



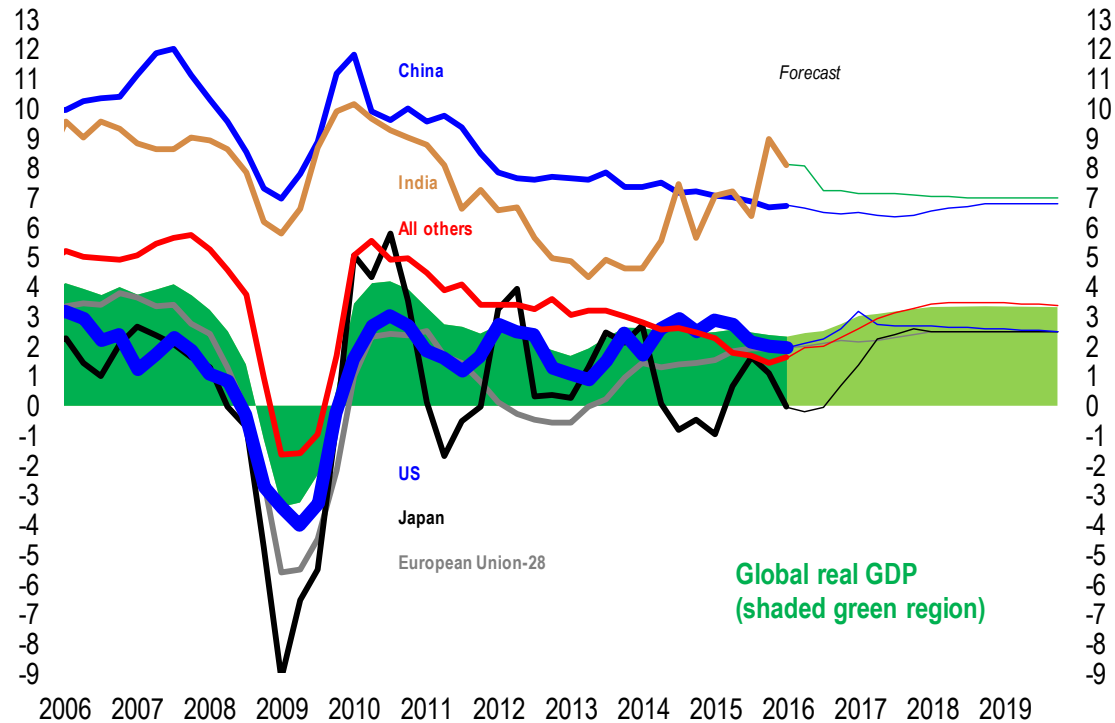
A New Chapter

(From Recovery to Sustained Expansion)

November 3, 2016

Most Regions Are Growing ...

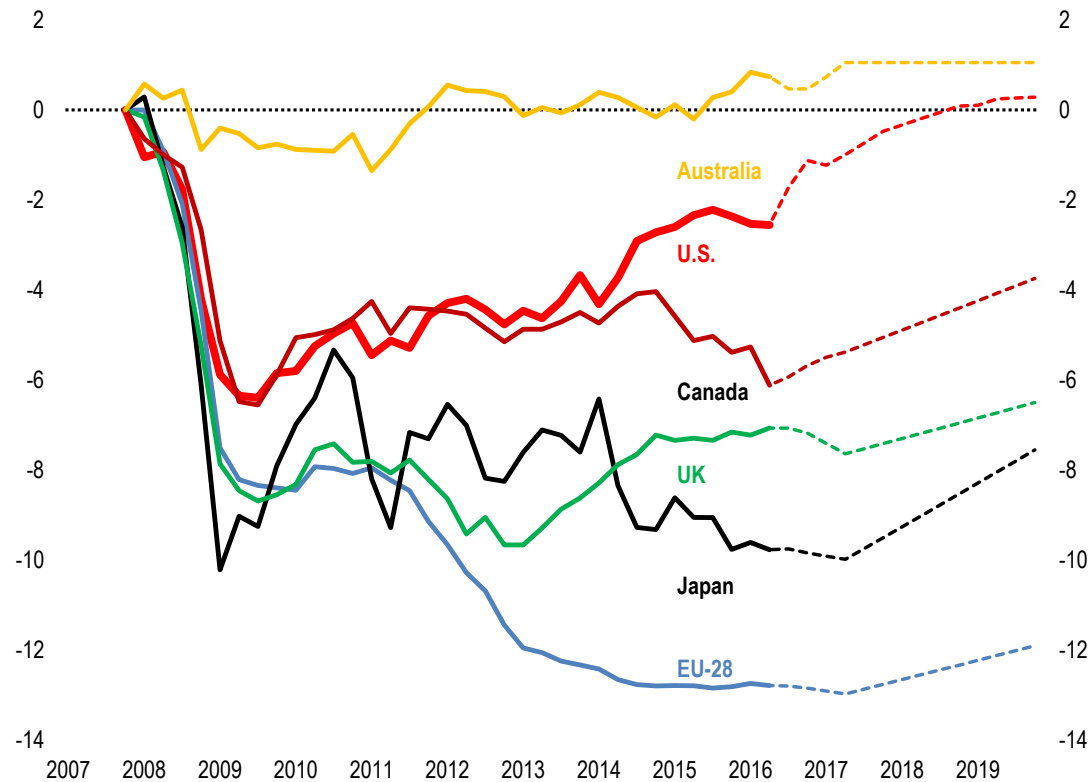
Real GDP in selected regions (percent change from four quarters earlier)



Sources: Haver Analytics; International statistical sources; U.S. Department of Commerce; J.P. Morgan. Updated through 2016 Q2.

