Musha Research

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Musha Research Commentary

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Trump rather than Piketty is the best prescription for the world's surplus savings

- The Trumpnomics economic boom will spark a strong Japanese stock market rally

Musha Research Co., Ltd.
President
Ryoji Musha
Direct ＋81-3-5408-6821
musha@musha.co.jp
http://www.musha.co.jp

901 Renai Partire Shiodome
2-18-3 Higashishinbashi,
Minato-ku, 105-0021 Tokyo

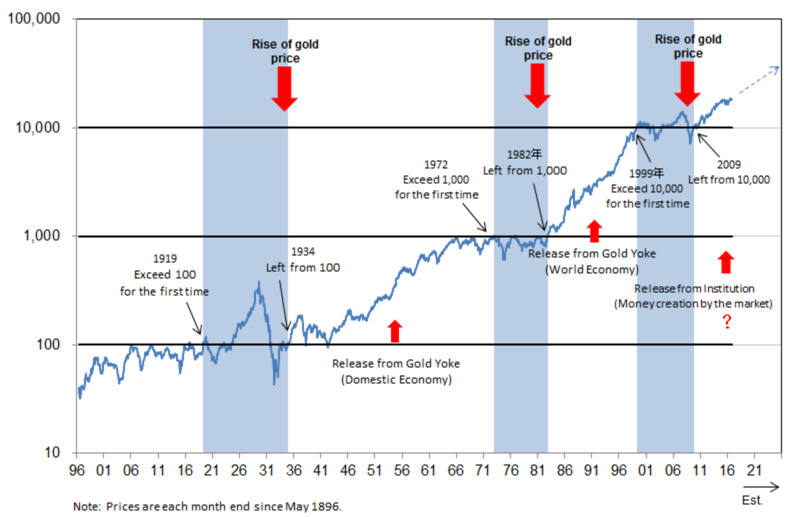
(1) We may witness a stock market rally similar to the Reagonomics rally

A new dimension for the world's economy and financial markets

Donald Trump's election victory has created a new dimension for the global economy and financial markets (and the global geopolitical picture). There is a high probability that the ongoing Trump rallies in the stock market and the dollar can be sustained. Rising stock prices and the stronger dollar demonstrate strong confidence among investors in Mr. Trump's economic policies. During the election campaign, Mr. Trump adopted a populist stance that included U.S. protectionism and isolationism. But now as Mr. Trump backs away from these positions, financial markets are turning their attention to the huge economic benefit of large-scale spending programs, pro-business deregulation, higher defense spending and other actions.

Fiscal initiatives, more defense spending and deregulation are exactly the same economic measures that were enacted by President Reagan, who is viewed as the godfather of the revival of U.S. capitalism. President Reagan's election in 1980 was the beginning of the biggest U.S. stock market rally ever. Over the ensuing 18 years, the Dow Jones Industrial Average moved up about 10 times, rising from $1,000 to $10,000. Due to the radical nature of Mr. Trump's policies, there is a possibility of stock prices climbing during his four-year term by about the same as the 150% upturn (12% annual increase) that happened during President Reagan's two terms.

Figure 1: NY Dow 100 years ･･ the greatest ever Reagan boom



Note: Prices are each month end since May 1896.
Source: djaverages.com, Musha Reserach

There is little doubt that Mr. Trump's economic policies can boost the US economic growth rate over the next few years. Moreover, as I explain later in this report, there are now only small barriers to growth in the United States. As a result, prospects are excellent for the impending economic boom to last a long time. One reason is that the fundamentals of the US economy are basically sound. Second, Mr. Trump's policies will probably be an effective prescription for surplus savings and surplus capital, which are the diseases that plague the global and US economies.

(2) Trumpnomics is likely to spark a US economic boom in the near future

An economic benefit on a massive scale

All we are hearing about now is budget deficits resulting from enormous spending programs and the concerns about the impact of the dollar's strength on emerging country economies. But people should instead focus on the chain reaction of benefits from faster economic growth resulting from this spending. Proposals for dramatic tax reductions are particularly significant. They include (1) a cut in the corporate tax rate from 35% to 15%, (2) a reduction in the personal income tax rates from the current progressive seven steps to 12%, 25% and 33% (cutting the top tax rate from 39.6% to 33%), (3) an extension of the tax reduction for capital gains and dividends, and (4) the elimination of the inheritance tax. Another proposal calls for lowering from 35% to 10% the tax on overseas cash held by multinational corporations, which currently totals $2.5 trillion, that is repatriated to the United States. The goals are to increase tax revenue while bringing overseas income back to the United States.

