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As US growth is at risk of decelerating, possible roadmap through a distribution period for key assets. Inflection point may happen by mid Q1

As mentioned above, we have several issues with the market perception that the Donald Trump effect will continue to be the most significant market and economic driver during H1 2017.

The first issue, as we said earlier, has something to do with the timing of the impact ofwhatever salubrious measures the administration of Mr. Trump may take in restructuring regulations, cutting taxes and rebuilding public infrastructure.

Despite Republican Party control of both houses of Congress and a majority of State governorships, passage of Mr. Trump's agenda does not appear to be a slam dunk insofar as Congress is concerned. We seriously doubt some market participants' characterization of the Republican-controlled Congress as a rubber-stamp entity, as even now some Republican politicians look like having cold-feet with regards to the size of the budget deficits that Mr. Trumps infrastructure projects entail, during a time when taxes will be cut as well. Massive budget deficits, in the scale proposed by Mr. Trump during his election campaign, do not go well with the natural, conservative bent of many Republican congressmen and senators.
In fact, it was this miserly attitude which may contribute to the growth hiccup that we expect during H1 2017 and possibly for most of the year thereafter, until early 2018. Simply put, the US economy was starved of sufficient funds by trimming down the budget deficit as from 2012, even as the economy struggled to reach take-off velocity. Lower deficits reduce systemic liquidity, and that does impact the economy after 8 to 12 quarters -- there is some sense of proportionality between the size of the deficit that was trimmed and the size of subsequent dislocations in growth (see graph 1 next page).

Therefore, it appears that problematical growth issues that have already been "baked in the cake" due to the very significant reduction of the US budget deficit over the past 4 years. We do not really expect a full-blown recession, just a "technical" growth recession over the next two or three quarters of the new year.
If Mr. Trump does what he said he will do, and assuming the Republicans who control the Congress and Senate go along, then the worse scenario case may be avoided. But the economy will nonetheless battle the negative impulses that have already been set into motion. And there is indeed a non-trivial risk that slower growth will keep inflation subdued, an environment which suggest that longer term interest rates may still revert to the mean and could hypothetically retrace sharply the recent rise.

We believe that if these events come to pass, we should see better levels and better timing for reflation trades sometime in the second quarter of the new year.

Bad as the "baked in the cake" growth issues emanating from miserly budget allocations, the recent Fed tightening of monetary policy, on top of a sharply higher US Dollar and long term rates added to the long list of negative factors which may indeed tip the economy over to at least a technical growth recession (of two consecutive quarterly GDP declines).

For one, there is a strong negative relationship between a strong US Dollar and a subsequent growth slowdown 2 to 3 months thereafter. The transmission mechanism in the relationship is probably the next exports component of GDP (see graph 2 next page). This outlook does not hew to what is considered today as conventional wisdom about the markets and the economy. The accepted mode is a continuation of the robust growth seen in Q3 2016, bolstered by the positive implications of a rising equity market, and a confirmation coming from rising bond yields – all of these being de rigueur in an environment of rising growth and activity. However, market-based leading indicators of systemic risks are flashing unwelcome signals -- spreads between the market price for LIBOR and FRA pricing, and the spread between Libor and OIS are widening again.

We think those widening spreads spell rising systemic risk, even as consumer confidence elevates, tracking conventional wisdom (see graph 3 next page). Half of the world's $300 trillion in total debt and derivatives is denominated in US dollars. It is therefore not unreasonable to call the US dollar LIBOR as the single most important daily market rate posted globally, and moreover because it is a reference for money managers of US dollar denominated fixed-income portfolios. One basis-point shift (a basis point is 1/100th of 1%) in LIBOR amounts to an annual transfer of $15 billion from lenders to borrowers or vice versa. The Libor spot price is the interest rate the banks are charging for unsecured loans to each other. Commercial borrowers and institutional agents that transact with those banks also usually structure their transactions at a spread above a LIBOR benchmark.

It is the spreads that are discussed and negotiated, and therefore what makes the difference, in the transaction world of high finance. Therefore, changes in the spreads are lead indicators of rising or falling market-based risk perceptions -- an early warning system, so to speak. In the current context, that risk may be coming from the sudden sharp rise of US rates, the consequent sharp ascent of the US Dollar, putting billions of USD denominated EM loans in danger, or the outlook of higher energy prices could push inflation (actual and expected) higher, further providing a tailwind to rising rates globally. Or it could be a recognition of the "baked in the cake" future growth angst embedded in the US growth structure – nobody can say.

But the early warning emanating from the rising Libor spreads should be heeded. We believe it is premature to stay heavily into reflation trades during H1 2017.