... but Legacy Slack Plagues and ...

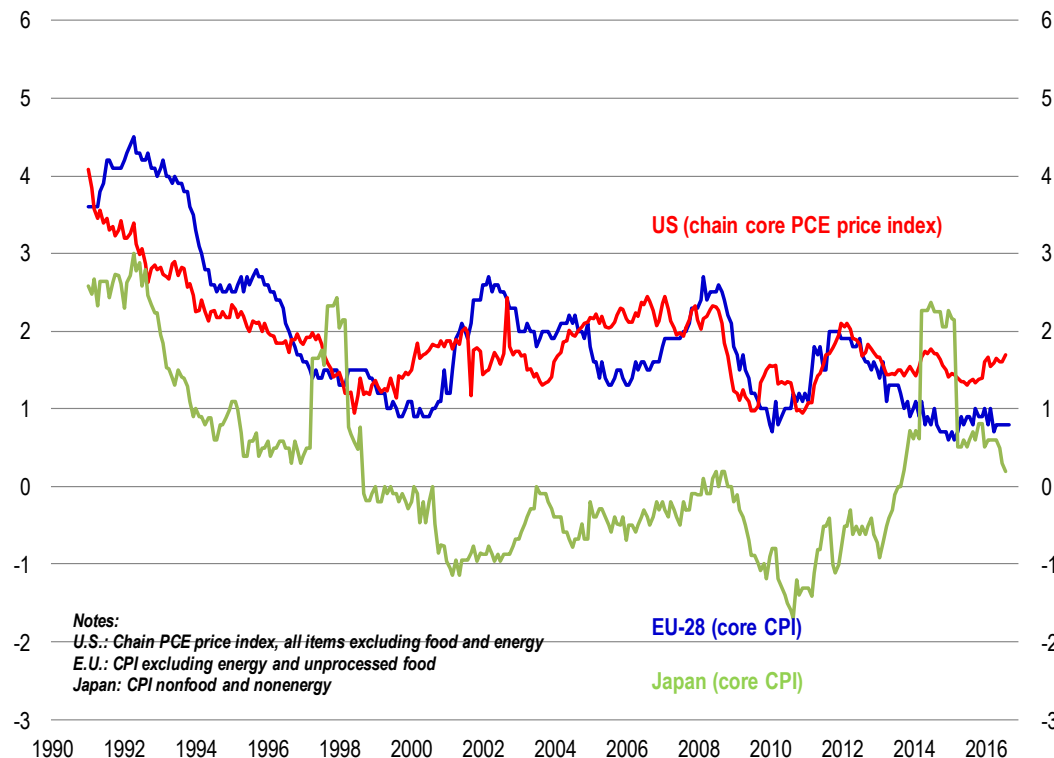
Output Gap, actual less potential real GDP (percent of potential real GDP)



Sources: Haver Analytics; International statistical sources; U.S. Department of Commerce; J.P. Morgan. Updated through 2016 Q2.

... That's Why Inflation/Policy Diverges

Core inflation in selected regions (percent change from 12 months earlier)

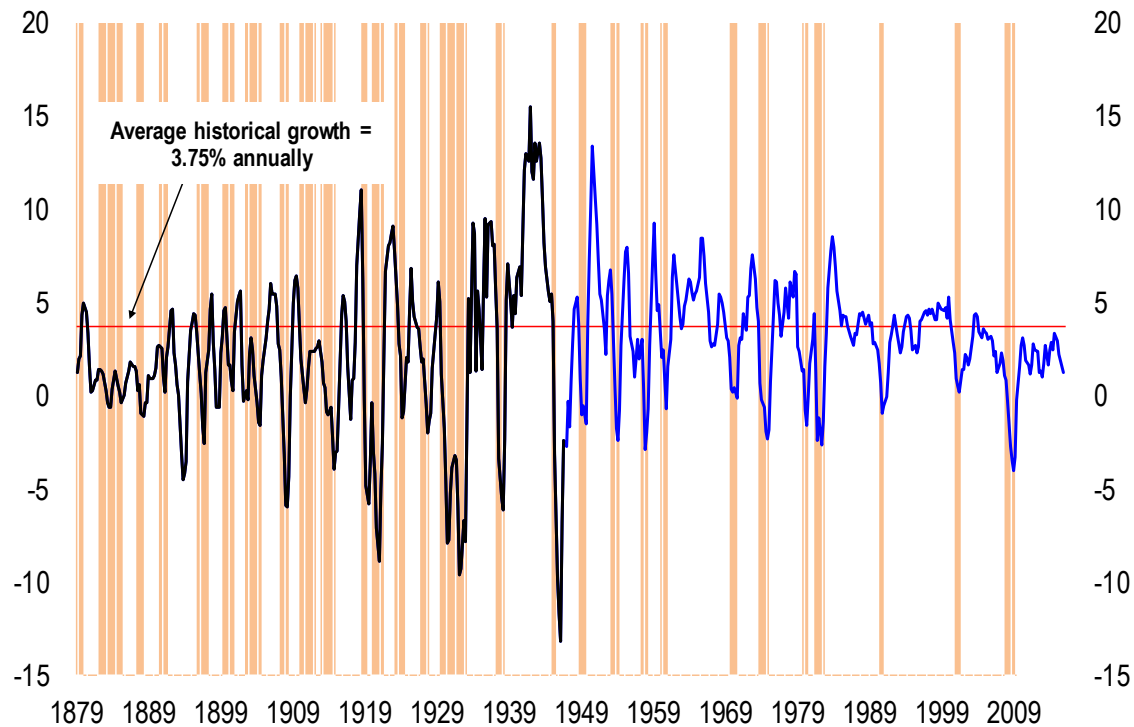


Note: Japan introduced a consumption tax in 1989, setting it at 3 percent. It raised this to 5 percent in April 1997 and then to 8 percent in April 2014. Plans to raise the tax to 10 percent in October 2015 have been put on hold.

