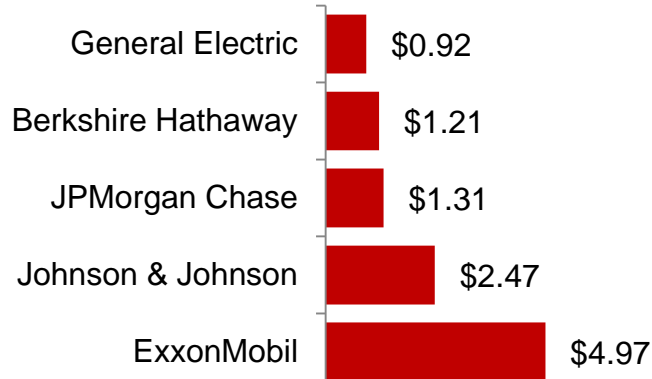
- Global trade, like technical progress, has increased efficiency and living standards
- U.S. skilled/educated workers wages rise (more scarce globally than domestically) more than unskilled workers wages (they now compete with a large global supply)
- Capital has gained bargaining power over labor due to credible threat to move
- Capital and labor have shifted to R&D intensive innovative industries: the technology sector has attracted resources away from manufacturing
- Trade is not the only, and probably not the biggest, culprit for labor market changes

Other Factors Shaping Labor Market Outcomes

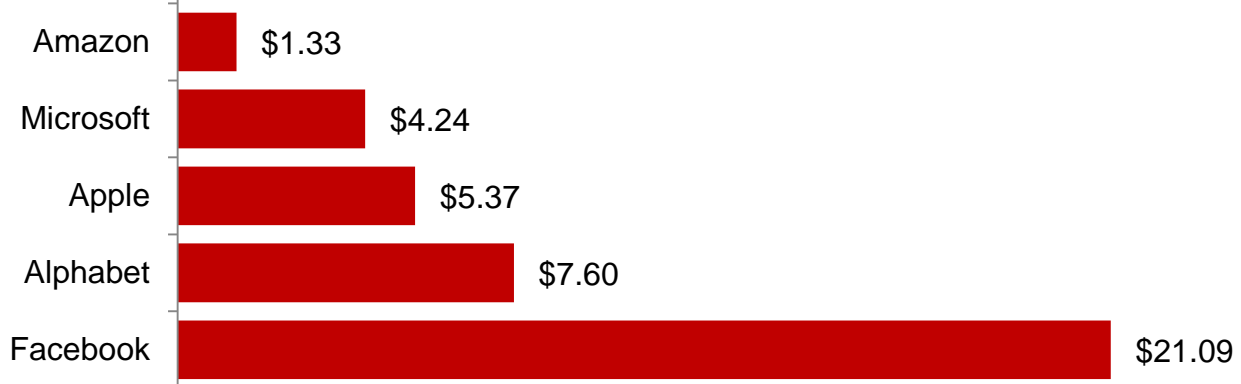
- Our greatest economic strength is innovative, leading-edge tech firms and products
- Many of the largest public companies in the U.S. are less than 40 years old
 - Amazon, Alphabet, Apple, Microsoft, Facebook
 - Their products disrupt entire industries
 - They are the tip of a very large iceberg
- These companies share many features:
 - Small, highly educated workforce
 - More highly concentrated ownership
 - Directly or indirectly disruptive to traditional businesses

Ten Largest U.S. Companies and their Market Value per Worker

Founded before 1975



Founded after 1975



\$ millions/employee, as of 12/30/16

The Challenge of the New Economy: Shared Success

- Innovation and trade drive growth, efficiency, disruption AND changes in income shares across workers
 - Can we retain the benefits but mitigate the side effects of innovation and trade?
- Some potential solutions include:
 - Public infrastructure projects
 - Improve the education/skills of more people
 - Redistributive taxes
 - Stop trading
 - Ban farm equipment or robots

The First Days of President Trump

- Withdrew from Trans Pacific Partnership
- Promised to renegotiate NAFTA
- Placed a hiring freeze on federal employees
- Discussed slashing regulations by 75%
- Met with GM, Ford, and Fiat Chrysler to pressure them to boost U.S. employment
- Budget director declared war on national debt
- The Wall is on!
- Deportations to come?
- Travel ban!