Implementing all of these tax reductions would cut taxes by about $5 trillion over the next decade, which is an estimated 2.8% of the nominal US GDP. There are also plans to spend $550 billion on infrastructure projects and increase defense spending. All of these actions would probably easily boost US GDP growth from the 2.1% pace since the global financial crisis (2011-2015 average) to more than the long-term 3% growth rate that has occurred since 1990.

Deregulation in the energy and financial services sectors will also increase business activity. By 2018, which is the next US mid-term election, the United States could likely be in the midst of an economic boom with an annual growth rate of 4% to 5%. These events will eventually create two major barriers to economic growth: inflation and a larger budget deficit. Rising long-term interest rates would then bring about the next recession. Faster inflation in the United States, which is already at full employment (4.9% unemployment), and an enormous budget deficit fuel worries about the economy in 2018 and the following years. However, a strong dollar would probably be a powerful remedy for rising inflation and interest rates. This is because a continuation of the dollar's appreciation would increase the probability that the expected US economic boom keeps going throughout Mr. Trump's term of office. Obviously, a stronger dollar will strengthen the global financial clout of the United States. This would in turn help reinforce US hegemony, which may be a goal of Mr. Trump.

China will be the loser of Trumpnomics – But it will lose very slowly

An article in the November 19 issue of The Economist raised three concerns about Trumpnomics. The first is worries about a stronger dollar causing the finances of emerging countries to collapse. The second is trade friction resulting from a worsening US current account balance as the dollar appreciates. The third is the growth of income inequality. But income inequality can probably be reduced by faster economic growth. The reason is that dissatisfaction with income inequality will decline as infrastructure, energy, housing and other investment create more jobs for manual laborers.

Consequently, we should focus on the first two concerns about Trumpnomics. But both of these points are mainly problems involving China. The first concern is whether a strong dollar will lead to financial crises in emerging countries. In the early 1980s, there was a financial crisis in Central and South America. The dollar's strength due to Reagonomics sparked outflows of capital and falling currencies in this region, where economies were booming because of the growth of debt during the 1970s. This crisis was followed by a prolonged period of no economic growth in Central and South America as countries were held back by debt. Now these countries are worried about another strong-dollar financial crisis.

The biggest source of concern today is China, which has accumulated a massive volume of external debt. The country's external debt totals $4.6 trillion, which is 40% higher than its foreign exchange reserves of $3.2 trillion. Due to this situation, a continuation of the dollar's appreciation and yuan's depreciation would create a serious problem for China. After all, whether debt is denominated in dollars or yuan, the loss would be the same for a lender or a borrower.

Trade friction is the second source of concern. Since 1980, the US has greatly reduced its trade deficit with Japan, which was the greatest source of trade friction at that time. Now, China is clearly the biggest target because it accounts for about half of the entire US trade deficit. This friction has already started. Mr. Trump has stated that he will designate China a currency manipulator on his first day as president. In addition, China is the target of criticism regarding its unfair trade practices, such as infringement on intellectual property rights. Although China poses a potential risk concerning Trumpnomics, this country is unlikely to create a problem for some time. China can probably prevent its economy from losing momentum for the next year or two by implementing monetary easing and spending programs on a massive scale. Nevertheless, China will still continue to move closer and closer to an economic crisis as trade friction impacts the trade surplus, weakens the yuan and contributes to the growth of debt within China (that may become non-performing loans in the future).

(3) The US economy has been sound for years

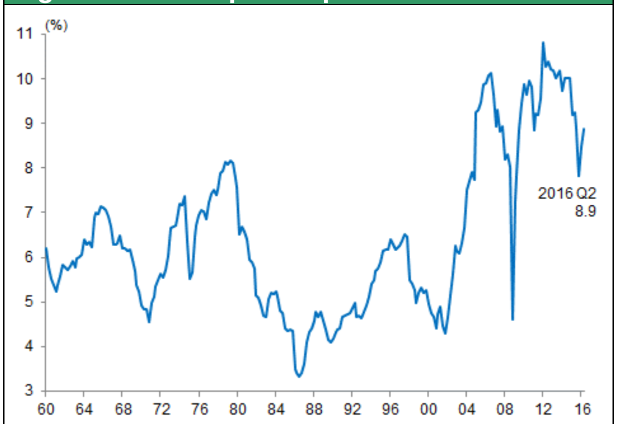
People have overlooked the soundness of the US economy for a long time

