Northern Trust

WEEKLY ECONOMIC COMMENTARY

March 18, 2016

Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312.557.8820
ct92@ntrs.com

Asha G. Bangalore
Economist
312.444.4146
agb3@ntrs.com

- **The Economy and the Election**
- **A New Element of Bank Capital May Do More Harm Than Good**
- **Little in the U.S. Federal Budget Is Truly Discretionary**

I hesitate to admit this, but I haven't watched a moment of the debates among U.S. presidential candidates. I know that I am supposed to stay current on American economic policy, but I have been busy with other things. Like watching my grass grow… even though it's wintertime.

It's not that the debates haven't been entertaining. But while long on drama, they are short on substance. I typically wait to get engaged in election-year issues until after the summer conventions, when the field has narrowed to two and their platforms are better defined.

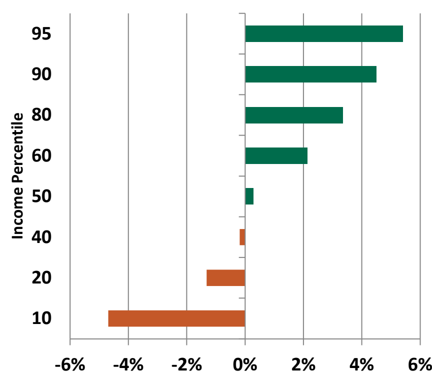
Unfortunately, the number one question I have been asked during the first quarter is: what will the American election mean for the economy? I will try to offer some early thoughts on the subject. But first, I'll ask whether the question should be turned around. The economy seems to be driving the campaign, not the other way around.

The selection of a U.S. president is a process that takes altogether too long. Prospects begin showing up in states with early primaries more than 18 months before the balloting. Fields are far more crowded than they are in other countries, making it difficult to distinguish among individuals. There are almost always a few candidates who are outside the mainstream, but they are usually excused from consideration in the preliminary rounds.

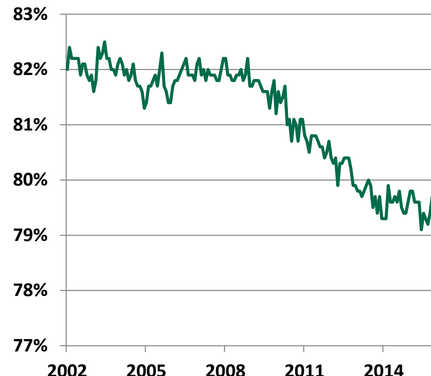
Not this time. Donald Trump and Bernie Sanders are still around, despite holding views that do not align with their party's traditional positions. Their supporters are deeply unhappy with the status quo and are very receptive to the populist messages they offer.

On one level, this should not be surprising. While the American economy and American equity markets have progressed nicely since 2009, gains have been very uneven.

Change in Mean Family Income, 2010-2014



U.S. Labor Force Participation Ages 45-54



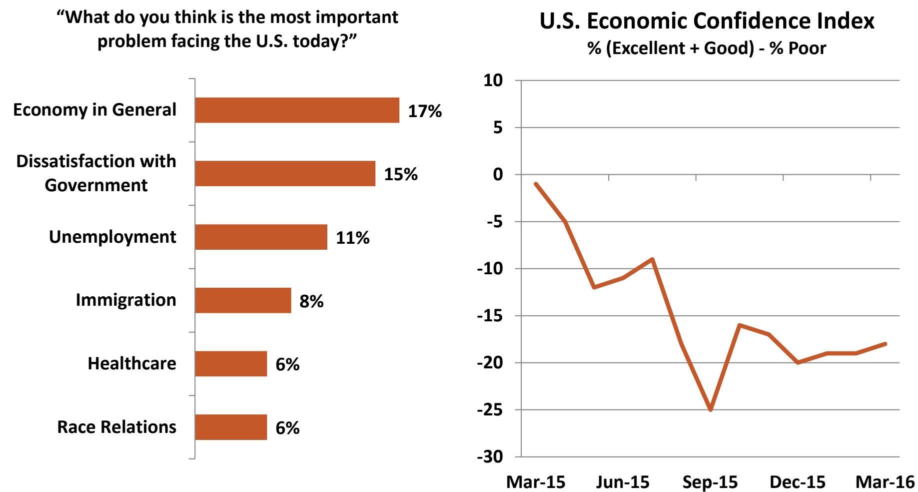
Sources: Census Bureau, Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

The bottom half of the spectrum has seen their incomes fall; many families are arriving on the doorstep of retirement with insufficient savings. There has been alarming decline in the labor force participation rate among prime-aged workers, as job prospects for some of them have dimmed. Those with more modest levels of education have been most vulnerable.

Those left behind during the current expansion are expressing their displeasure.

