



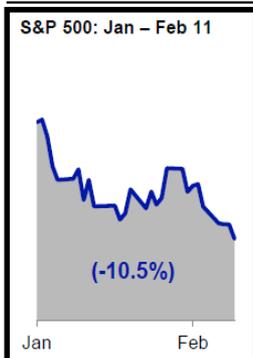
# Economic View from Cisco Treasury

Mohit Badlani & Nathan Andros

March 28, 2017

# 2016: A Year of Surprises

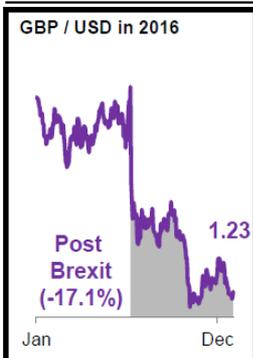
**Q1 Equity Correction**



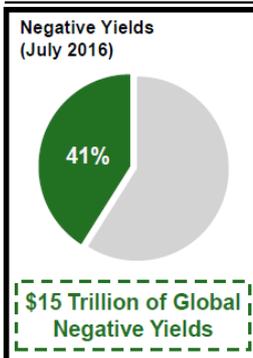
**China Capital Controls**



**Brexit**



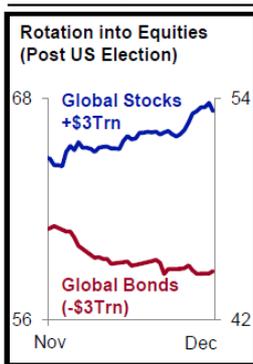
**Global Rates Shock**



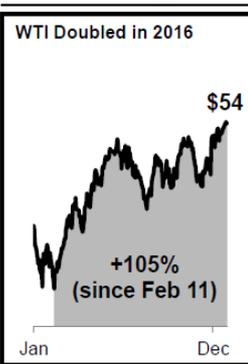
**US Election**



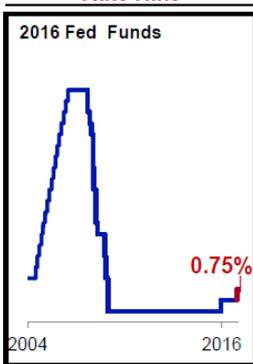
**Market Regime Change**



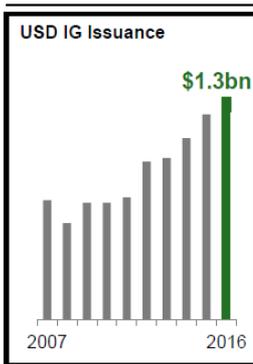
**OPEC Strategy Shift**



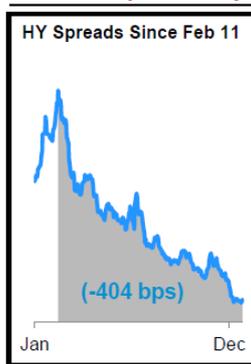
**Only 1 2016 Fed Rate Hike**



**Another US IG Record**



**USD HY Spread Rally**



# Poll Question #1

# Key Market Themes for 2017

## Politics and Policy

- US as G10 Outlier
  - Fiscal easing, monetary tightening, deregulation bias
- Deflation to reflation shift globally
- Political risk as an important driver of markets
- Rising nationalism & inward-looking policy
  - Trade, immigration
- China policy toolkit constraints
  - Fiscal easing, FX policy, capital controls, reform agenda

