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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Twitter with Dave

TRUMPONOMICS WILL SPARK THE NEXT RECESSION – AND SOON

Trumponomics will cause the next recession within the next 12 months. I know that sounds soon, but who saw the recession coming in December, 2006, when visions of endless housing-related prosperity danced through everyone's minds? Who saw the recession coming back in March, 2000, as the Nasdaq was still at nosebleed levels, and talk of a new paradigm in technological advances went viral?

The policies pursued by Donald Trump's administration, from purely a macro standpoint, have on net been detrimental to the economic outlook. This is not to say that the deregulation efforts were not beneficial. (But who cares about the environment, right? Or about ensuring there is an adequate regulatory system for the financial sector?).

This is not to say that the "reform"' part of the tax package was not a great idea – it was absolutely vital to put the United States' corporate tax structure on a global competitive footing. Ireland recognized this long ago. President Emmanuel Macron in France recognizes this. Now, Australia is trying to push through lower tax rates as well. Only the federal government in Canada doesn't seem to get it.

People are simply too scared to talk about the dark side of Trumponomics. I'm amazed at all the TV pundits waxing about how great an idea it is to stimulate fiscal policy at this stage of the cycle. So let's call it for what it is – stimulus, not just reform. The tax base was never broadened, there were bells and whistles everywhere, and to sell the corporate tax cuts to the general public, somebody in Washington thought it was a dandy idea to also provide tax relief to the personal sector. Regressive tax cuts at that, which will only serve to accentuate already-record levels of income inequality. And, to add fuel to the fire, we get more government spending.

Some will argue that there are tremendous supply-side elements to the tax package that was passed last year. Pure bunk. It is almost all classic Keynesian-style stimulus. And it's all being financed by issuing more debt at a time when the structural or "cyclically adjusted" budget deficit already is 3 per cent of GDP. At this stage of the cycle, at full employment, the government should be running a balanced budget or even surpluses – as they do in Germany. Running structural deficits at this level is destabilizing for the financial markets, and I am concerned that there is less discussion on this than there is on how wonderful the earnings season is – which is primarily because of the transitory effects of the tax stimulus.

As Newton's laws taught us, every action has an equal and opposite reaction. To engage in overall fiscal stimulus now is akin to giving steroids to a musclebound wrestler. And to be tacking on large-scale deficits on top of an already intractable fiscal largesse will go down in the history books as one of the most colossal policy missteps of all time.

The opposite reaction is interest rates – they can only go higher given the current backdrop of heightened material cost pressures; evidence that wages are picking up and the booming supply crop of Treasuries. And the same countries that President Trump and his protectionist team are attacking with tariffs on steel and aluminum are the ones that financed nearly half of last year's fiscal deficit, soon to double in size. Imagine what happens to the U.S. economy if domestic entities have to be the ones to fund their own fiscal rectitude.

As it stands, the futures market has repriced for better-than-even odds that the U.S. Federal Reserve hikes rates three more times this year, compared to a one-in-three chance just a month ago. The yield on the 10-year T-note has broken into a new and higher range, where a 3-per-cent yield is likely now a floor as opposed to the ceiling it had been for the past few months. This then comes right back into the housing market, where mortgage rates are rising in tandem with higher bond yields, crimping affordability along the way. This is readily evident in the fact that mortgage applications for new-home purchases have sagged for three weeks running, housing starts slumped 3.7 per cent sequentially in April to their low-water mark of the year and the S&P 500 home-building stocks saw a 20-per-cent bear-market decline from the nearby highs. Housing is the quintessential leading indicator of the economy, and the action beneath the veneer of the major equity indexes is flashing a warning sign on this expansion – the second-longest ever at 107 months.

Compounding the problem for the Fed, and the housing market, are these trade policies. So the Trump team cuts taxes on the one hand, and then raises them with the other with all these tariffs. If you don't see growth-crunching inflation, you obviously haven't looked at the chart of lumber prices. Prices have skyrocketed 68 per cent in the past year to record highs, courtesy of the tariffs imposed on Canadian softwood lumber. The National Association of Home Builders estimates that this policy alone has made the average single-family home more expensive to first-time buyers by $1,360 a unit. All in the name of protecting the U.S. lumber industry, at the expense of the consumer. Nice going.

Just remember: Ronald Reagan cut taxes in 1981 and the Fed triggered a recession that same quarter. We had the historic tax reform in the summer of 1986 and that didn't stop the stock market a year later from rolling over in a very material way – again, with the Fed's thumbprints all over that event.

As Albert Einstein famously said, the power of compound interest is the eighth wonder of the world. He didn't say late-cycle fiscal stimulus, he said interest rates. Together with a firmer greenback, monetary conditions are beginning to tighten in the United States in a rather material way. This will outlast the ill-timed fiscal relief, and blaze the trail for another recession that once again is far away from the mainstream consensus forecast.

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For further information, please contact: research@gluskinsheff.com

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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