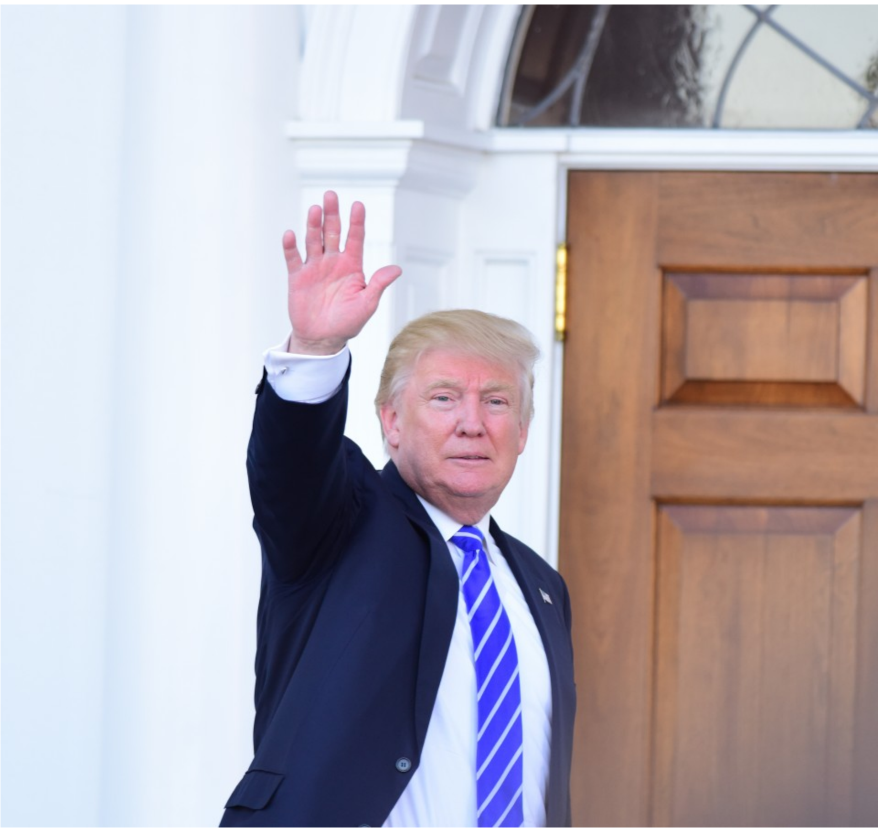
Regaining the initiative in the US

There are just 14 months until the mid-terms and Trump is keen for his first "win"



Tackling tax reform

With lawmakers set to return to Washington in coming days, President Donald Trump will be keen to get his first major legislative "win". Failure on healthcare reform, a lack of progress on tax reform, ongoing questions over ties to Russia and his response to events in Charlottesville mean his poll ratings continue to languish.

With mid-term elections just 14 months away the need to regain the initiative is clear.

Tax is now the priority. Gary Cohn, head of the White House's National Economic Council, states that the administration and key Republicans on Capitol Hill have come up with a "good skeleton" of a plan for tax reforms. However, there isn't much detail other than an aspiration to lower corporation tax, remove many personal deductions (but keep the big three of charitable donations, mortgage interest payments and retirement savings) and abolishing estate taxes. Instead, it will be up to the House Ways and Means Committee, under Chairman Kevin Brady, to put "flesh and bone on it". This will allow a bill to be drafted in the next three to four weeks with the administration looking to get the legislation passed by Congress this year, according to Cohn.

The debt ceiling

Before that though, a budget must be passed and then there is the rather important matter of the US debt ceiling. It is currently set at $19.8 trillion and was hit in March this year. Since then the government has been using "extraordinary measures" to shuffle money around to give itself time to reach an agreement. The Treasury Department estimates that these measures will be exhausted by 29 September leaving just twelve working days to raise the debt ceiling (note that the Congressional Budget Office believes that they could perhaps survive for another week or so).