# Key Market Themes for 2017

## Markets

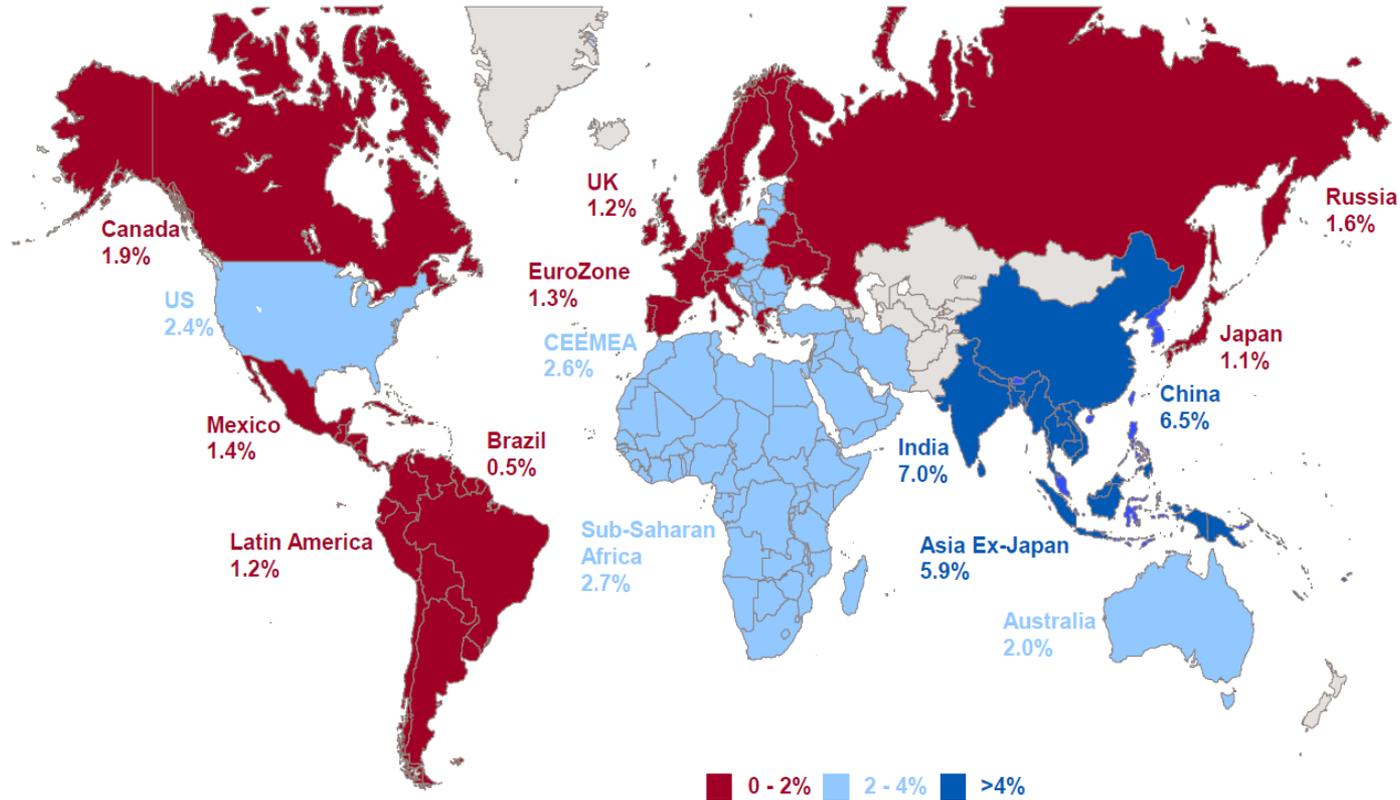
- Market regime change
  - Rotations into equities and financials, earnings-driven equities, rate & yield curve paradigm shift
- Animal spirits re-awakened in markets
- Rising rates and steeper yield curve
- Resurgent US Dollar strength
- Higher and more episode volatility

# Key Risks to Watch in 2017

- Dovish Fed falling behind rate curve
- Stagflation if US growth slow to materialize
- Fed or USD induced tightening of financial conditions
- Escalating US-China trade disputes / retaliatory measures
- US Dollar contagion
  - EM, China, oil, exports, earnings
- European politics
  - Brexit, elections, migrant crisis
- Republican failure to pass “comprehensive” tax reform
- Oil supply glut
  - US production upside; OPEX production cut enforcement
- Recovery delays for commodity exporters
- Geo-political escalation
  - Cyber security, failed states, terrorism

