Letter n°117

Trump's economic policy: between constraints and contradictions?

"Reason is the madness of the strongest," Ionesco, Fragments of a Journal.

The madness of the strongest is embodied here by Trump: provocative, populist, and brash, he has prevailed. He is fortunate to take charge of a country that, although indebted, is experiencing robust growth. In implementing his ambitious programme, he can rely on his majority, but stock market investors will not forgive any missteps.

- ***Trump's good fortune***: He repeatedly chants his MAGA slogan, but thanks to Biden's various plans, he inherits a favourable economic climate, low unemployment, and growing consumption. China, which accounted for 75% of the US GDP in 2021, now stands at 65%, and few still discuss a potential catch-up. Friendly G7 countries, such as Japan, Germany, and others, are grappling with low growth and falling further behind the United States. In 1980, the US made up 40% of the G7 GDP; today, it accounts for 50%.

- ***The economic programme is ambitious*** and includes numerous elements to please the markets: deregulation in finance, lowering the corporate tax rate from 21% to 15%, and extending income tax cuts. However, these will need funding, and other aspects, such as border protection through high tariffs, are far from unanimous.

- ***Trump has two years ahead of him and controls both Chambers*** that he did not have in 2016.

- ***The stock market has already welcomed the programme,*** but initial enthusiasm quickly wanes. The public struggles to make sense of this composite government, which blends conservatives, libertarians, populists, and business representatives. Everyone sees the constraints and contradictions of this policy, which we must analyse in this Letter 117.

The 5 constraints: Trump projects a determined stance, but his room for manoeuvre is often limited:

The constraint of public debt: let's examine 4 points.

- *The situation is more challenging than in 2017*:

The budget deficit was 3.1%; today, it is 6.4%. Core inflation was 1.7%; today, it is 3.3%. The 10-year Treasury yield was 1.8%; today, it is 4.3%. Interest payments on the debt were $250 billion; today, they exceed $1 trillion. Public debt was 105% of GDP; today, it is 120% of GDP.

In 2017, public spending was 20% of GDP; today, it is 23%. Public revenues were 18% of GDP; today, they are 17%.

National public debt has reached $36 trillion, or $107,000 per capita. It has increased by $10 trillion in 10 years and has tripled in 20 years.

- *The budget constraint cannot be ignored by Trump*:

At 6.4% of GDP, $1.8 trillion, the budget deficit has never been higher since the Second World War, except after the 2008 financial crisis and during the Covid crisis.

Interest payments on public debt have doubled in 2.5 years and now represent 4% of GDP, equivalent, in percentage terms, to Italy, and double that of France.

- *Trump's plan is expensive and currently unfunded*:

Scott Bessent, the next Secretary of the Treasury, is concerned about worsening indebtedness, but Trump's programme could significantly worsen public finances.

During his first term, Trump's measures added $8.4 trillion to the debt over 10 years, and with his new presidency, this debt is expected to increase significantly.

Extending tax cuts would cost $4 trillion over 10 years. The idea of offsetting income tax cuts with customs duties is an illusion. Even in the unlikely scenario of 50% tariffs on all imports, the revenue would not exceed 40% of that from income tax.

- *Musk's ambitions are likely to be thwarted*:

Musk has set an ambitious target of reducing public spending by a third, achieving $2 trillion in savings, but this ignores inherent rigidity. 75% of federal expenditure is non-negotiable (debt servicing, security, healthcare...), and Trump has pledged not to touch it. As a result, the tax cuts are unlikely to be funded.

The trade constraint and its 3 aspects:

- *China, the primary target, has the means to respond*:

China accounted for 20% of global manufactured exports in 2020, compared to just 3% in 1995. Chinese industry is unavoidable on the international stage, with production exceeding the combined output of the United States, Germany, Japan, South Korea, and the United Kingdom.

Since 2018, when Trump introduced his initial measures, the value of imports from China has decreased by 20%. The trade deficit with China now represents only 26% of the total, compared to 47% in 2018. However, a significant portion of these flows now passes through Mexico or Vietnam, where Chinese companies have established operations.

China has numerous means of leverage:

From a monetary perspective, China can depreciate its currency to offset American tariffs and, in collaboration with the BRICS nations, it can strive to diminish the role of the $ as the currency of international trade.

From a financial perspective, China can sell all or part of its $1 trillion portfolio of U.S. Treasury bonds ($780 billion held by the PRC and $230 billion via Hong Kong).

From an economic perspective, China is considering blocking exports of rare earths essential to the tech sector as retaliation against strengthened American controls on the export of components that support the development of China's semiconductor industry. China holds up to 80% of the rare earth market and has expressed its intention to ban Nvidia in China.

From a personal angle, China can unsettle Musk, whose main factory outside the United States is located in China and faces competition from BYD. Car sales in China increased by 16% year-on-year in November, but BYD significantly outperformed Tesla, selling 504,000 vehicles compared to Tesla's 78,000. Many competitors in the market are heavily subsidised.