We have been hearing depressing outlooks for the US economy for years. So why are we just now suddenly reading about extremely positive scenarios for the United States? The answer is that the next president will inherit an economy that is basically healthy. The following five key indicators of US economic fundamentals are all at historically high levels. First is the unprecedented level of corporate earnings backed by the information and Internet revolution. Second is the competitive superiority of US industries underpinned by the country's global leadership in innovation. Third is low interest rates in tandem with a substantial volume of money that is available for investments (large volume of savings). Fourth is the increasing financial soundness of the US government. Fifth is the low level of inflation. Slowing economic growth is the only problem. Some regions of the United States and some segments of the population are not benefiting from economic growth. But this problem can be solved easily by implementing necessary political initiatives. This environment will allow Mr. Trump to use monetary measures and deregulation to boost the growth rate. The current stock market rally demonstrates that investors have confidence in this outlook.

Mr. Trump will inherit a favorable economic environment

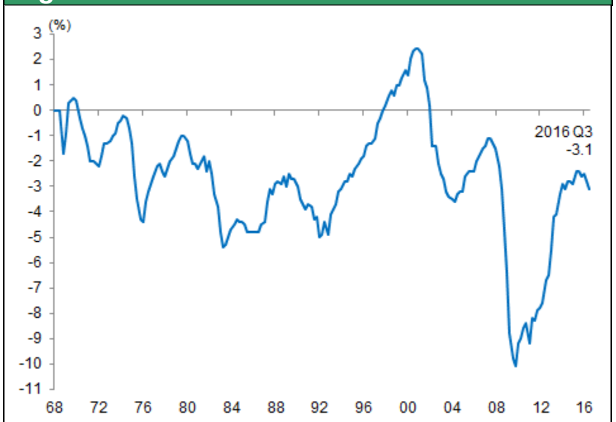
After his inauguration, Mr. Trump will be in an excellent position to utilize this favorable environment for the purpose of providing people with extensive economic benefits. Regardless of the winner of the election, Musha Research believed that the next president would be able to speed up economic growth, boost stock prices and make the dollar stronger. But Mr. Trump's policies are more pro-business and pro-growth.