Source: U.S. Department of Commerce. Updated through August 2016 (Japan and U.S.) and September 2016 (EU-28).

Person A ... ☹️

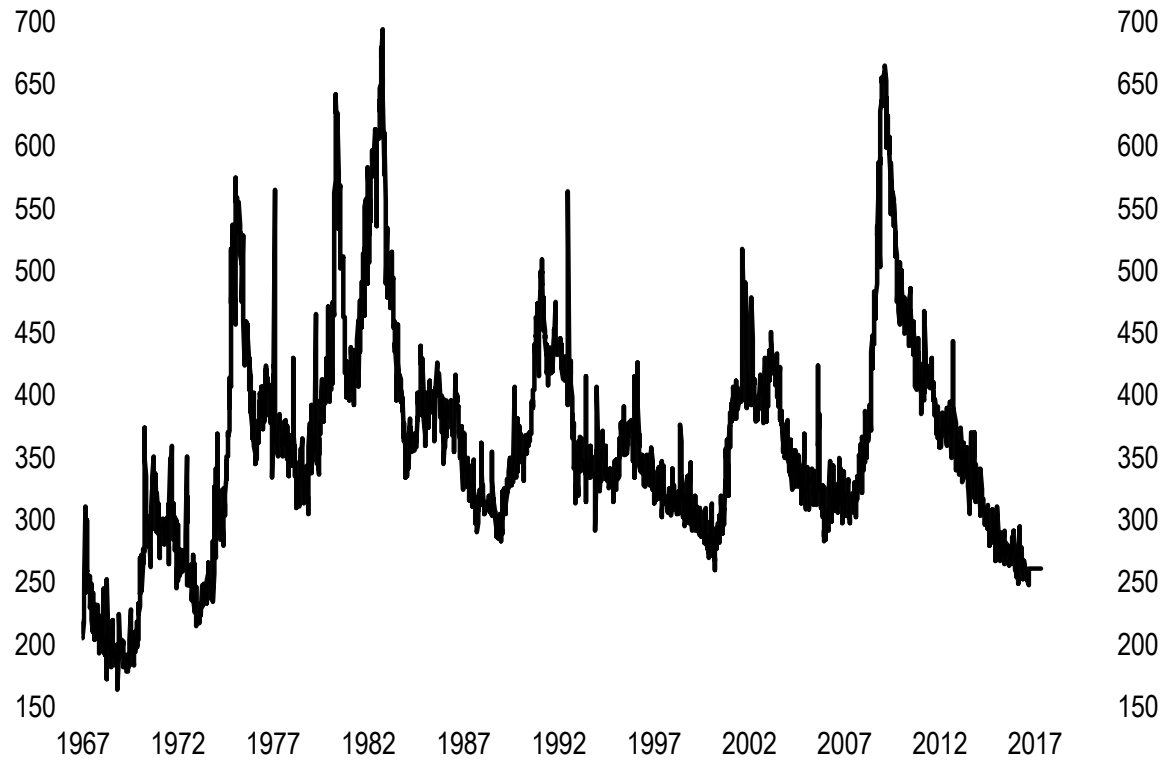
Real U.S. GDP growth (percent change from four quarters earlier)



Sources: Haver Analytics; U.S. Department of Commerce; NBER Macroeconomic database. Updated through 2016 Q2.