Rightly or wrongly, some have attributed their struggles to trade policy, financial institutions, immigration and the politicians that support those things. And while there are many reasons to favor a particular candidate, polls suggest that the outsiders have benefitted from a deep sense of economic discontent.



Source: Gallup

One might reasonably ask why all this is happening now. For example, the theme of income inequality has been out there for quite some time; the Occupy Wall Street protests occurred almost five years ago. The best answer is that Trump and Sanders sensed the unhappiness and built their messages around it.

Among the economic subjects bandied about most forcefully on the stump is free trade. It is sometimes easy for the average person to overlook the benefits of trade, but the products we buy every day would not be as inexpensive if we sourced everything locally. What is more visible, however, is that free trade has created economic dislocation for some workers. This leaves many with a negative impression.

Immigration has also been a controversial topic since the campaign began. Immigration has its challenges; but renewing our labor force as baby boomers retire is a critical exercise for the United States. Studies from non-partisan sources suggest that some of the economic caricatures about immigrant communities may not be correct. Here again, though, the issue can be reduced to something more elemental and less positive.

Another area that may garner attention from our next president is monetary policy. The Federal Reserve has come under heavy criticism from Congress in recent years, with Janet Yellen receiving rough treatment when she offers testimony. Proposals to audit the Fed's conduct of

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

monetary policy (their other affairs are already audited), or set interest rates formulaically, have won some adherents. Several candidates have taken turns criticizing our central bank and may advance these ideas.

There are positive arguments for free trade, immigration and an independent central bank. But I recognize that the somewhat academic way I approach these issues may be at odds with the way the average voter views them. Not better or worse, just different.

The disconnect between the intelligentsia and the average voter is huge.

Each of the remaining candidates has a fiscal outline that encompasses tax and spending plans. Some are more specific than others, and estimated impacts are therefore difficult to assemble. We'll devote some analysis to alternate paths later this year.

Before we get too carried away about statements made on the campaign trail, there are a couple things to remember. First, pledges made to attract votes don't always translate into policy. And secondly, Congress will have a great deal to say about any measure our next president proposes.

We often overestimate the president's influence on the economy and markets. But some of the opinions expressed this year are a little further from the ordinary, and that makes people nervous. Reluctantly, I suppose I'll have to set my landscaping aside and pay closer attention.

CoCos and Crisis

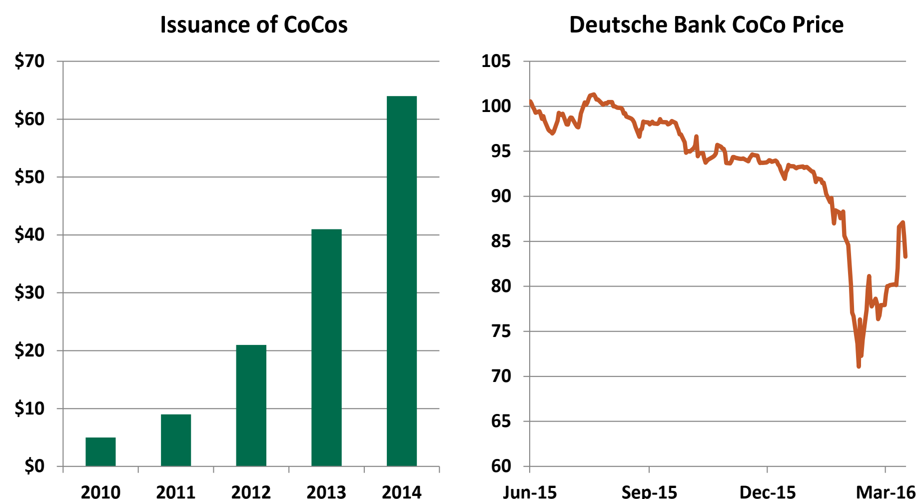
When I was studying finance a generation ago, debt and equity were as different as night and day. Equity holders were the primary beneficiaries of corporate performance and the first to feel pain when things went wrong. Bond holders were guaranteed principal and interest in all but the most-extreme circumstances. The academic work of Merton Miller on capital structure and Robert Merton on debt pricing was predicated on this dichotomy.

Over the years, however, the lines between debt and equity blurred. Financial instruments now span a broad spectrum of seniority that offers investors a range of risk/reward combinations. In theory, portfolio managers benefit from expanded choice. And academics are keenly interested in these kinds of hybrid assets because their prices can serve as early warning signals of corporate distress. But the practical reality surrounding these engineered securities is somewhat troubling.

Among the highest expressions of this genre are contingent convertible securities, otherwise known as "CoCos." These instruments have the characteristics of a bond: scheduled interest payments until a stated maturity date. But they convert to equity under stated circumstances, usually when a company's balance sheet deteriorates to a certain point. The trigger can be formulaic or subject to the discretion of a third party.