# Poll Question #2

# The World in 2017: GDP Forecasts

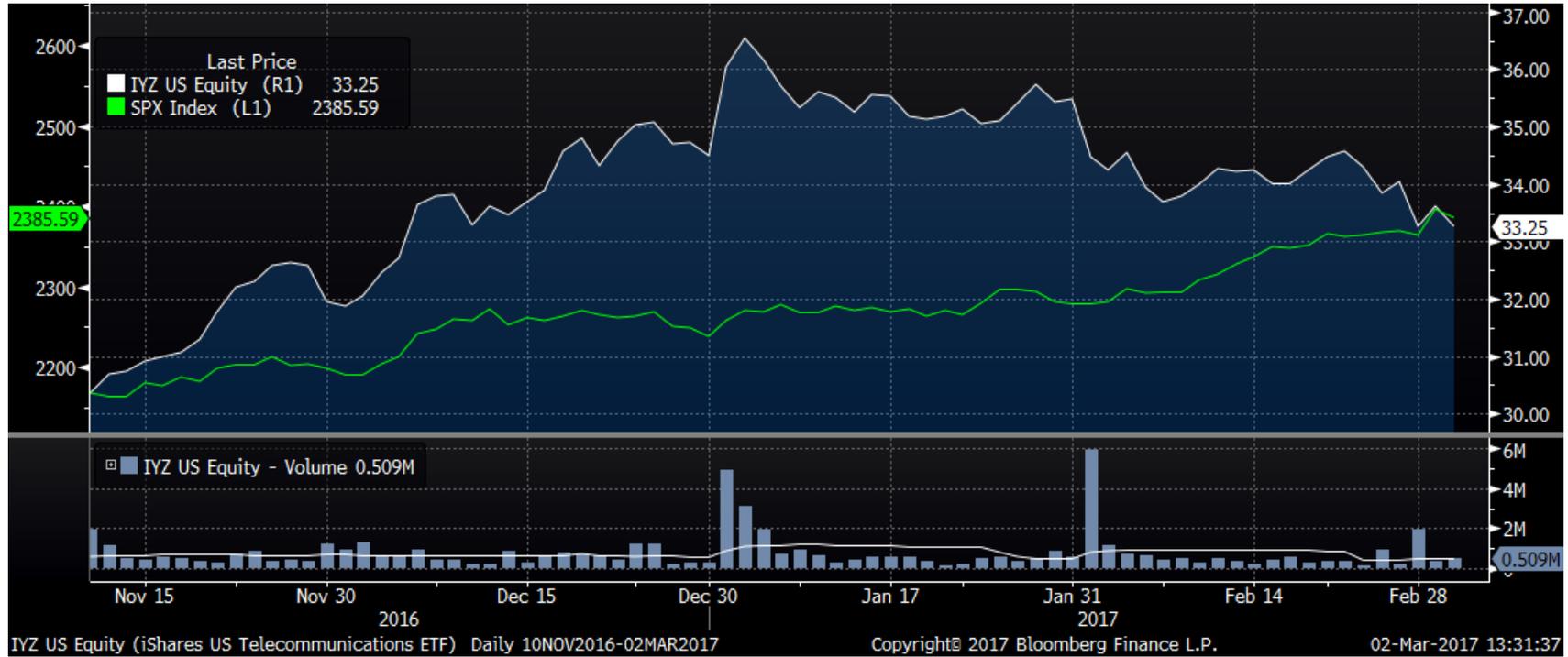


# Key Policy Initiatives

Key Policy Initiative	
Tax Reform / Repatriation	Key Features: System, Tax rate, Cap Ex depreciation, Interest expense, Overseas earnings
Dodd – Frank ( Deregulation)	Substantive changes to Dodd-Frank are likely to be limited. Most financial regs are statutes, not executive orders, and so not easily repealed.
ObamaCare	Repealing ObamaCare tax and spending provisions is the #1 priority of the GOP in 2017. The path to replace is less clear, could be 1-3 years, and remains a concern for many GOP leaders.
Infrastructure Spending	\$1 Trillion proposed Infrastructure spending. Likely to fall short as fiscally conservative republicans are high unlikely to fund it
Immigration Policy	
Trade	Withdraw from the Trans-Pacific Partnership (TPP) and renegotiate NAFTA
Energy Policy	Pipeline approvals, Repeal the clean Power Plan (coal)

# Stock Price Performance of Service Providers (IYZ)

## *Since Election*



# Poll Question #3

# Industry perspective: Impact of Tax Reform

- Lower corporate tax rate should result in significant cash flow benefits.
  - Need to be balanced against removal of certain deductions
- Impact on financial statements can be pretty substantial.
  - If tax rate gets lowered, SPs will be able to write down the liability and create ton of net worth
- Immediate expensing of tangible and intangible assets will also be cash flow positive.
  - However, SPs could consider delaying large capex until investment expensing proposals are further developed
- Limitations on interest deductibility will be cash flow negative.
  - Could lead to exploration of preferred stock in lieu of debt to obtain rating agency equity credit given loss of interest deduction makes preferred relatively less costly

# Industry perspective: Deregulation

- Most compelling policy-related outcome remains the de-regulatory aspect
- The biggest target will be net neutrality, a rule created in 2015 that prevents internet service providers from blocking or discriminating against internet traffic
  - Most compelling would be changes in privacy rules, giving carriers the same abilities and a level playing field as Google and Facebook for digital advertising/ data
- Expectations will be for industry capex to pick up should there be a net neutrality repeal or other pro-capex policies

# Industry perspective: Other Key Policy Initiatives

- M&A: Borrowing costs could get less appealing but regulators maybe open for large (or even horizontal) consolidation
- Sprint/ T-Mobile: In a capital intensive industry such as wireless, the market could be more stable with three players vs four players
- Infrastructure spending: should be positive for the overall economy
- Obamacare: If the initial focus is on ACA, could lead to potential delays on the de-regulation front, tax reform and infrastructure spending

# Poll Question #4

# Back Up

# Make Growth Great Again

## Trump's Pro Growth Agenda: Tax Reform, Deregulation & Infrastructure

### From Deflation to Reflation

5Y 5Y Inflation Swap

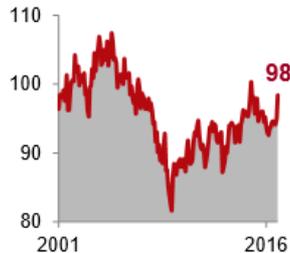


### Business & Consumer Confidence

Consumer Confidence

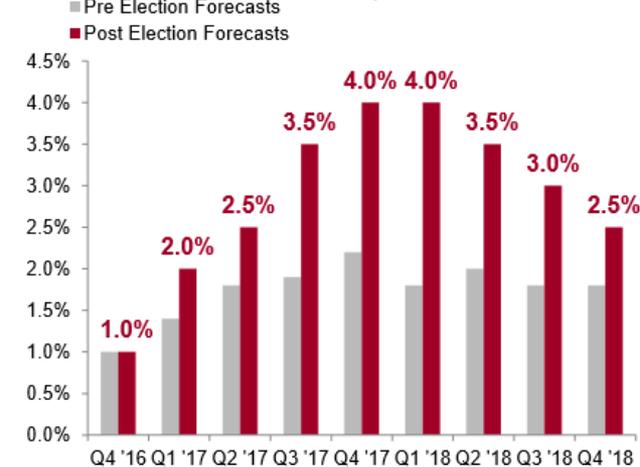


Small Business Optimism



### US GDP Growth

US GDP Growth (Q/Q Annualized)