Person B ... 😊

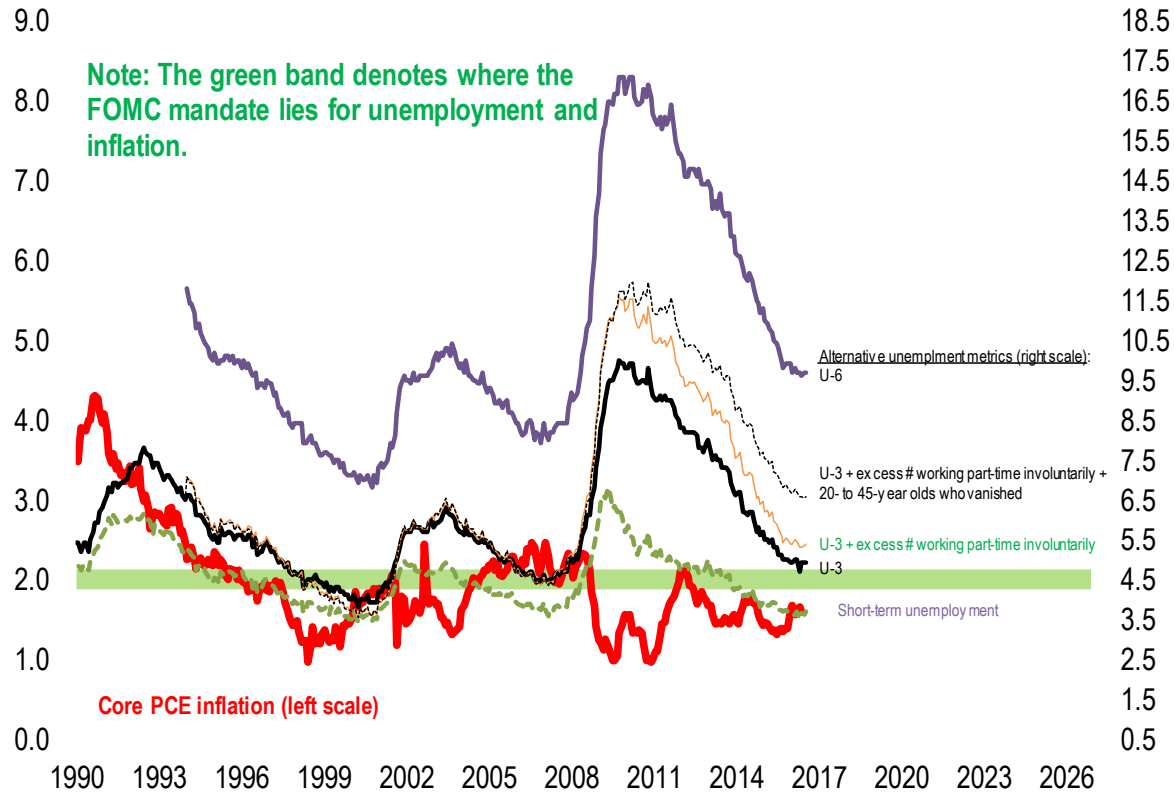
Jobless claims (thousands weekly)



Sources: U.S. Department of Labor. Updated through October 15, 2016.

The Fed's Mandates Are In View

Core PCE inflation (% ch from 12 months earlier) Unemployment (% of the labor force)



Sources: Haver Analytics; U.S. Department of Commerce; U.S. Department of Labor. Updated through Jaugust 2016 (inflation) and September 2016 (unemployment).

The 2016 National Election & the Economy

#1. A divided electorate begets divided governmental.

#2. A recovered economy quiets calls for new stimulus.

#3. A daunting fiscal challenge overrides bucket lists.

... or, economic reality drives the agenda more than campaign promises.

#2. WE'RE BACK
***(THE GROWTH RATE HAS NO MEANING
WITHOUT A REFERENCE POINT)***

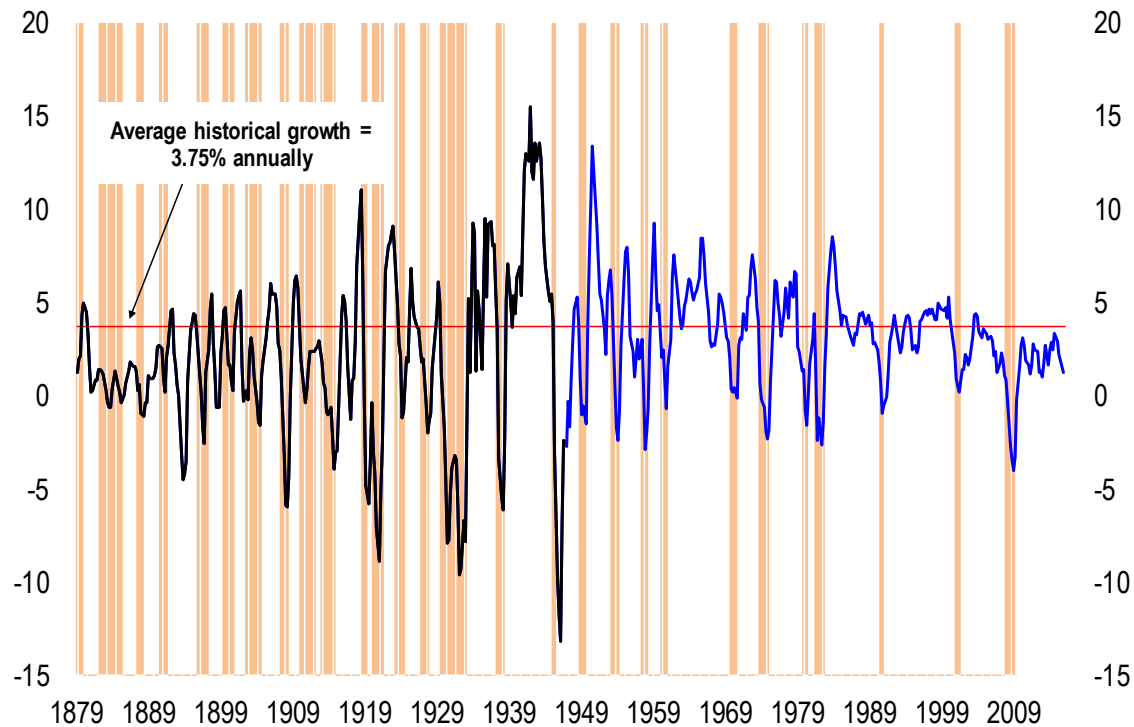
The “Great Confusion” ...

Economic Growth Is Not the Same Thing As
“Economic Conditions” ...