Figure 2: US corporate profit / GDP



Source: US Dept. of Commerce, Musha Research

Figure 3: US fiscal balance / GDP



Source: Bloomberg, Musha Research

Figure 4: US GDP by public/private demand

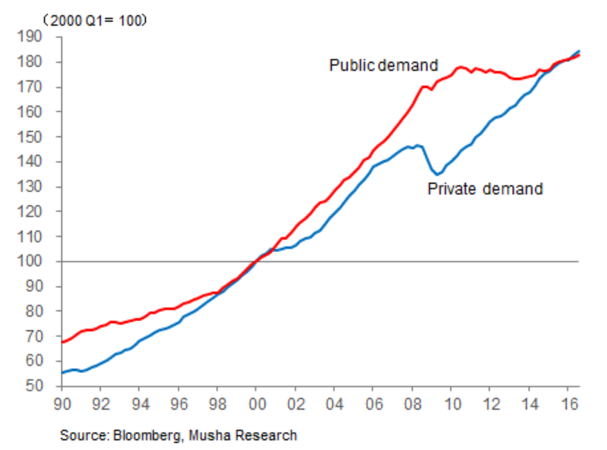


Figure 5: US aging infrastructure

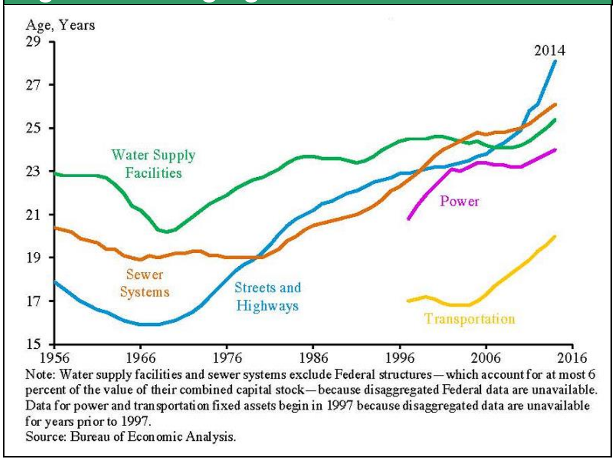


Figure 6: US net savings by sector

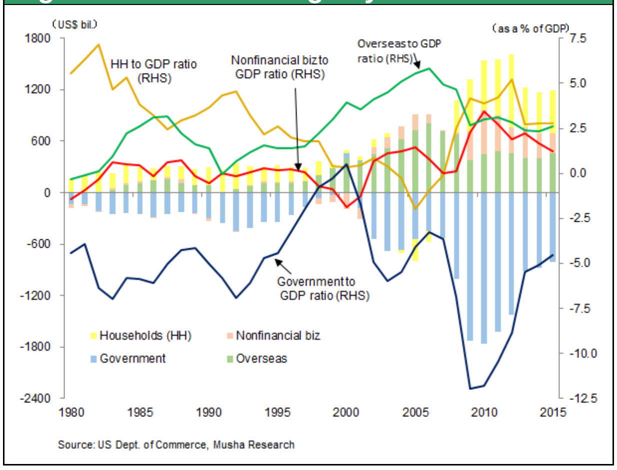
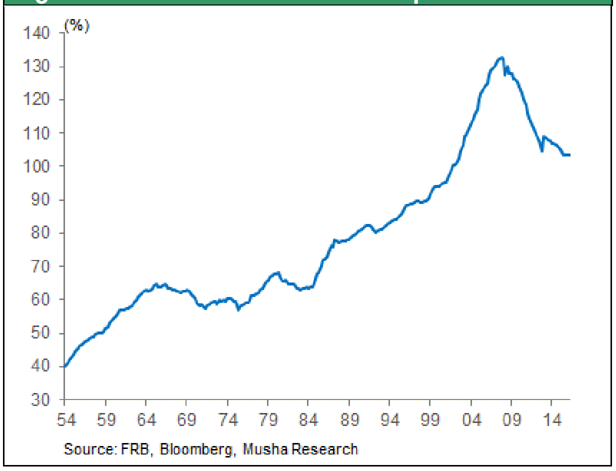


Figure 7: US household debt / disposable income



(4) Trumpnomics aims to convert surplus savings into a driver of growth

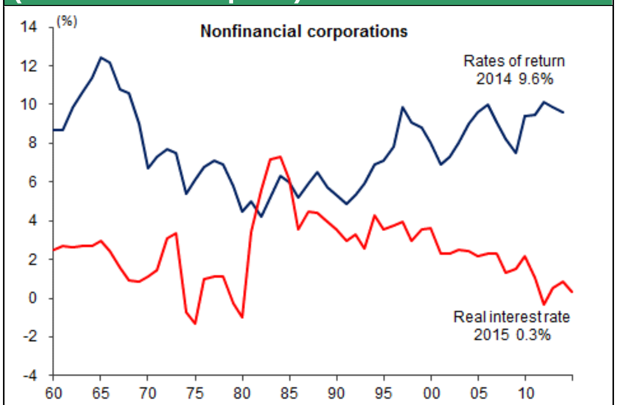
The theoretical justification for Trumpnomics

The pro-business, pro-growth policies of Mr. Trump are probably correct and will lead to higher stock prices. This view is based on the belief that these policies are the most effective prescription for dealing with the global surplus of savings. For several years, Musha Research has stated that the accumulation of idle surplus capital is the fundamental problem holding back the US and global economies. This surplus capital is caused by the inability to effectively recycle the unprecedented volume of cash that companies currently hold back into the real economy. Mr. Trump's plans to use fiscal measures to create demand and deregulation to stimulate investments are right on target for putting this surplus capital to work.

During the past several years, companies have been reporting record-high earnings while interest rates fell to levels never seen before. Profit margins and interest rates should be the same. This movement in opposite directions has been viewed as a problem. Under normal circumstances, record-high earnings and record-low interest rates should not exist at the same time. Most likely, the fundamental cause of this situation is the large volume of extra earnings at companies resulting from higher productivity made possible by the new industrial revolution. Companies are earning enormous profits. However, this money is sitting idle because companies cannot reinvest these funds. Interest rates moved down as a result.

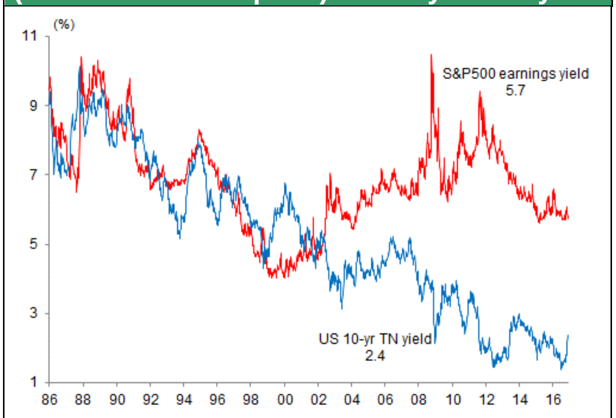
The remarkably low interest rates in industrialized countries are an indication of the existence of surplus capital. Moreover, the lack of growth in jobs (resulting in rising unemployment, low workforce participation, minimal upward pressure on wages) is an indication of the existence of surplus labor. Why have these surpluses increased to the point where they are problems? The answer is probably the big improvements in labor and capital productivity at companies. The new industrial revolution is defined by IT, smartphones, cloud computing and other advances. This revolution along with globalization has sparked an enormous improvement in productivity. Higher productivity means that companies require much less labor and capital for their operations. If nothing is done about surplus capital, the widening gap between rich and poor will create more social instability. Furthermore, the accumulation and hoarding of capital is a sign of the death of capitalism. In other words, capitalism may collapse without a commitment to the policies that can end this problem.

