First Trust Portfolios Canada
Monday Morning **OUTLOOK**

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Don't Forget the Lags

In our lifetimes, the best comparison for Trump's election win is Ronald Reagan's in 1980. That election, like this one, pitted big spenders and champions of government against tax cutters and critics of government.

It is pretty clear that markets approved of both winning campaigns as they were happening. Leading up to the election in 1980, like this year, the S&P 500 rallied as it became clearer that Reagan (like Trump) was likely to win. The market also rallied in the days following the election because markets like tax cuts, deregulation, and restrained government. And, at the same time, the policies the markets didn't like – such as a tax on unrealized capital gains – were now dead.

But after being euphoric at the outcome of the election in 1980, reality set in. Paul Volcker was fighting inflation with tight money, a recession was inevitable and tax cuts took time to pass. The S&P 500 fell in 1981 and in the first eight months of 1982 before the Reagan bull market really started.

History doesn't repeat itself, but at times it rhymes. And while there are similarities between today and 1981, there are also some key differences. For example, the Federal Reserve is now cutting interest rates, not raising them. However, there are some big differences that investors need to pay attention to. First, in October 1980, the Price-Earnings ratio of the S&P 500 was 8.6. In October 2024, the PE ratio was 27. In other words, while the market may appreciate better policies, it sure looks like they are already priced in.

Moreover, while Trump is selecting his cabinet rapidly and his team has likely already done the homework needed to move fast on executive orders that can boost growth, much of the real work will take time. It appears Congress wants to move fast, but it is still Congress and that means it's messy.

Reagan cut tax rates across the board, Trump plans to maintain most current tax rates with some small changes, and promised to eliminate taxes on tips, social security, and overtime. These tax cuts are welcome, but they are not true supply-side tax cuts…the ones that boost entrepreneurship and innovation.

The really powerful potential of the Trump plans will come from DOGE, the Department of Government Efficiency, where Musk and Ramaswamy plan on proposing big cuts to the fourth branch of government – the Bureaucrats. Every regulation that they can cut, every bureaucrat that they can keep from gumming up the private sector, will boost productivity.

But in addition to cutting red tape, the US must cut the absolute size of government. John Maynard Keynes wanted deficit spending ended after a crisis was over. But, after both the Panic of 2008 and COVID, the US kept spending elevated. Government spending has risen from 19.1% of GDP in 2007 to 23.4% this year. Government is a ball and chain on the economy. We estimate that every one percentage point increase of spending as a share of GDP reduces underlying real GDP growth by 0.2%.

Every dollar the government spends is taken from the private sector, and the government taxes and borrows nearly 5% more of GDP today than it did seventeen years ago. From 1990 through 2007, real GDP grew 3% per year. From 2008 through the second quarter of 2024, real GDP has only grown 2% per year. No wonder "the economy" was the #1 factor for Americans in this election. Two percent annual growth is stagnation.

And this shouldn't be happening according to fans of big government. Economists like Mark Zandi and Paul Krugman support government spending and argue that it has a positive multiplier ($1 of government spending creates more than $1 of GDP). Add this to the fact that the US has invented unbelievably productive new technologies in the last 17 years, and the economy should be booming. Especially with the Fed holding rates at zero for nine of those years.

But it hasn't, and the reason is that government is just too darn big. Cutting government spending is a double-edged sword. Half of all job growth in the past year has been in government jobs directly, as well as healthcare which is dominated by government. Taking away that spending will initially slow job growth, but, with a lag, eventually boost economic activity.

In other words, the Trump Administration has a chance to boost underlying economic growth rates, and that would be extremely positive for living standards and equity values over the long-term. But initially, it may result in slower growth. The US had a car wreck with COVID. Easy money from the Fed and big deficits were like morphine. The US is addicted to short-term fixes that do nothing to boost long-term growth. Withdrawal from the pain killers hurts, but is necessary to get truly healthy.

While we are extremely positive about the long-term benefits of policy changes, like under Reagan, weaning the US from massively easy fiscal policies does not guarantee overnight success. It will take time, and the US will come through to the other side stronger. The entire world will benefit…with a lag.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-19 / 7:30 am	Housing Starts – Oct	1.335 Mil	**1.334 Mil**		1.354 Mil
11-21 / 7:30 am	Initial Claims – Nov 16	220K	**219K**		217K
7:30 am	Philly Fed Survey – Nov	7.5	**4.1**		10.3
9:00 am	Existing Home Sales – Oct	3.950 Mil	**3.970 Mil**		3.840 Mil