Or, Economic Growth Has No Meaning
Without Context

Person A ... ☹️

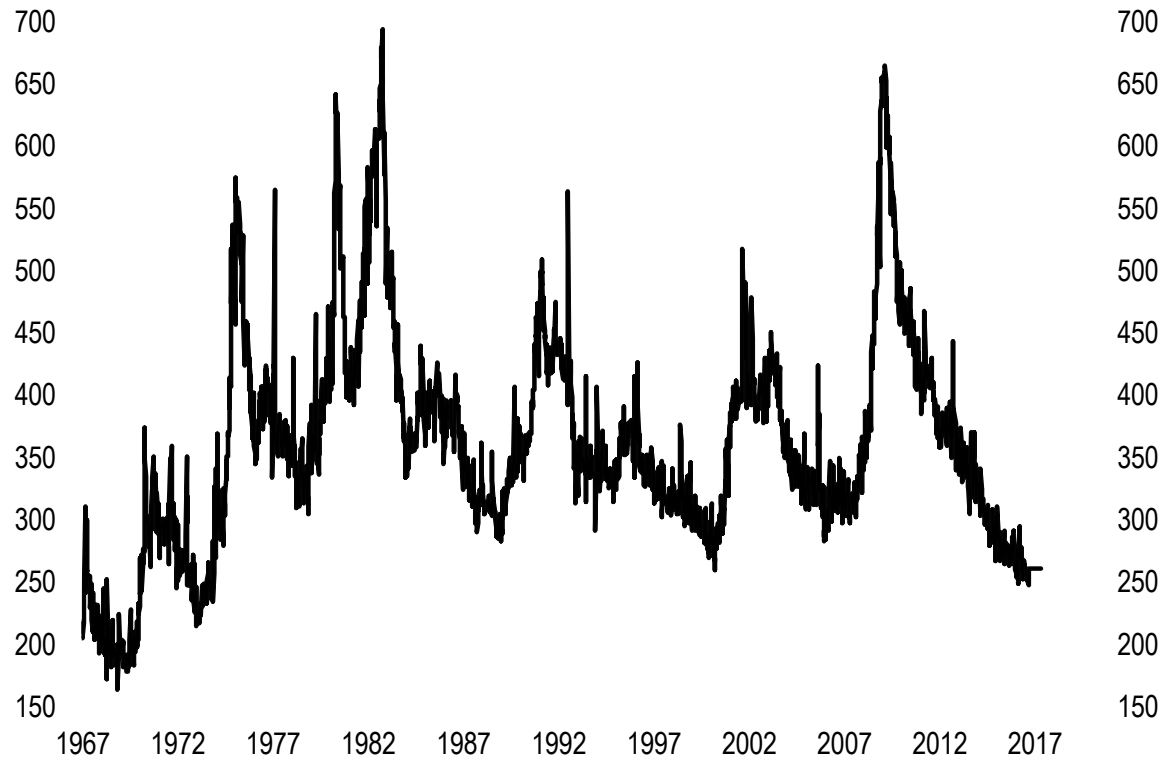
Real U.S. GDP growth (percent change from four quarters earlier)



Sources: Haver Analytics; U.S. Department of Commerce; NBER Macroeconomic database. Updated through 2016 Q2.

Person B ... 😊

Jobless claims (thousands weekly)



Sources: U.S. Department of Labor. Updated through October 15, 2016.

A RECOVERY BY ANY OTHER NAME ...

(Recovering in seven years from the worst downturn since the Great Depression doesn't sound like an “anaemic” recovery)

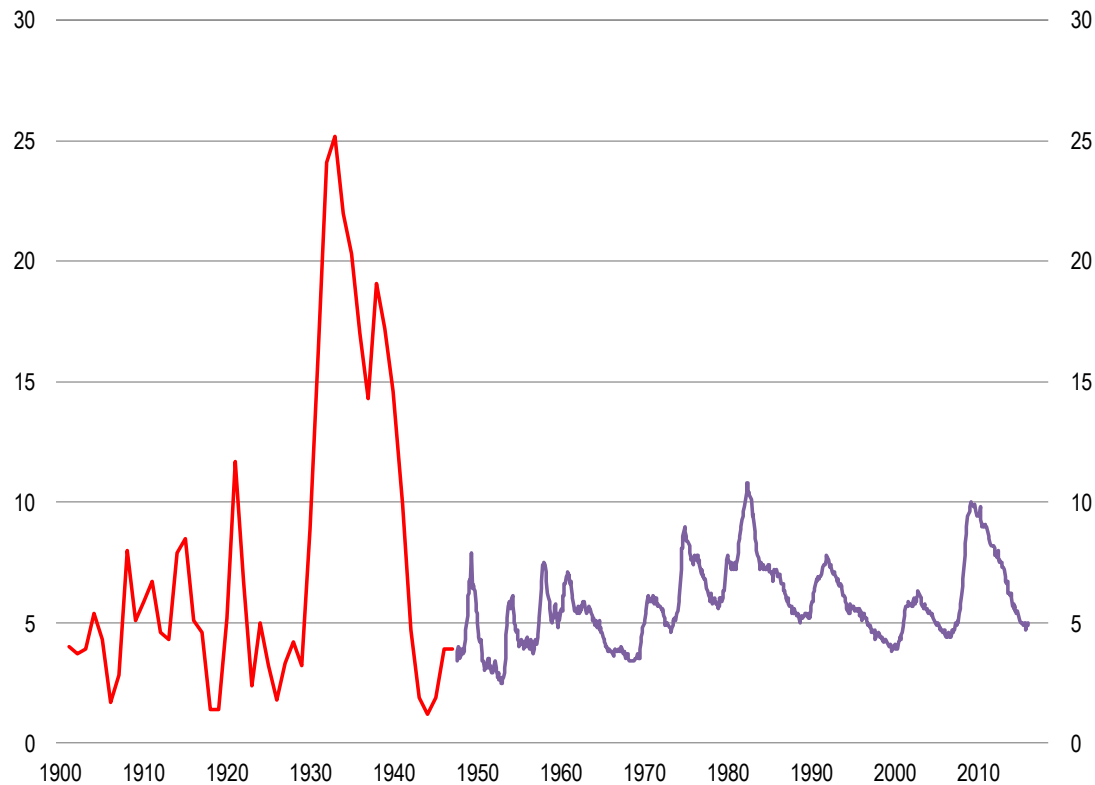
Remember What You Thought in 2009 ...

