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"Escape Velocity?"

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Economists are fond of catchy metaphors to describe economic progress. As the global economy recovers from the worst financial crisis since the depression, the idioms green shoots and animal spirits are suggestive of hope. Another oft repeated saying is the need for the economy to reach escape velocity. To a scientist, escape velocity is the point at which an object no longer needs assistance in offsetting the gravitational pull of a larger object. A rocket requires massive thrust to offset the pull of Earth's gravity in reaching space. Massive central bank stimulus may have assisted in avoiding a complete collapse, but has not propelled economic growth to escape velocity. Reality has been somewhat different. Monetary policy alone has proven ineffective in moving the economy to a self-sustaining level of growth. The recent excitement in markets relates to the prospect for structural reforms of tax and spending programs providing the needed boost for the economy to overcome the drag of lingering headwinds of debt burdens, demographics and deflation.

The outcome for the global economy is highly dependent on just how much fuel is left in the tank. The idea of fiscal policy is nothing new. We have been following the Keynesian playbook for most of the post-war period. The counter-cyclical weight of monetary and fiscal policy has no doubt smoothed economic cycles in the short run. The long run is still open to debate, however. The secular trends reflect increasing gravitational resistance. Global debt to GDP is at a new high with accelerating velocity. The developed world has improved life expectancy and well-being, at the cost of higher health care costs. Technology has made us more productive as a society but reduced the productivity of labor in favor of capital.

The economic recovery that started in 2010 is now approaching its seventh year. It is notable as one of the weakest expansions in history due to some of the factors identified above. The positive is that a tepid recovery does not generate the traditional excesses that lead to its demise. The final phases of recoveries are usually associated with capacity constraints for labor and capital where policymakers are forced to respond in order to mitigate inflationary pressures. This recovery is unlikely to generate the kinds of imbalances that generate unwanted inflation. In fact, the central bankers around the world have pledged to generate inflation to reduce debt burdens. To the extent that they can fool bond markets, they hope to let things run a little hotter.

This cycle's imbalances are likely found on the balance sheets of central banks and governments rather than the private sector. The larger challenges will be to unwind

unconventional monetary policies before the next recession. Policymakers' ability to manage business cycles depend on their capacity to restore markets to "normal" in good times so that they can intervene in the more challenging years. If they are hesitant to increase rates in the face of stronger growth and inflation, then they will never be able to reduce balance sheets. Failure to reduce balance sheets limits their ability to manage monetary policy below the zero bound.

Likewise, aggregate debt is likely to constrain the political process from achieving the magnitude of stimulus necessary to meaningfully impact demand. Fiscal policy, similar to monetary policy, is most effective during the trough of a business cycle. It is somewhat difficult to see how it will impact real growth after an extended subpar recovery. Given low levels of unemployment, fiscal stimulus, to the extent it promotes higher inflation, will likely be offset by a more aggressive cycle of Fed tightening.

A more aggressive Fed, concurrent with a credible fiscal plan, is going to push up interest rates and promote further strengthening in the U.S. dollar. The headwinds to the U.S. economy eventually will give way to a recession. While a recession in 2017 is difficult to forecast given that these policies will play out over the next 18-24 months, it is very conceivable to see how a recession can develop during Trump 's first term. The timeframe could be accelerated by further restrictions on trade and protectionist policies. Apparently, investors, imbued with animal spirits, prefer to take Trump at his word with regards to tax cuts and spending but are disbelieving as to his protectionist rhetoric.

For 2017, we foresee a gradual shift up in short rates due to Fed policy and a flatter yield curve. It is difficult for us to see the 10 Year Treasury rate approaching 3%. In fact, the terminal rate for short rates this cycle may only be around 2.5%. Nevertheless, the fact that growth in the U.S. is likely to improve relative to its trading partners infers further strength in the dollar. Higher interest rates and a stronger dollar will constrain growth in the short run regardless of possible tax and spend policies. Moreover, any indications of protectionist trade policies will further undermine growth and promote higher inflation. Higher inflation is a larger risk than growth in the formulation of Fed policy.

Since the great recession, hopes of the economy reaching escape velocity have continuously led to disappointment. By the same token, when the U.S. growth rate has approached zero, it has always experienced a bounce. We see more of the same. With each twist and turn, the risk of not exceeding the downward gravitational pull of the global economy becomes more pronounced.

Ground control to President Trump, take your protein pills and put your helmet on.

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