Road trip
Traveling in Asia and Europe over the last few weeks underscored that the US election has eclipsed the Fed as the number one concern of investors. Three questions came up repeatedly, sending us back to the library to refine our views.

Are Trump supporters “shy”?
The most common question in Europe was whether the polls and betting websites are underestimating the likelihood of a populist (Trump) victory. After all, the Brexit vote came as a big surprise and there could be a similar “shy voter” effect where polls underestimate the support for Trump. A corollary argument is that online surveys may be more accurate than in-person or phone surveys because people may be more ready to tell how they truly feel if it is anonymous.

We looked into this and would offer the following. First, online surveys are by nature nonscientific, with no attempt to get a representative slice of the population, but rather tell you what people who like to fill out internet polls think. Second, both candidates have very high unfavorability ratings, suggesting that people may be “shy” about expressing support for either candidate. Third, during the primaries there was no sign of a “shy voter” effect for Trump as polls did a good job of predicting his victory. Fourth, polls may underestimate the turnout for Clinton given her much bigger get-out-the-vote machine. Putting it all together, we think the polls and prediction websites have no obvious bias. Thus we continue to assume split government in our baseline economic forecast.

The power of the Presidency
A second common question is: what power does the President have to act unilaterally, without the support of Congress? This is particularly relevant given that election predictors suggest a high probability of split government. The simple answer is that on fiscal policy the President is severely constrained, but on international policy the President has considerable short-run discretion. This distinction is critical in assessing what policies are likely after the election and hence the economic outlook.

In theory, the President must get approval from Congress to engage in military actions and manage international trade. In practice, Congress has delegated a lot of authority to the President. According to a study from the Peterson Institute, a number of laws designed to deal with national security, unfair trade, economic emergencies, and war could be invoked to at least temporarily restrict trade. In many cases the executive action could be overturned by the courts or by legislation, but that takes time. An important example, given the complex integration of the North American economy, is “an escape hatch” in NAFTA: any member can withdraw after giving six months’ notice.

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2 See Halper “Hillary Clinton has a massive fundraising advantage. She’s using it to leave no vote to chance,” Los Angeles Times, 20 September 2016.
3 For example, the Predictwise website currently sees an 81% chance of Democrats taking the White House and a 63% chance of them taking the Senate, but only a 14% chance of them taking the House.
to other members. Actually raising tariff barriers would require additional actions, but invoking this cause could create considerable uncertainty for integrated businesses.

The situation is less clear for other delegated authority. The President has some latitude in how regulations and rules are enforced. Consider immigration. According to Pew Research, there are roughly 11 million undocumented immigrants in the US and about 8 million are employed (5.1% of the labor force). These figures have been essentially flat since 2009. According to Pew, 2.4 million people were deported from the US between 2009 and 2014 and the Obama administration has deported more people than any prior President (Chart 1). However, it will be hard to ramp this up further absent a bigger enforcement budget as the program is already stretched.

**Fiscal follow through**

A third, related question is how big of a fiscal expansion should we expect after the election. Clinton has proposed a slightly expansionary fiscal plan, including higher infrastructure spending financed by higher taxes on upper income people. She has also suggested some increase in defense spending. Trump has a much more aggressive plan including, a broad based tax cut, “double” Clinton’s infrastructure plan and some expansion in other parts of the budget. Building a wall on the Mexican border and tripling the number of Immigration and Customs Enforcement Officers (ICE) would add to the deficit unless alternative financing can be found.

How likely is a major fiscal expansion? In our view, as long as Republicans retain control of the House, a large fiscal expansion is unlikely. In Chart 2 we take a page from Fed watching and show the “dove-hawk” spectrum for the various players in fiscal policy. Given his large deficit expansion plan we put Trump on the Dovish, expansionary, end of the spectrum. Clinton, with her roughly equal increase in taxes and spending is in the middle. House Republicans are at the other end of the spectrum. Recall that this is the same group that delayed raising the debt ceiling in 2011, threatened to go over the “fiscal cliff” and shut the government down in 2013 in an attempt to maintain strong fiscal discipline. In our view, House Republicans could be convinced to do a moderate deficit expansion if tax cuts are a central part of the equation. As long as Republicans retain control of the House, however, Michelle Meyer and team expect only a small fiscal expansion regardless of the Presidential outcome.

**Maybe, just maybe, central banks can create inflation**

A major market myth is that the global economy is drifting toward deflation. It is true that the plunge in oil prices caused inflation to drop last year, but as oil prices have

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stabilized headline inflation is converging back to core inflation. The core itself is remarkably stable in both DM and EM (Chart 3). Looking ahead, we see a slight upward trend in core inflation, led by the US, Japan and parts of emerging markets.

