TIME FOR THE U.S. BUDGET – AND THE GREENBACK

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> The financial markets clearly have strong focus on France and North Korea these days, but the battle about the U.S. federal budget has begun and it will keep Wall Street busy.

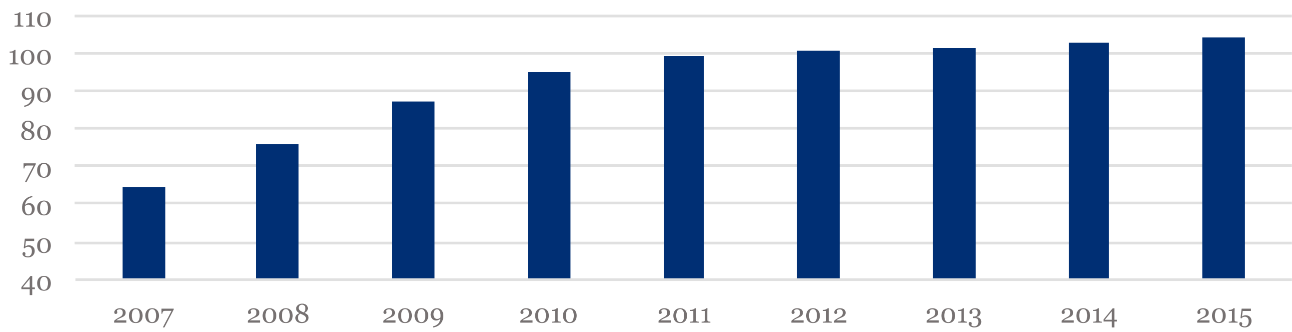
The government in Washington D. C. announced their plan for a tax reform last week. A few days later the top politicians on Capitol Hill in Washington all agreed about the fiscal budget for this year ending in September. But the tax reform is a long-term fundamental part of the federal budget, therefore the real political battle about the federal budget has de facto just kicked off. In this battle I expect some fierce announcements, or tweets in the coming months which will move the financial markets.

For more than 10 years, a growing number of economists have pointed at the necessity of a major tax reform in the U.S., especially for corporations. Several presidents have had this task lying in their inbox without giving it any attention. Now, the newly elected President Trump, deals with the outstanding task which in principal should be perceived positively.
One challenge for the financial markets will be the assessment of how much additional GDP growth the tax cuts generates versus the risk of a large deficit gap in the government budget.
The unpleasant reality though is that the U.S. does not have much fiscal manoeuvre room or options for economic experiments. As graphic one shows the U.S. government debt is at 105 pct. of GDP. This is not a new story but the problem is the ongoing increase in the debt-ratio. Furthermore, the debt burden is close to a level which the International Monetary Fund (IMF) warns against. The debt pile even brings the United States into the global top 10 list of indebted nations just after Cyprus and Bhutan.

Since tax policy in the U.S. has not been reformed for many years, "tax" is not a component that the financial markets have taken into consideration when judging the federal budget, and in particular the risk of a deficit explosion. But now it becomes important to assess if it is economically possible to introduce a corporate tax at 15 pct. ? There is no doubt that it is just one of many issues where it requires new insight for investors when assessing whether the U.S. federal budget risks a deficit explosion or not.
Several experts have already made their comments concerning a reduction in the corporate tax from 35 to 15 pct. Some of them point out that if a current fiscal decision also has consequences for the federal budget in 10 years then Trump has to involve the Democrats in the decision to implement the tax reform. Some calculations estimate that after just two years with a lower tax revenue it has a bearing on the state budget 10 years later, i.e. the tax reform could only be implemented temporarily. It of course depending on the assumptions used in the calculations but it certainly illustrates how difficult it will be to reduce the corporate tax to 15 pct.
However, in the political debate about tax cuts, budget savings and reforms I expect suggestions and opinions to fire off in all directions, which will challenge the financial markets when judging the outlook for the public finances.