- *The EU can hold its ground*:

The EU may lower interest rates faster than anticipated, which could weaken the €.

The EU can also strengthen common policies by mobilising its abundant savings, which are too often directed towards the United States.

- *A lack of unanimity in the United States*:

In the U.S., evidence of the unpopularity of tariffs is seen in the rush by many manufacturers to import goods before Trump's policies take effect and imported components become more expensive.

Other companies, eager to preserve their exports to China, will oppose Trump's measures, just as they are currently contesting Biden's policies.

The monetary constraint:

The freezing of the Russian Central Bank's foreign assets and the prohibition on Russian banks using SWIFT for international payments have prompted Russia and China to seek alternatives to the $'s dominance. However, Trump has threatened the BRICS nations with 100% tariffs if they persist in their efforts to move away from the $.

Trump's aim to reduce the deficit contradicts the need to supply the world with $ to maintain its status as the reserve currency.

For now, according to the American Council, the $ still accounts for 58% of foreign exchange reserves, 54% of export invoices, and 88% of currency transactions.

The inflation constraint:

Let's not forget, Biden's defeat was primarily caused by inflation. Trump cannot afford to let inflation rise again.

However, many of his policies could lead to inflation, and the Federal Reserve is concerned about this. Imports, which are often inelastic, account for nearly 15% of GDP, and an increase in tariffs, even if offset by potential margin compression or depreciation of the exporting country's currency, would result in more inflation.

Given the initial expectation of 2.4% inflation in 2025, forecasters are now worried about an additional 1 to 2.5 percentage points of inflation.

The regulatory constraint:

Eliminating the FDIC and deregulating the financial sector has driven up the stock prices of financial institutions, particularly KKR and Schwab. However, abandoning deposit protection would trigger a panic among bank customers.

Contradictions:

After analysing the 5 constraints, let's explore the 7 contradictions in Trump's programme.

Contradictions in the team composition:

Trump has stated that he does not want to touch Social Security and Medicare, yet Musk dreams of reducing these expenditures. Scott Bessent wants to cut taxes and support businesses, but Ms. Chavez-DeRemer at the Department of Labor, like Vice President JD Vance, is in favour of unions. Kennedy and Musk support ecology, while others at the Department of Energy advocate for shale oil exploration.

Contradictions on immigration:

It is difficult to reconcile reducing inflation with the mass deportation of immigrants, as the U.S. economy has low unemployment and struggles to recruit in many sectors filled by immigrants. Deporting immigrants would push wages up, thus increasing inflation, particularly in the services sector.

Trump's stance here contradicts traditional Republican views, which have been open to immigration to curb wage inflation and promote business profitability.

Contradictions on tariffs: 4 key points to consider.

- *Inefficiency of tariffs*:

Indeed, imports from China dropped by 35% between 2017 and 2023, now representing only 14% of total U.S. imports, the lowest in the last two decades. Indeed, the share of these imports could fall to 5% in the case of a 60% tariff (according to Oxford Economics). Indeed, the deficit with China now accounts for only 26% of the total, down from 47% in 2018. However, as long as U.S. growth remains higher than that of many of its competitors, the overall deficit will not decrease.

Despite higher tariffs, U.S. imports between 2017 and 2023 rose from $2.3 trillion to $3.1 trillion.

Despite the tariffs imposed by Trump, the trade deficit increased during his presidency and has continued to worsen. It was $790 billion in 2017, and is now $1.06 trillion.

Despite restrictions imposed by Biden, Chinese exports to the United States increased by 8.1% year-on-year in November, while imports rose by only 6.6%.

- *Diverging views within the government*:

Lutnick, the Secretary of Commerce, adopts the President's radical ideas. Vance, the Vice President, and Chavez de Remer, the pro-union Secretary of Labor, are in favour of tariffs, while Musk, pro-business, is less supportive. Bessent, the Treasury Secretary, a moderate market figure, advocates for a gradual increase in tariffs, but limited to China.

- *Risks for global growth*:

In the ultimate contradiction, taken to extremes, the tariff war could lead to widespread protectionism, a contraction of international trade, and a crisis comparable to that of the 1930s, far from the goal of strong growth set by Trump.

Contradiction on interest rates and the $:

Trump says he wants a rapid reduction in interest rates by the Fed and a weaker $, but his policies on immigration and tariffs are inflationary. Moreover, tax cuts could worsen the budget deficit and national debt, potentially pushing interest rates higher.

These are reasons that could prompt the Fed to pause in reducing interest rates, and there are also risks of further appreciation of the $ after an initial 6% increase since early October.

Higher interest rates mean additional borrowing costs for households and businesses.

Contradictions on growth:

- *Labour shortage, an obstacle to reindustrialisation*:

Trump wants to reindustrialise, but like Biden, he will face a labour shortage. The percentage of employees in the manufacturing sector was 25% 50 years ago and has steadily declined since. Under Trump, it had fallen to 8.4%; today, it is 8.1%, and a recovery is not expected.