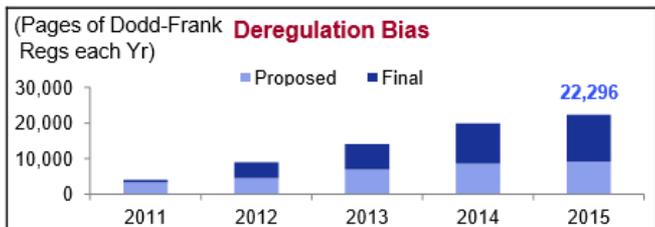
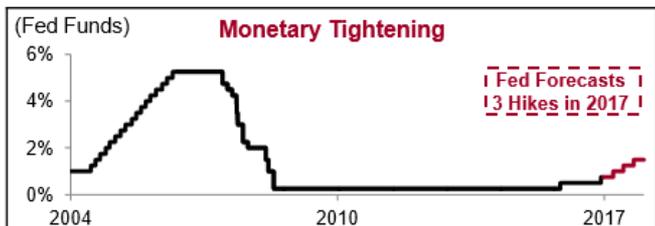
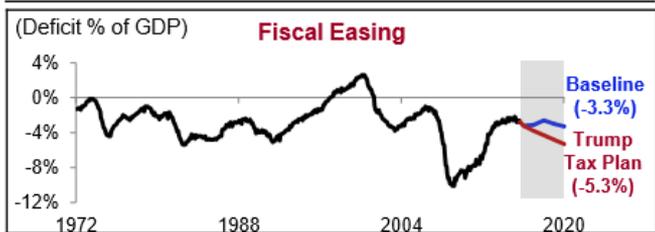
Annual GDP Forecasts (Y/Y)		
2016	2017	2018
1.5%	2.4%	3.6%

**You May Not Know:** The Conference Board's US consumer confidence index has jumped 13 points since the US election, and is now at its highest reading in 15 years (August 2001). On the back of Trump's pro-growth agenda, 2017 US GDP growth is projected to be approximately double other developed markets: EU (1.3%), the UK (1.2%), and Japan (1.1%).

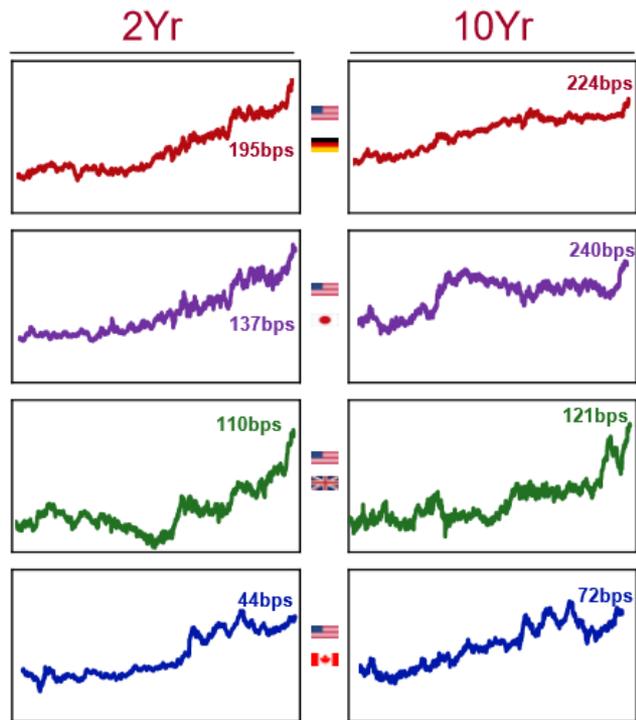
# US as G10 Outlier



## US as G10 Outlier



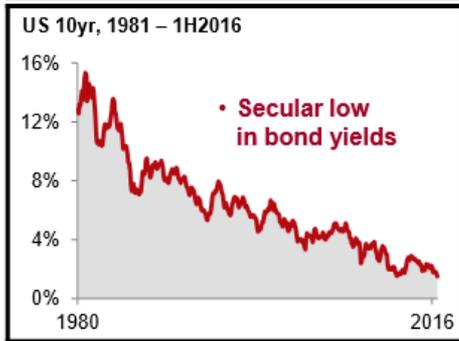
## Yield Differentials



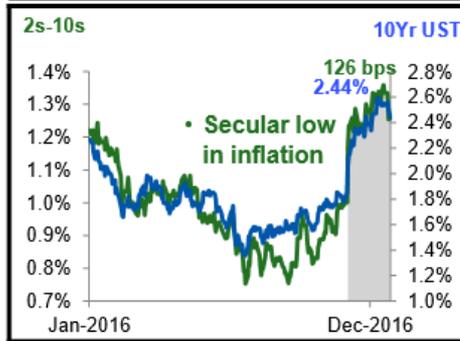
**You May Not Know:** The US is the only G10 country pursuing significant fiscal easing, monetary tightening and a strong deregulation bias in 2017. In fact, the differential between US and German yields is at its widest in a quarter century. The tailwinds from this notable policy pivot will have significant implications for US equities, credit, the Dollar and rates in the year ahead.