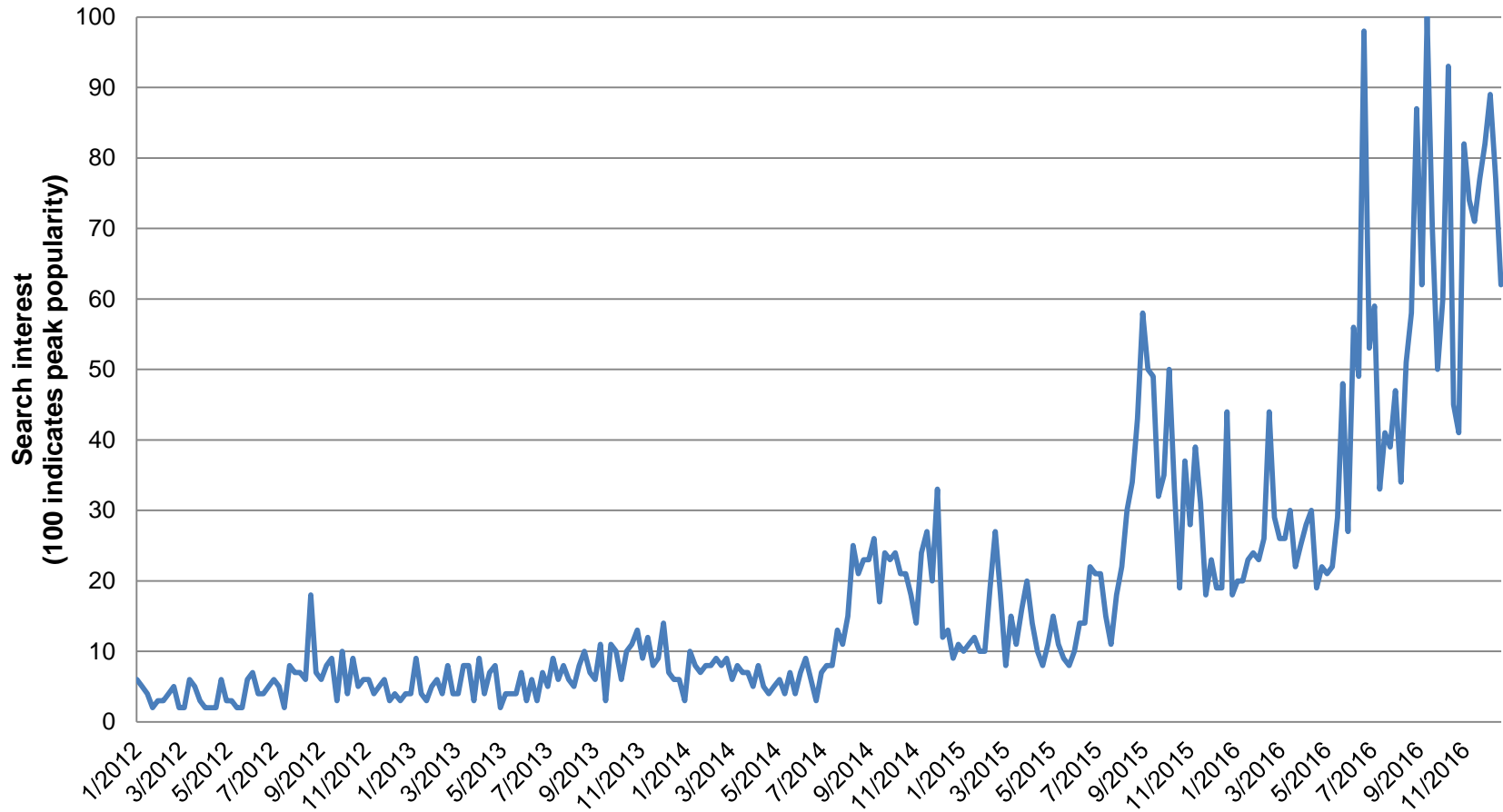
“Don't just do something, stand there!”

Uncertainty: Part 1

- Inconsistency between tax cuts, infrastructure investments, and reducing federal debt
- Inconsistency between promoting innovation and admonishing capital investment in industries it was leaving
- What are the economic and political costs of changing trade agreements?
- Bonus prediction: the 2016 “word of the year” best days are yet to come

Will this 2016 trend grow or shrink?

Incidence of American Dialect Society's word of the year
"dumpster fire" as Google Search term



Uncertainty: Part 2

Leadership May Trump Economics

- People don't like change and we are making big changes
- Great leaders of large organizations must temper self-interest with empathy and ability to serve greater good to lead change
- People develop these abilities through values, experiences, sacrifices, challenges
- We will find out if the style that worked in real estate development works for the President of the United States
- Can he manage the domestic and international relationships that hold our society together?
- Can he be trusted with facts or "alternative facts"?
- Can he put national interest ahead of personal interests and personal needs?
- We are only 100 yards into a marathon...