- *6 contradictions in sight*:

Trump aims to increase growth, but challenging the IRA or Biden's semiconductor plan would hinder growth.

Increasing tariffs will raise the cost of imported components for companies, affecting the competitiveness of many businesses, which will lose market share internationally.

Raising tariffs to 60% on Chinese products, 10-20% on products from the rest of the world, 25% on imports from Mexico and Canada, and possibly 100% on products from the BRICS, will reduce consumer purchasing power by $4000/year, increase product prices, exacerbate inflation, and disproportionately impact the poorest.

Higher tariffs will provoke retaliatory measures that could hinder U.S. exports.

An appreciating $ would make imports more attractive, and other countries will be pleased to see their currencies depreciate to maintain exports and support their growth. This will slow investment and growth in the U.S.

A rise in interest rates due to worsening debt would also slow growth.

Contradiction on oil production:

U.S. crude oil production in 2024 is expected to reach 13.2 Mb/d. Trump aims to increase this production to lower prices to $50 per barrel, compared to over $70 per barrel today. Scott Bessent has proposed an increase of 3 Mb/d, but convincing producers is challenging, as it would decrease the value of their land reserves and their profits.

Contradiction on the future of monopolies:

There are differing positions within the Trump team on this issue. JD Vance wants to break up Google, but Musk advocates for deregulation that could strengthen these monopolies. Trump may support defending these companies in the face of international competition.

Musk's appointment to the government is itself a source of conflicts of interest. He already has $11 billion in contracts with NASA for the next five years and will seek increased cooperation. He benefits from Biden's electric vehicle subsidies ($7,500 per vehicle), which Trump may want to eliminate. He also receives $1.8 billion in carbon credits, which Trump could cut. Musk will likely push for federal approval of the self-driving car and Neuralink projects.

Conclusion:

- ***Stock market evolution***: After an initial surge driven by Trump's election, the markets are returning to a more measured outlook. Since November 4, the S&P 500 has risen by only 2.8%, and the Nasdaq by 6.2%, modest increases compared to the impressive performance of the U.S. stock market this year (+23% for the S&P 500 and +29% for the Nasdaq).

  A populist candidate's election campaign is often marked by unrealistic and demagogic promises. Today, it is important to differentiate between what is possible and what is not, assess the constraints, and recognise the contradictions within Trump's programme and the positions of key members of his team.

  Even with a majority in both chambers of Congress, Trump cannot accomplish everything. He has a reputation for being pro-growth, but the average annual GDP growth during his first presidency was lower than under Biden, 1.8% versus 3.2%. The unemployment rate under Trump fell from 4.7% to 3.5%, but under Biden, it dropped from 6% to 3.4% before rising to 4.2%. Most notably, Biden holds the record for job creation in a single term since 1981, with over 16 million jobs created, bringing total employment to 158 million.

- ***There is a risk of stagflation***: Stimulating the economy in a context of near full employment tends to be inflationary. Furthermore, the expulsion of many immigrants and the increase in tariffs will also contribute to inflationary pressures.

  The stock markets, already expensive after a period of strong performance, could be particularly sensitive to any missteps. As analysed in Letter 116, although the US stock market has generally appreciated by around 7% per year since 1900, recent performances have been exceptionally high: +24% in 2023, +23% this year, and even +70% since October 2022. Therefore, any bad news could lead to significant corrections in the stock indices.

- ***To take a step back*** from the various considerations explored in this Letter, and as the holidays approach, here are some recommendations for gifts or readings, including books on the Trump presidency, the evolution of inequalities, elite competition, and the origins and consequences of populism:

  From ***Timothy Snyder***, historian and professor at Yale, we recommend "The Road to Unfreedom", as it documents Trump's connections with Russia from the early 2000s. Snyder's latest book, "On Freedom" (2024), examines the shift of the United States towards fascism and analyses libertarian theses.

  From ***Walter Scheidel***, we suggest "The Great Leveller: Violence and the History of Inequality from the Stone Age to the Twenty-First Century". This is a subject that affects all countries and has significant political implications.

  From ***Michael Sandel,*** professor at Harvard, "The Tyranny of Merit", a book about the failures of meritocracy today, and the social mobility, which is more blocked than before.

  From ***Yascha Mounk,*** professor at Harvard, three books: "The Identity Trap", "The Great Experiment" (on democracies tested by diversity), and "The People vs. Democracy". These works address the rise of illiberalism, the dangers of extreme-right populism, and a critique of wokeism in his most recent book.

  From ***Pankaj Mishra,*** "Age of Anger", an analysis of resentment against the unfulfilled promises of modernity.

  Finally, perhaps the best, from ***Peter Turchin,*** "End Times", particularly on the overproduction of elites as a cause of chaos.

- To sum up these books on an America weakened by populism, let's ponder Napoleon's words, collected by JL Gaudy, ***"It is never useful to inflame hatred."***

Geneva, 20 December 2024

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