# Market Regime Change

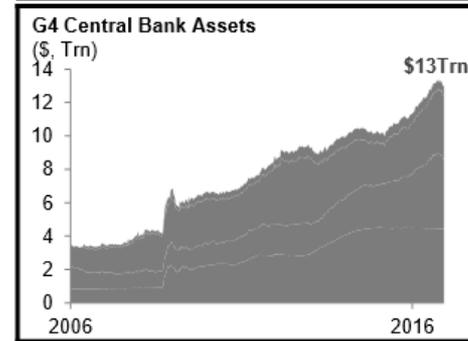
End of the 35-Year Bond Bull Market?



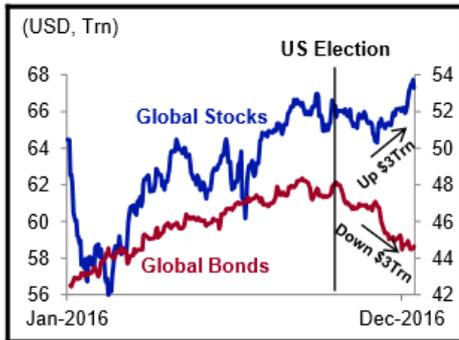
From Deflation to Reflation



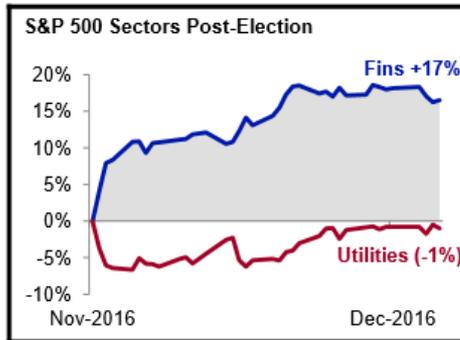
Central Banks No Longer Primary Driver



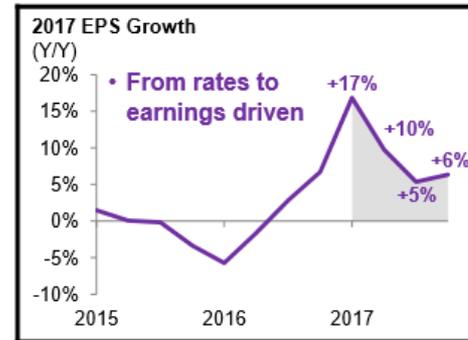
Rotation into Equities



Unwinding Post-GFC Financial Underweight



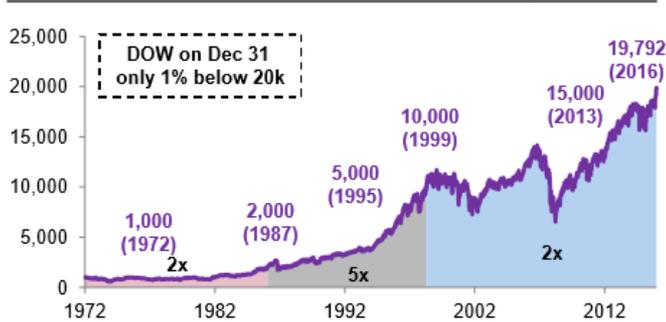
Earnings-Driven Equity Markets



**You May Not Know:** Since the US election, global bonds lost over \$3 trillion, while global equity market increased by over \$3 trillion. While bond yields and inflation have likely hit their secular lows, the stock market is transitioning from rates to earnings driven. Investors, meanwhile, are shifting sector exposures, which includes unwinding a multi-year underweight in financials.