Figure 8: US corporations capital return (based on book price) and real interest rate



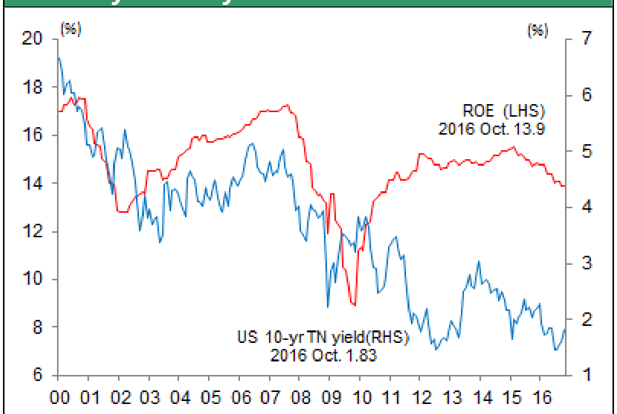
Notes : Rates of return= nonfinancial corporations profit before tax / produced asset, Interest-rate =10Y Bond yield - CPI
Sources : Survey of Current Business, FRB, Musha Research

Figure 9: US corporations capital return (based on market price) and10-year TN yield



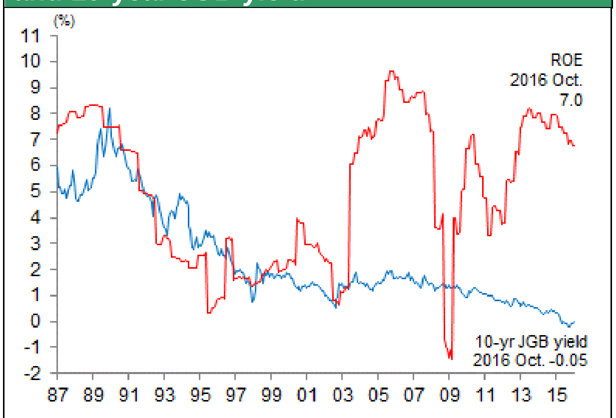
Note: As of Nov .25, 2016
Source: Bloomberg, Musha Research

Figure 10: US ROE (based on book price) and 10-year TN yield



Source: Bloomberg, Musha Research

Figure 11: Japan ROE (based on book price) and 10-year JGB yield



Note: TOPIX
Source: Bloomberg, Musha Research

At this point, the world needs initiatives for leveraging the power of government policies in order to recycle surplus capital back to the real economy. Faster economic growth fueled by this capital will push interest rates up. Accomplishing this goal will make the outlook bright. There are three policy options for recycling capital.

1) Fiscal policy – Enact Keynesian policies and implement institutional reforms to stimulate private-sector investments

2) Monetary policy – Lower capital return based on market price (=earnings yield) by boosting stock prices; stock repurchases by companies are the first step in this direction

3) Income policy (social policy) – Wage hikes, increasing labor’s share of income and higher consumer spending, social income distributions such as basic income

Using these initiatives can increase the economic growth rate by drawing on the benefits of the technology industry revolution and improving the public’s quality of life. Mr. Trump has selected the first option: fiscal policy. The United States has already fully utilized monetary policy and the role of this policy is coming to an end. And Mr. Trump has been criticized for his stance on social policy. One of the primary examples is contained in “Capital in the Twenty-First Century”, a best-selling book written by Thomas Piketty.

Mr. Piketty has been extremely critical of the positions of Mr. Trump. Mr. Piketty believes that tax cuts will benefit rich people. He also expects the America-first stance to strengthen due to fiscal dumping resulting from corporate tax cuts and to environmental dumping (the easing of environmental standards). Another criticism is that deregulation will result in companies receiving preferential treatment. Mr. Piketty supports the position of Bernie Sanders, who calls for tighter regulations and income reallocation (tax increase for high-income brackets and payments to implement social policies) in order to reduce the economic and regional differences that exist in the United States (based on articles in the Nov. 23 Asahi Shimbun and Nov. 13-14 Le Monde).