- House prices had fallen by one-third, leaving \$3 trillion of mortgages underwater.
- They said consumers would have to cut spending and boost saving, reversing the 1980-90's rise in the consumer spending share of GDP.
- They said recovery would take decades, echoing Japan's experience post its bubbles.
- That wrote obituaries for securitized finance, one of the great innovations of modern finance.

Seven Years Later, You Wake to This ...

History Books Will Call This 'Normal'

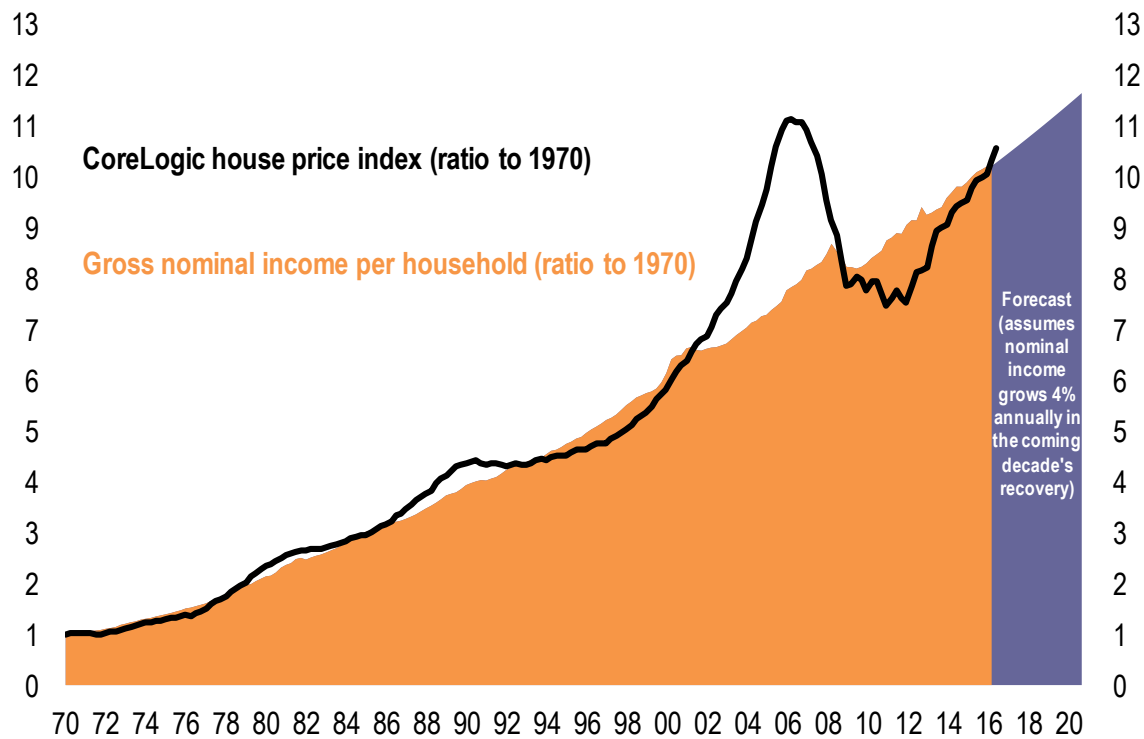
Unemployment (percent of the labor force)



Sources: Haver Analytics; U.S. Department of Labor. Updated through September 2016.

House Prices Recovered ...