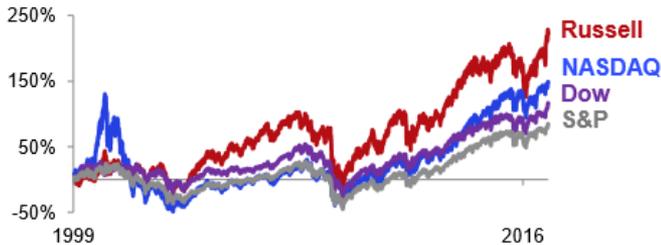
# Animal Spirits Awaken

## Dow Reaches Historic High

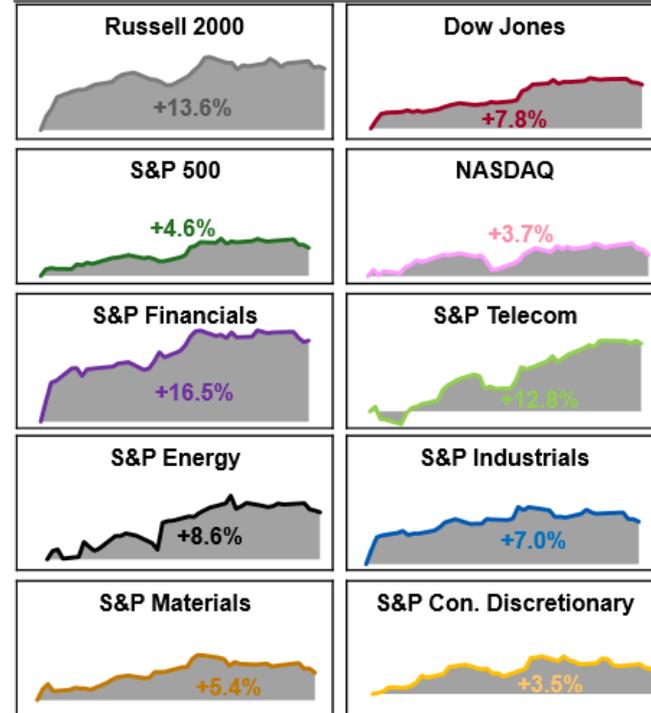


## 4 Benchmark Indices Hit Simultaneous Records

### Equity Index Performance Since Jan 1999



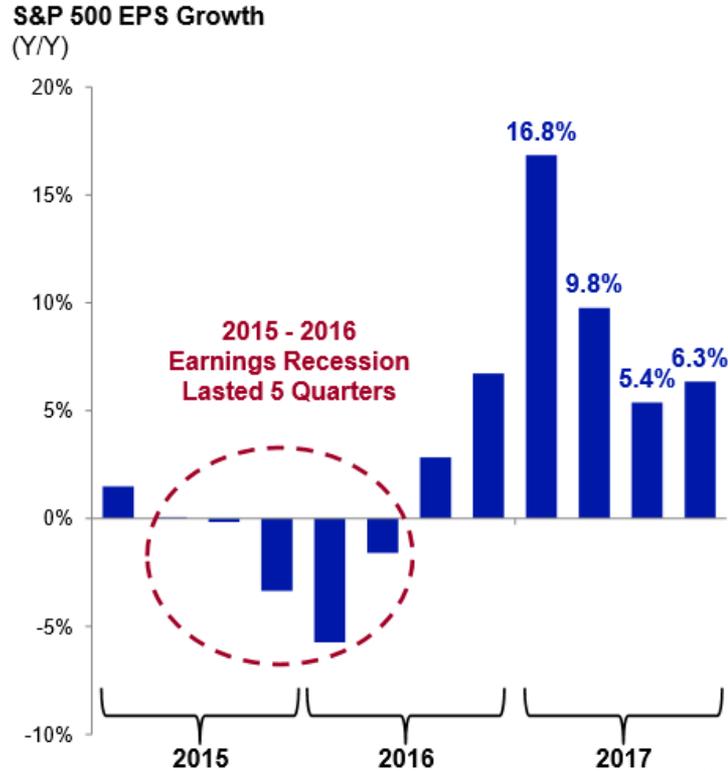
## US Equities Since Nov 8



**You May Not Know:** Since the US election, US equity market cap has risen to 39% of the world's total, its highest level since 2006. During the 1982 to 2000 bull market, the DOW rose 10x in 18 years. It then proceeded to take 17 years to double. Since financial crisis lows, the DOW has actually tripled. Trump's pro-growth agenda has sparked a reawakening in markets to new historic highs, with central banks receding to the backdrop as the primary driver of markets.

# Equity Earnings Revival

## S&P 500 Earnings Growth



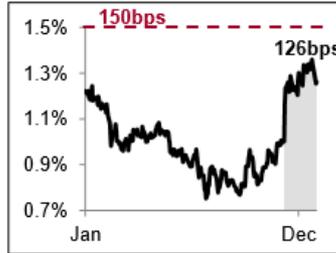
# Rates Paradigm Shift

## Post Election Paradigm Shift: Higher Rates / Steeper Curve

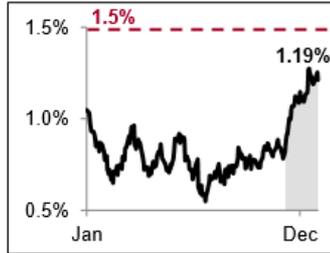
### Trump Agenda Bearish Rates

- Fiscal stimulus
- Deregulation
- Border adjusted taxes
- Yellen replacement
- Rising protectionism