Raising taxes on companies and wealthy people would allow the government to collect surplus savings and redistribute this money to people in need. This would clearly have the positive effect of utilizing surplus capital. However, selecting this course of action would probably not create the animal spirits needed for the growth and investments needed to boost economic growth and make interest rates and stock prices climb.

Mr. Piketty focuses solely on this relationship:

r (return on capital) > g (economic growth rate)

The belief is that these two figures should be equalized by using income reallocation and taxes. There was very little interest in taking actions aimed at increasing the economic growth rate.

But Musha Research believes that there two coexisting inequalities:

r1 (profit margin) > g (economic growth rate) > r2 (interest rate)

The link between low interest rates and surplus savings exists because demand is currently being pushed back into the future. The economic growth rate will increase if surplus capital is put to work. Faster growth would also be likely to help reduce income equality and poverty. The powerful stock market rally that started after Mr. Trump’s victory demonstrates the significant benefits of using fiscal initiatives to create demand.

(5) The inevitability and historical significance of the Trump victory

Necessary reforms of the world order and recycling of affluence were at a dead end

It is far too soon to determine if Mr. Trump can become a president of the same historical significance as Ronald Reagan. However, if the emergence of Mr. Trump, a complete political outsider, was inevitable, then Mr. Trump has the potential to become a great leader.

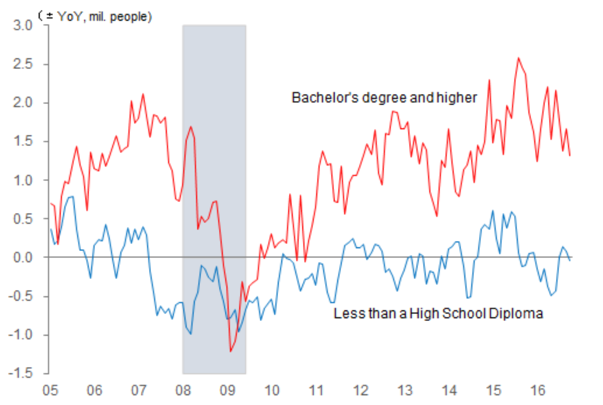
The media and financial markets have reacted to Mr. Trump’s victory with bewilderment. No one can deny that his statements are full of contradictions and deceit. In some respects, we have to regard Mr. Trump as a typical populist who relied on inciting the anger of the public. Nevertheless, most of the people who voted for Mr. Trump were probably not supporters of populist positions. So exactly what are the hopes concerning Mr. Trump among the US electorate, which has one of the longest democratic traditions in the world? This is a critical point. The magnitude of the stock market’s positive response should obviously provide a reasonable answer. We must admit that Mr. Trump’s statements touched the hearts of many voters.

The first expectation of voters involves the fragile state of the world order (the spread of lawlessness from the standpoint of the United States). Voters have shown that they do not want to permit lawless activities in the world, including everything from illegal immigration to extremist statements about Islam. As a result, voters appear to expect Mr. Trump to reestablish US global leadership and world order. Accomplishing will entail a return to a military buildup, which is a move in the opposite direction of isolationism. Mr. Trump’s repeated use of President Reagan’s theme of “peace through strength” apparently shows Mr. Trump’s commitment to US hegemony and world order. Sound US economic fundamentals provide strong support for investing in defense and reinforcing US global leadership. The United States needs to preserve national security while dealing with threats from new rogue states, terrorism and new types of cyber attacks.

The second expectation of voters involves the inability of the economy to transform strong corporate earnings into more jobs and a better standard of living. This expectation exists in regions of the United States and low-skilled workers that have been left out of prosperity fueled by globalization. These workers interpreted Mr. Trump's statements about protectionism and isolationism as a message that he would not overlook the current difficulties of people lacking advanced skills. Mr. Trump believes that pro-growth policies can solve this problem. The highest policy priorities are invigorating regional economies and creating jobs for lower-skilled workers. Voters had to decide whether Donald Trump or Hillary Clinton would be better able to tackle these two issues. Obviously, more voters placed their faith in Mr. Trump.