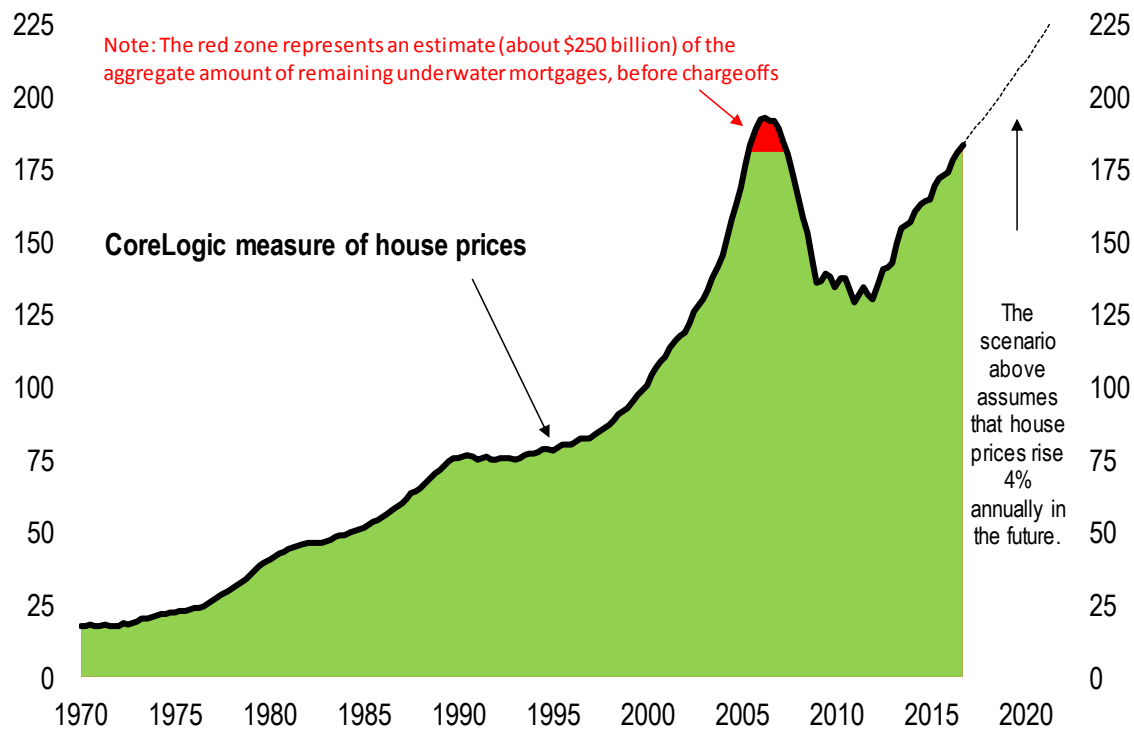
Household income and house prices (ratio to 1970)



Sources: U.S. Dep. of Commerce; CoreLogic. Updated through 2016 Q2 (income) and 2016 Q3 (August 2016) for the CoreLogic survey.

... Erasing the “Underwater” Problem ...

U.S. house prices (January 2000 = 100)

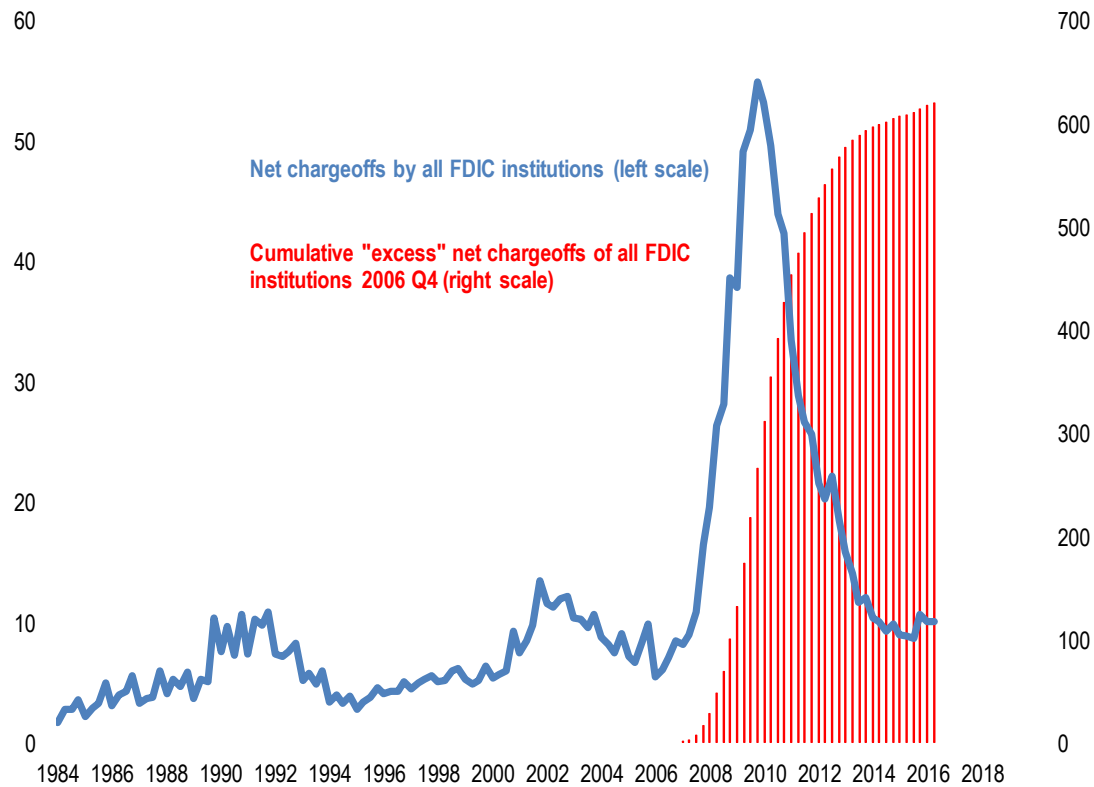


Sources: Haver Analytics; CoreLogic. Updated through 2016 Q3 (August 2016).