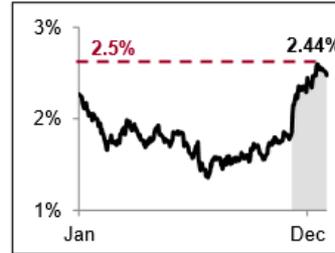
2s-10s



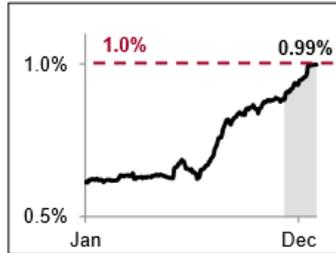
2 Yr UST



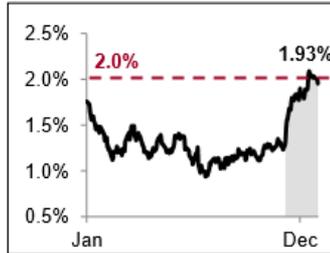
10Yr UST



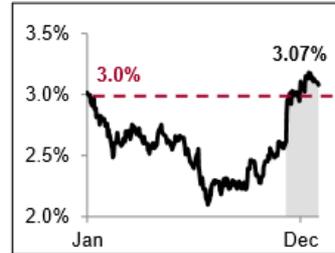
3M Libor



5Yr UST



30 Yr UST



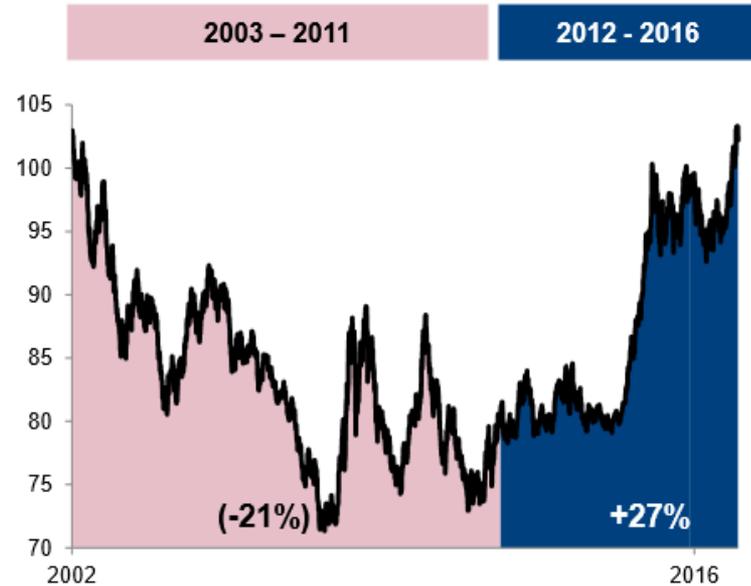
	Dec 31, 2016	Q1	Q2	Q3	Q4
10Yr	2.44%	3.00%	3.60%	3.60%	3.10%

**You May Not Know:** As evidenced by 3M LIBOR at 1% for the first time since 2009, US rates and yield curves have embarked on a reflationary paradigm shift higher and steeper in 2017. Given DB's 3.6% forecast for Q2 2017, 10 year UST yields are projected to rise 225 bps in the 12 months from the historic low of 1.36% in July 2016. DB's Konstam has forecasted US rates to peak in Q2 2017 on expectations that the market will price higher growth more quickly than the Fed.

# Resurgent US Dollar

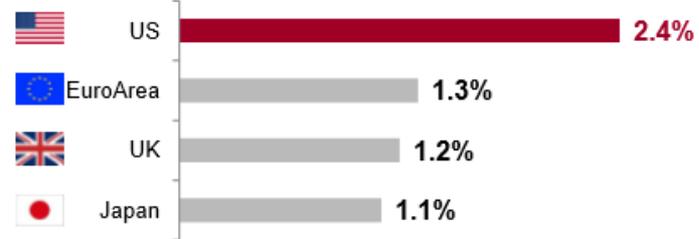
## US Dollar Cycle

DXY Index



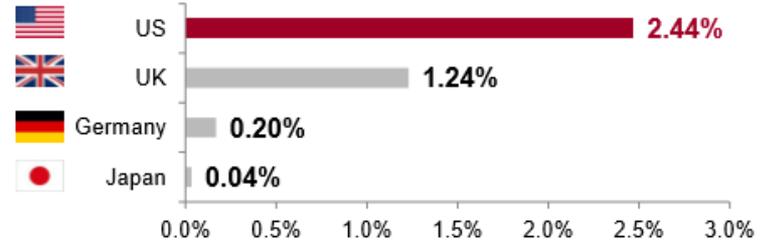
## Growth Divergence

2017 GDP Growth (Y/Y)



## Rate Divergence

10Yr Yields



# Rebalance US – China Relations

## Rising US – China Trade Deficit

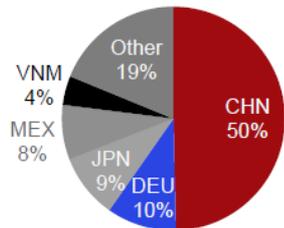
US Balance of Trade with China

(\$, Bn)

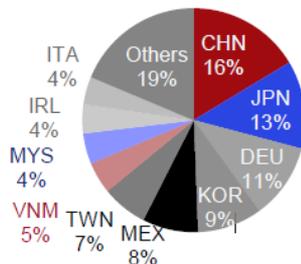


## US Trade Deficit Breakdown

In absolute terms



On a value-added basis



## Policy Considerations

### More Likely Policy Actions:

- Designate China a “currency manipulator” (even if criteria questionable)
- Initiate WTO trade cases (anti-dumping, IP, subsidies)
- Intensified Sino-US competition (Asia & globally)
- Tighter investment restrictions on China in the US (via the Committee on Foreign Investment in the US – CFIUS)

### Less Likely, but Possible:

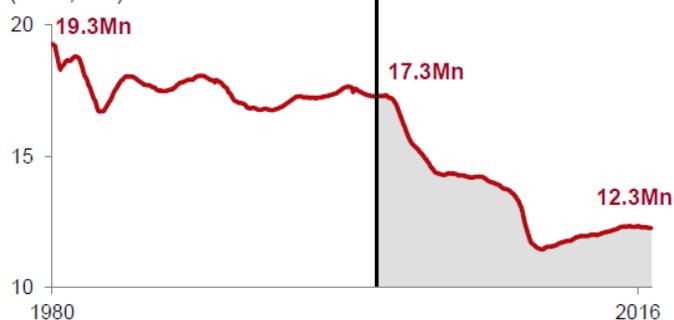
- Impose tariffs of 15% for 150 days (1974 Trade Act, Sec 122)
- Raise tariffs outside WTO procedures (1974 Trade Act, Sec 301)
- “National security”-based economic actions
- Significant increase in US Asia-Pacific military “presence”