Fail, and the US faces the prospect of a government shutdown of non-essential services and potentially even a debt default. For a debt ceiling bill to pass it needs 60 votes in the Senate. Given Republicans hold only 52 seats a bi-partisan deal is required, but this is complicated by the fact Republicans themselves are not united. While many support the party leadership, which is aiming for a "clean" raise, others want it tied to either outright government spending cuts or at least a slower rate of spending. This will be opposed by Democrats.

We expect a quick deal

There could also be problems in the House with conservative lawmakers (the Freedom Caucus) stating that "a simple clean raising is not something our members are going to get behind". Given the divisive nature of politics right now, legislation may not pass first time. If this leads to a shutdown the government's first response may be to suspend non-essential services and put some government workers on furlough.

In 1995, 800,000 workers experienced this for five days with a further 280,000 workers furloughed for an additional 22 days before an agreement was reached. 800,000 workers were also furloughed in 2013. In a worst case "perfect storm" a new debt ceiling crisis could lead to a spike in Treasury yields and a plunge in equities as fears over a debt default rise. This, combined with the furloughing of hundreds of thousands of workers would undermine economic confidence and risk a slowdown in activity. Politicians don't ever come out of this situation well and history tells us that these events don't last long. With the mid-term elections not far away we suspect a deal will be quickly agreed.

The economy is steaming ahead

However, we remain sceptical on the proposed timeline on tax reform even though administration officials suggest that they are prepared to use "dynamic scoring" in order to help facilitate a revenue neutral budget projection for the next ten years. This would mean the tax reforms could pass with a simple majority in the Senate rather than the 60 seat threshold typically required.

Despite the lack of progress on Trump's legislative agenda, the economy is performing relatively well.

Jobs continue to be added in significant numbers, consumer confidence is close to all-time highs and the economy looks set to grow faster than 3% in 3Q17, fuelled by strong consumer spending and investment, coupled with a positive boost from inventories.

We also expect inflation to move closer to the Fed's 2% medium-term target. Wages may be showing some nascent signs of moving higher in response to a tightening labour market, commodity prices are edging upwards while the dollar's 10% fall since the start of the year appears to be pushing up import price inflation. With Fed officials already mentioning easier financial conditions and "somewhat rich" asset price valuations as factors they are watching, we still think the market is being too complacent in fully pricing just one interest rate rise over the next 18 months.

How the Fed's balance sheet unwind could look

Variable	Median			
	2019	2020	2021	Longer run
Change in real GDP (June FOMC)	2.1	2.0	1.8	1.9
(Expected Sep FOMC)	1.9	1.9	1.8	1.9
Unemployment rate (June FOMC)	3.6	3.7	3.8	4.2
(Expected Sep FOMC)	3.7	3.8	3.9	4.2
PCE inflation (June FOMC)	1.5	1.9	2.0	2.0
(Expected Sep FOMC)	1.5	1.9	2.0	2.0
Core PCE (June FOMC)	1.8	1.9	2.0	
(Expected Sep FOMC)	1.8	1.9	2.0	
Fed funds rate (June FOMC)	2.4	2.1	2.4	2.5
(Expected Sep FOMC)	1.9	1.9	2.1	2.5

The Fed's next moves

For now, we expect the Federal Reserve to announce formally its balance sheet reduction strategy following the conclusion of the 20 September FOMC meeting. From October the Fed would then start to gradually limit the reinvestment of the proceeds from maturing assets on its $4.5 trillion balance sheet. However, should the debt ceiling negotiations prove to be highly fractious with seemingly little prospect of a deal in the very near-term, the Fed may choose to delay so as to not run the risk of amplifying any financial market volatility.

The FOMC meeting later this month will also see the Fed release new updated economic forecasts and individual projections for the path of the Fed funds rate. Given the fact inflation is below target we suspect that there could be fewer members who feel that the most likely scenario will see the Fed hike rates by 100bp over the next 18 months.

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