The U.S. indebtedness as a percentage of GDP (graphic two) shows that the financial crisis caused a huge fiscal expansion but since then the annual budget deficit rate has been reduced significantly. The development is far better than among many Eurozone member countries and one could argue that the U. S. has fiscal room to increase public spending or to lower tax revenues. Despite some fiscal flexibility, it's

USA - GOVERNMENT DEBT TO GDP



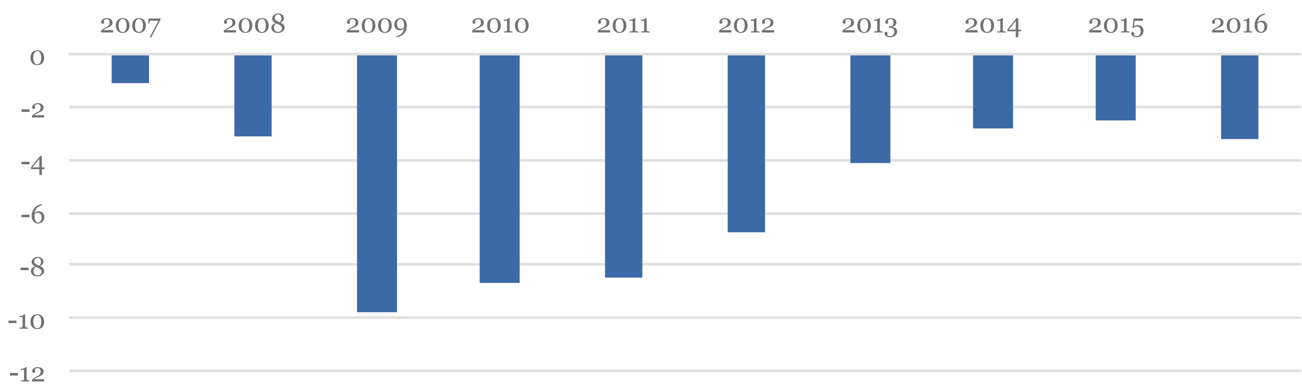
Source: U.S. Bureau of Public Debt

hard to imagine though that the desired great tax reform can be implemented. Just the discussions about Trump's ideas and other reforms will create more tension in the American bond market in the coming months. A big risk is precisely a fundamental doubt about the country's federal budget when the U.S. is already on the global top 10 list of debt nations. For the same reason, I argue that the U.S. Treasuries will come under pressure in the next months.
In the same period, I expect the Federal Reserve Bank (Fed) either to hike interest rates or continue to confirm that there will be more interest rate hikes this year despite the relatively weak Q1 GDP growth. A further increase in Fed funds is expected by the markets, but the hikes will steadily add further pressure in the bond market especially if the mood turns sour. Due to other geopolitical developments that attracts focus, such as France and North Korea, I am of the opinion that the financial markets have not yet worked extensively with the outlook for the U.S. budget deficit. Furthermore, I do expect the same factors to affect the U.S. dollar temporarily.

My view on the dollar at the start of this year was the same as in the previous year namely a five pct. increase towards other currencies in general throughout the year. In 2017 the greenback so far has lost 3.50 pct. which means that if I maintain my four month old view the dollar will climb by eight to nine pct. during the next eight months.
At the start of the year I saw two strong opposing forces for the dollar, where President Trump's possible desire to let the dollar decline was a threat. This threat is still intact, though counterweighted by Secretary of the Treasury Mnuchin who pleads for a strong dollar policy.
Supporting for the dollar was, and is, the prospect of rate hikes by the Fed. Despite the general market expectation about the same, my experience is that the capital movement in the foreign exchange market happens after the interest rates have changed. This will reverse the trend for the greenback upwards during 2017 - As long as Trump does not get through with a "dollar fading policy".

Currently there is a slight short to medium downward momentum for the dollar. The federal budget uncertainty will contribute to keep this pressure on the dollar for another 6 to 8 weeks. In addition, the euro is rising due to the result of the first round of the presidential election in France. Overall I estimate the trend in the euro in 2017 as quite flat due to ongoing lack of reforms. It is the dollar that will show the swings and I maintain my assessment with a stronger dollar during this year, but if President Trump gets away with skipping the strong dollar policy, then it will likely be a reason for me to change my view on the dollar.

USA - BUDGET DEFICIT AS PCT. OF GDP



Source: U.S. Treasury

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