# Channeling Populism

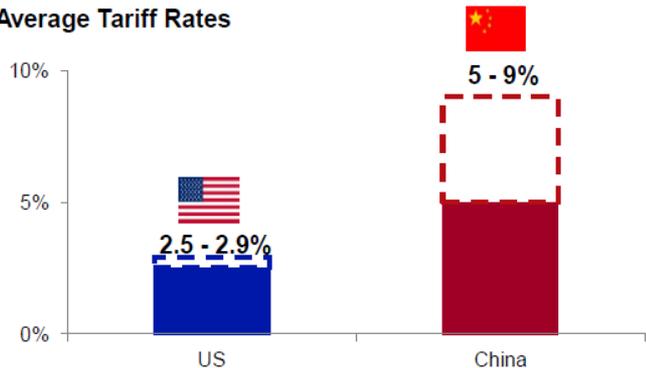
## Nationalist Corporate Policy

### US Manufacturing Decline

(Jobs, Mn)



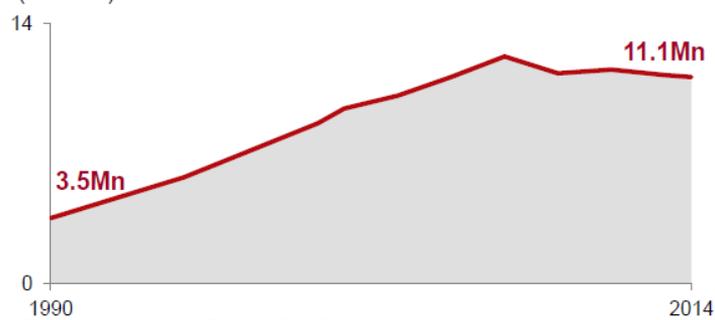
### Average Tariff Rates



## Immigration Policy

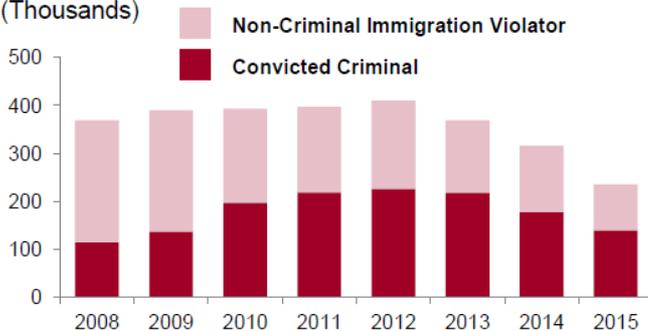
### Unauthorized Immigrant Population in the US

(Millions)



### US Deportations Since 2008

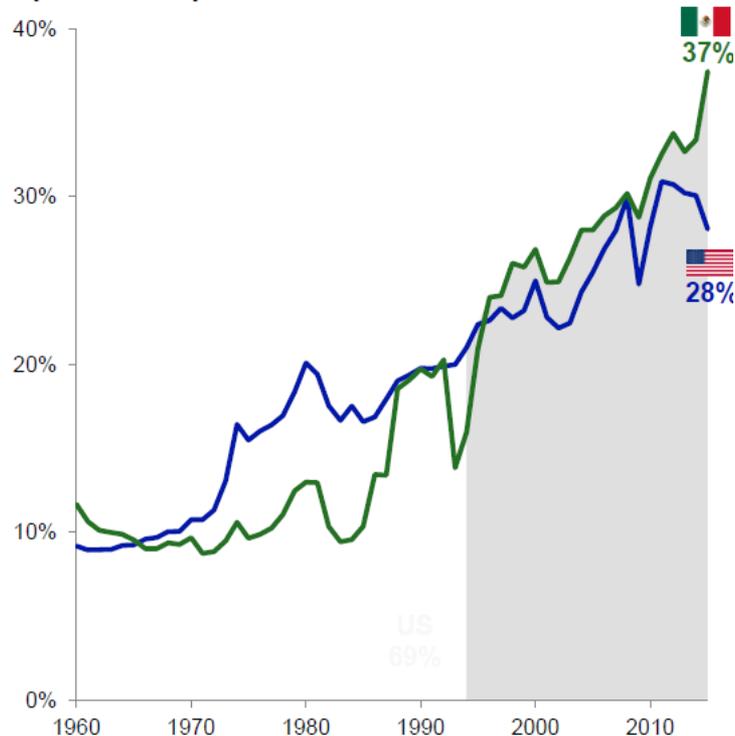
(Thousands)



# Tough on Trade

## Trade Since NAFTA

Exports and Imports as % of GDP



## Expectations

### More Likely:

- Withdraw from the Trans-Pacific Partnership (TPP)
- Renegotiate NAFTA (NAFTA Article 2202)
- TTIP with Europe on permanent hold
- More unilateral deals (Post-Brexit US-UK deal)
- Commerce Secretary to identify all overseas trade violations
- USTR to initiate WTO cases (anti-dumping, IP, subsidies)
- Pressure US corporates on offshoring
- Push for “border-adjusted taxes” within tax reform

### Less Likely:

- WTO withdrawal (requires 6 months notice)
- NAFTA withdrawal (requires 6 months notice)
- Raise tariffs outside WTO procedures (1974 Trade Act, Sec 301)