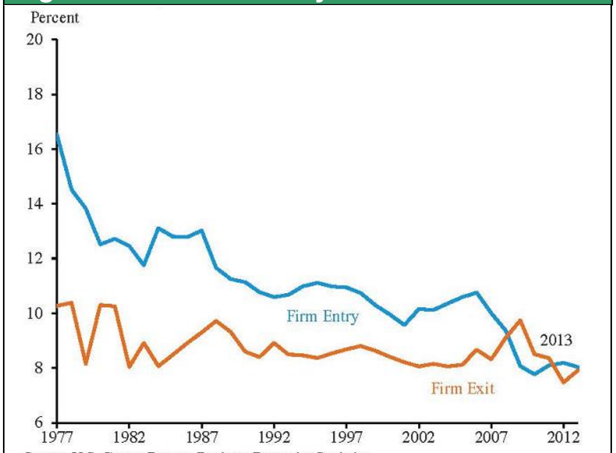
After the global financial crisis, the United States significantly tightened regulations on the financial services sector, causing a big downturn in new business creation. This is probably one more factor that is hindering the US economy. Mr. Trump plans to enact bold measures while reflecting the traditional policies of the Republican Party, which controls both houses of Congress. If Mr. Trump makes revisions to the populist policies (protectionism, isolationism, xenophobia) that no one thinks can be implemented, he may succeed at bringing about the second wave of the Reagan-style conservative revolution.

Figure 12: Growth rate of employment by educational attainment



Source: BLS, Musha Research

Figure 13: US firm entry and exit rates



Source: U.S. Census Bureau, Business Dynamics Statistics.

Mr. Trump has displayed the spirit of saying just what he thinks and has been severely critical of excessive regulation and idealism simply for the sake of appearance. But all of these qualities may have been precisely what the people secretly wanted.

No more upward pressure on the yen due to the outlook for friendly US-Japan relations

Mr. Trump's mindset is similar to how Prime Minister Abe thinks. Their relationship may develop into the type of relationship that existed between President Reagan and Prime Minister Nakasone. One positive sign is the fact that Prime Minister Abe was the first foreign leader to meet Mr. Trump after the election. Therefore, Mr. Trump's election may be beneficial rather than harmful to ties between Japan and the United States. Mr. Trump will undoubtedly appreciate Japan's establishment of new national security legislation and a budget that reflects US wishes (75% of the cost of US bases in Japan, the highest contribution percentage in the world). Mr. Trump should also be appreciative of Japan's cooperative investment policy of allocating all its foreign exchange reserves to U.S. Treasury securities. This clearly sets Japan apart from China. Overall, Mr. Trump should welcome the increasing influence of the Japanese economy for two reasons: the existence of a mutually complementary division of labor between Japan and the United States and the ability to prevent China from gaining too much influence.

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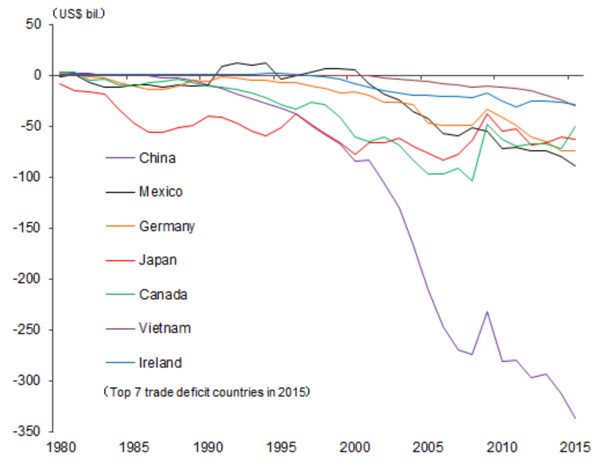
The U. S. is likely to end its policy of a stronger yen and we may see revisions to the U.S. foreign exchange manipulation country monitoring system that is unfair to Japan

Figure 14: US trade deficit by country



Source: IMF, Bloomberg, Musha Research

Figure 15: US evaluation criteria for trading partners

	(1) Bilateral goods trade balance	(2) Current Account		(3) Intervention	
		% of GDP	3 year change	Net FX purchases	Persistent net purchases of FX
	Trailing 4Q, $ bil.	Trailing 4Q, %	% of GDP	% of GDP	
China	**356.1**	2.4	0.0	-5.1	N
Germany	**71.1**	**9.1**	2.3	-	N
Japan	**67.6**	**3.7**	2.6	0.0	N
Mexico	62.6	-2.9	-0.8	-2.2	N
Korea	**30.2**	**7.9**	2.0	-1.8	N
Italy	28.3	2.3	1.9	-	N
India	24.0	-0.8	4.2	0.3	N
France	18.0	-0.5	0.4	-	N
Taiwan	13.6	**14.8**	5.2	**2.5**	**Y**
Switzerland	12.9	**10.0**	-1.6	**9.1**	**Y**
Canada	11.2	-3.4	0.1	0.0	N
UK	-0.3	-5.7	-2.0	0.0	N
Euro Area	*130.2*	*3.2*	*1.9*	*0.0*	*N*