Why is the deflation story so hard to kill? Some central banks—like the ECB and BOJ—have added to the confusion by focusing on headline rather than core inflation. Thus the collapse in oil prices—a huge windfall for these heavy energy importers—was somehow construed as bad news as they were allegedly losing the war against deflation. Another source of confusion is the plunge in inflation breakevens. In our view, this is less a signal of inflation expectations but more a sign of the powerful spillover effect of negative rates and aggressive QE in Japan and Europe. These policies have driven down both real rates and breakevens. The deflation story has also been fed by oversimplified models of inflation. Thus a popular refrain in Japan is that adverse demographics and weak productivity lower GDP growth, making it hard to create inflation. In our view, nothing could be further from the truth: weakness in the labor force and productivity reduce the growth in the supply of output relative to demand, adding to inflation pressure.6

Our new Japan economist Izumi Devalier joined us in the past week and we have started a robust dialogue around the current policy environment in Japan. At their last meeting the BOJ not only introduced yield targeting, but also promised to keep expanding QE until the inflation rate exceeds the 2% target “and stays above that target in a sustainable manner.” Not surprising, the announcement was meet with deep skepticism: isn’t the BOJ out of ammunition and how can they overshoot when they can’t even achieve the target in the first place?

We think the pessimism on Japan is overdone. In our view Japanese policy makers have finally hit on a winning formula. Easy policy and the business cycle recovery have already pushed core-core inflation from roughly -1% to +0.5%. The labor market has tightened significantly with the unemployment rate at a 21-year low and job openings at a 25 year high (Chart 4). Despite deeply depressed inflation expectations, wages have also started to inch higher.

Now the ball is in Abe’s court. He has already postponed the ill-advised consumption tax hike. Now he needs to deliver sustained fiscal easing, pushing the unemployment rate down until wage and price inflation pick up in earnest. With the BOJ pegging interest rates at zero, this can trigger a virtuous feedback loop: higher inflation means de facto easing of monetary policy by pushing down real interest rates, stimulating growth and inflation and eventually taking the pressure off of fiscal policy to support growth. In our view, this is the best opportunity to both vanquish deflation and improve debt dynamics.

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6 To take a simple example, what happens when a person retires? Their spending may decrease modestly, but their supply of output plunges to zero, creating excess demand.

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**Chart 3: Developed vs emerging markets core inflation (% yoy)**

![Graph showing Developed vs Emerging Markets Core Inflation](image-url)

**Chart 4: Tightening Japan labor market**

![Graph showing Japan Unemployment Rate and Ratio of Active Job Openings to Applications](image-url)

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*Source: BofA Merrill Lynch Global Research, Haver Analytics*

*Note: Shaded regions represent Japan recessions. Source: Ministry of Internal Affairs and Communications, Ministry of Health, Labour & Welfare*
in the last two decades.

Will it work? We are encouraged by the changing dialogue in Japan. Over time many of the excuses for failing to create inflation have dropped to the wayside: (1) deflation is a structural problem and can’t be cured with monetary policy, (2) if they want to be “credible” the central bank should only set goals that are easily achievable like a zero target, (3) they will be forced to “taper” as the supply of bonds shrinks and (4) the BOJ should avoid the appearance of working with fiscal authorities. We are particularly encouraged by the BOJ’s shift to yield targeting and away from quantity targeting. This makes it clear that the simple “monetarist” view of QE is wrong: expanding reserves does not lead to a surge in bank lending. Rather, QE stimulates the economy by lowering interest rates and causing portfolio rebalancing into risk assets. At his latest press conference, Kuroda did his best to puncture one remaining myth: the idea that an eventual reduction in purchases is a sign of fading stimulus. He noted that “the amount of JGBs available in the markets is declining steadily...if we continue making monthly purchases in line with the JPY80tn/year MB target, it’s very likely that the downward impact we achieve on interest rates with every unit of JGB purchases is becoming stronger and stronger.” (Thanks for the translation Izumi!)

Markets: bullish equities; bearish bonds
The current policy environment, with modest fiscal easing and with central banks working overtime to create inflation is good for equities—underpinning growth and extending the economic recovery—and bad for bonds—eventually the market will concede that central banks can indeed create inflation.

What to watch: debate and deliver
The main near term risk to our economics and markets call is an uncertainty shock out of the US election. With split government the status quo continues and the election becomes a non-event. In the weeks following the first debate, the probability of split government rose significantly. So mark your calendar for the remaining debates on Sunday October 9 and Wednesday October 19. In the months ahead, we will also watch to see if Abe delivers real fiscal stimulus and if the ECB signals extended QE.
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