CoCos have been especially interesting as elements of bank capital. It is very difficult for financial institutions to raise capital in challenging times, so the conversion feature in a CoCo provides additional support automatically. By making conversion explicit, CoCos are also supposed to avoid the shock of "bailing in" debt holders under adverse circumstances. Investors are compensated for this tail risk with interest payments that are much higher than they are for more conventional bonds.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.



Sources: Economist, Bloomberg

Recently, however, the dark side of the instrument was on display. Deutsche Bank's CoCos fell sharply at the start of the year on concerns about the bank's earnings and strategy. This fed into market concerns about the health of one of Europe's largest banks, which is a major player in world derivatives markets. Fears of contagion had some thinking back to 2008.

False signals from a "canary in the coal mine."

Few thought that Deutsche Bank was in any danger of failure, given the likelihood of Bundesbank support in an emergency. But the signal taken from CoCos prices may have made counterparties hesitant to do business with the firm. Taken to an extreme, the market's suspicions can become a self-fulfilling prophecy. CoCos, like credit default swaps, have the flaw of sending off a lot of false positives and creating more worries than they quell.

No matter how transparent the indenture, it appears that the owners of hybrid bonds still expect them to behave like traditional fixed-income instruments in almost all circumstances. When debt starts to take on the character of equity, it seems tremendously unsettling. I wonder if investors still view financial instruments the way I was taught 30 years ago.

This may not be strictly rational. But it is a mistake to suggest that trading patterns should be discounted because they do not follow cold calculation. A wide body of behavioral economic work suggests that human beings do poorly with complex choices, even when informed by computers that operate formulaically.

More generally, it is not clear that buffers receive the credit they might deserve. Whether maintained by a bank or a sovereign, any decline in a buffer level is seen as a sign of weakness that could threaten viability. One might wonder what the value is in building a reserve if it provides little benefit in the market's eyes.

If there is a bright side to all this, it is that those textbooks I used such a long time ago are still relevant, in spite of all the financial innovation that has occurred since then. For the prices I paid, they had better be.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Discretionary Spending – The Small and Not-So-Flexible Pot

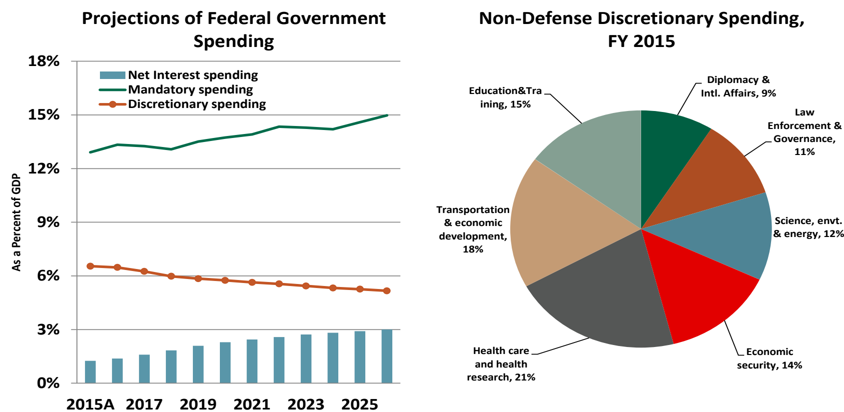
There is a belief that discretionary U.S. federal government spending can be pared back and taxes reduced without causing a wider federal budget deficit and a larger national debt. But unfortunately, close scrutiny reveals interesting limitations.

Total federal government expenditures in fiscal year (FY) 2015 stood at $3.7 trillion. Medicare, Medicaid and Social Security are mandatory outlays that account for 62% of the total spending and 13% of gross domestic product (GDP). Interest payments are the smallest, about 1.3% of GDP. It is well-known that these two components will continue to advance in the next 10 years.

Discretionary spending (Congress appropriates funds for each year) summed up to nearly $1.2 trillion in FY 2015. This category is estimated to reach 5.2% of GDP at the end of 2026, down from 6.2% today. The major items of discretionary spending are defense and non-defense spending. The allocation of federal dollars between these items in 2015 was almost equal (about $582 billion each).

Unless Congress is willing to tackle entitlements, the pot of money potentially available for managing federal government spending (non-defense discretionary spending) is roughly 16% of federal government outlays.

The opportunity for discretionary spending cuts is very small.



Sources: CBO, CBPP

What makes up non-defense discretionary spending? The chart above lists the major items of non-defense discretionary spending, which include health care for veterans; the Food and Drug Administration; air, ground and water transportation; education; law; national security; and scientific research.

Cutting these expenses could mean longer screening lines at airports, slower approval times for new medications, reduced hours at national monuments and fewer agents at the Internal Revenue Service. That latter might not seem so bad on the surface, but America's uncollected tax liability is currently close to $400 billion.

So what is categorized as discretionary may not provide many opportunities for reduction. And the bigger cost-containment opportunities lie elsewhere in the budget.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.