Note: 2016 Oct. report
Source: Haver Analytics, US BEA, US Treasury (incl. estimates)

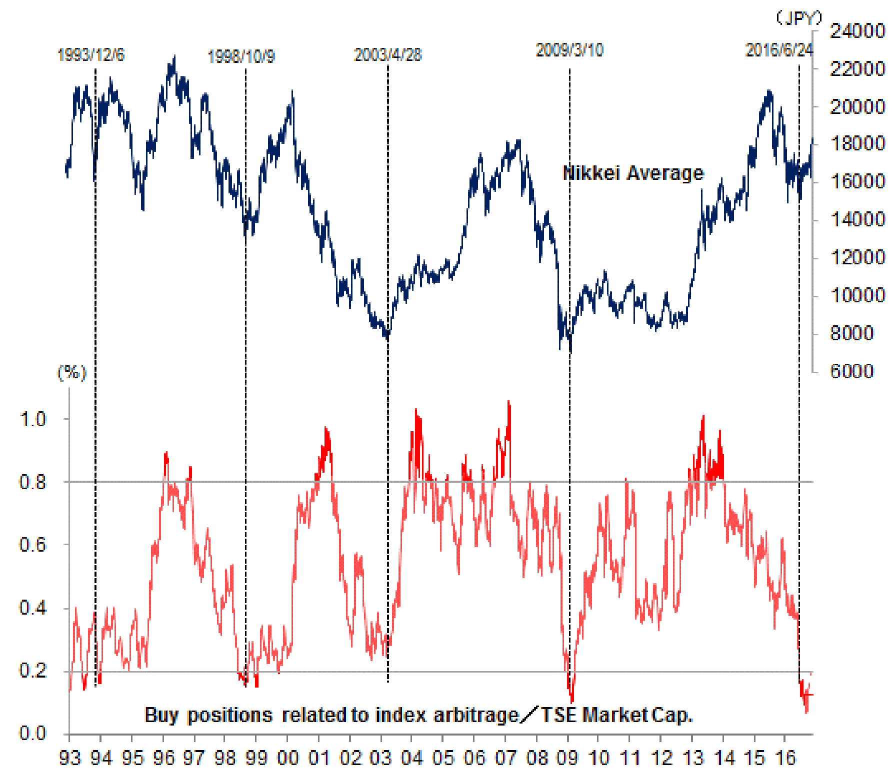
(6) Trumpnomics will be a powerful force behind a catch-up stock market rally in Japan

Immediately after his inauguration, Mr. Trump will probably enact large-scale reflationary initiatives as he looks ahead to the 2018 mid-term election and 2020 presidential election. Republican majorities in Congress will give the new president even more flexibility in implementing his policies. US economic growth is expected to increase in 2017. There is a high probability of measures to encourage multinational companies to the return earnings currently parked overseas to the United States and the use of these funds for cutting taxes and infrastructure projects. This policy will strengthen the dollar. We are very likely to see US stocks, interest rates and the dollar climb in 2017 as the economy accelerates and the Fed raises interest rates (in December and the middle of 2017, probably).

In Japan, we can expect to see full-scale reflationary initiatives due to large-scale fiscal and monetary measures that make up the second phase of Abenomics. In this environment, we should see wages and real estate rental rates increase as supply-demand dynamics improve for in the labor and real estate markets. Inflation in Japan is also likely to increase as the yen becomes weaker and the downturn in crude oil prices comes to an end. The resulting decline in real interest rates will probably make investors much more interested in directing their funds to assets with risk within Japan.

The first phase of the Abenomics stock market rally propelled the Nikkei Average from ¥8,600 to ¥20,860, an increase of 140%, between November 2012 and August 2015. The second Abenomics rally is probably starting right now with the Nikkei Average at the ¥16,000 level. If another mid-term rally does take place, the next upturn could lift the Nikkei Average to between ¥30,000 and ¥40,000 by 2020. The outstanding arbitrage stock purchase ratio (using market capitalization of the Tokyo Stock Exchange first section) is an indicator of market sentiment that can pinpoint the bottom of a downturn. As you can see in Figure 16, this ratio has fallen to an all-time low of 0.1 in October, demonstrating that prospects are excellent for the upcoming rebound in stock prices to take place on an enormous scale.

Figure 16: Nikkei average and buy positions related to index arbitrage / TSE market cap.



Source: TSE, Musha Research