... Along With Write-Offs

Loan charge-offs (\$ billions quarterly)

Cumulative charge-offs since 2006 (\$ billions)

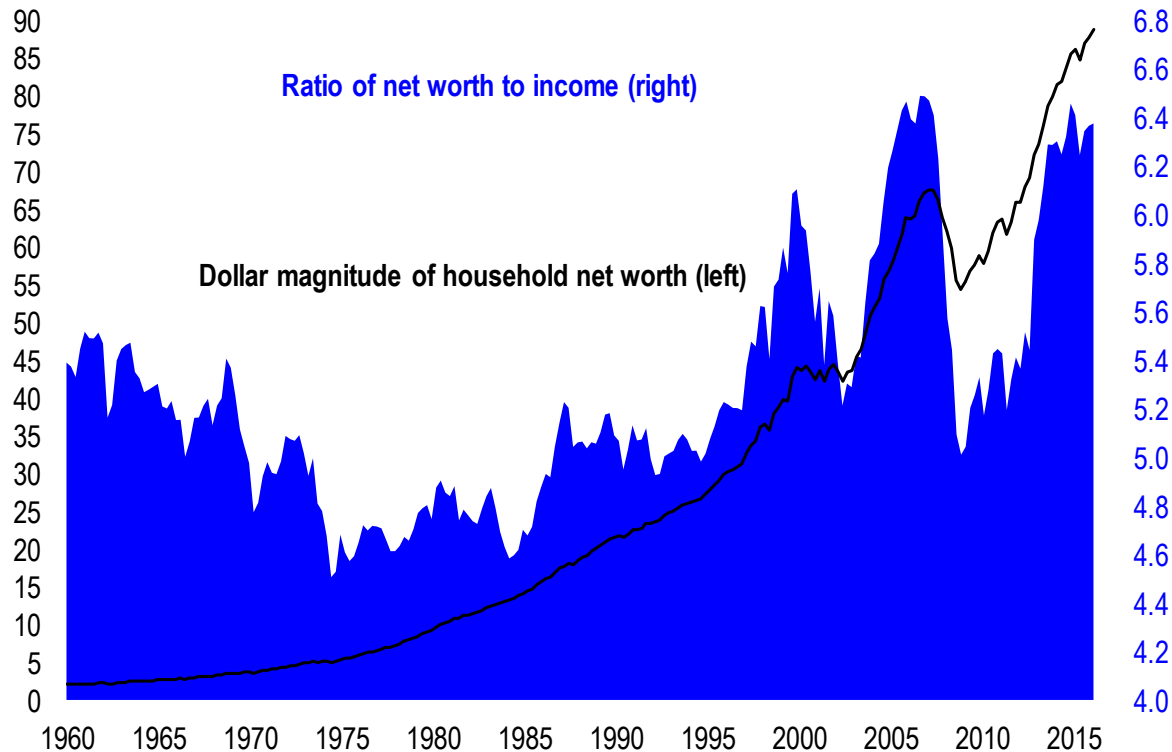


Source: Federal Deposit Insurance Corporation. Updated through 2016 Q2.

Net Worth Is Back in Record Territory

Household net worth (trillions of dollars)

(ratio to disposable income)

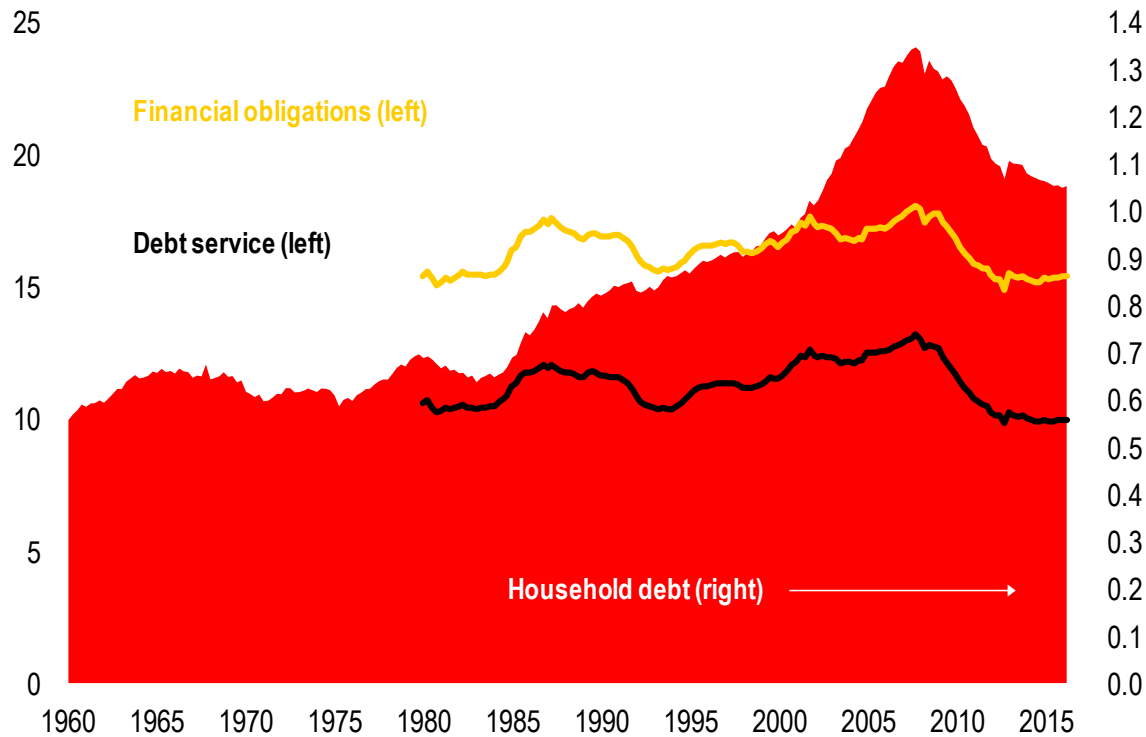


Sources: Haver Analytics; Federal Reserve Board; U.S. Department of Commerce. Updated through 2016 Q2.

Household Debt Service Is Historically Low

Debt service burden (percent of income)

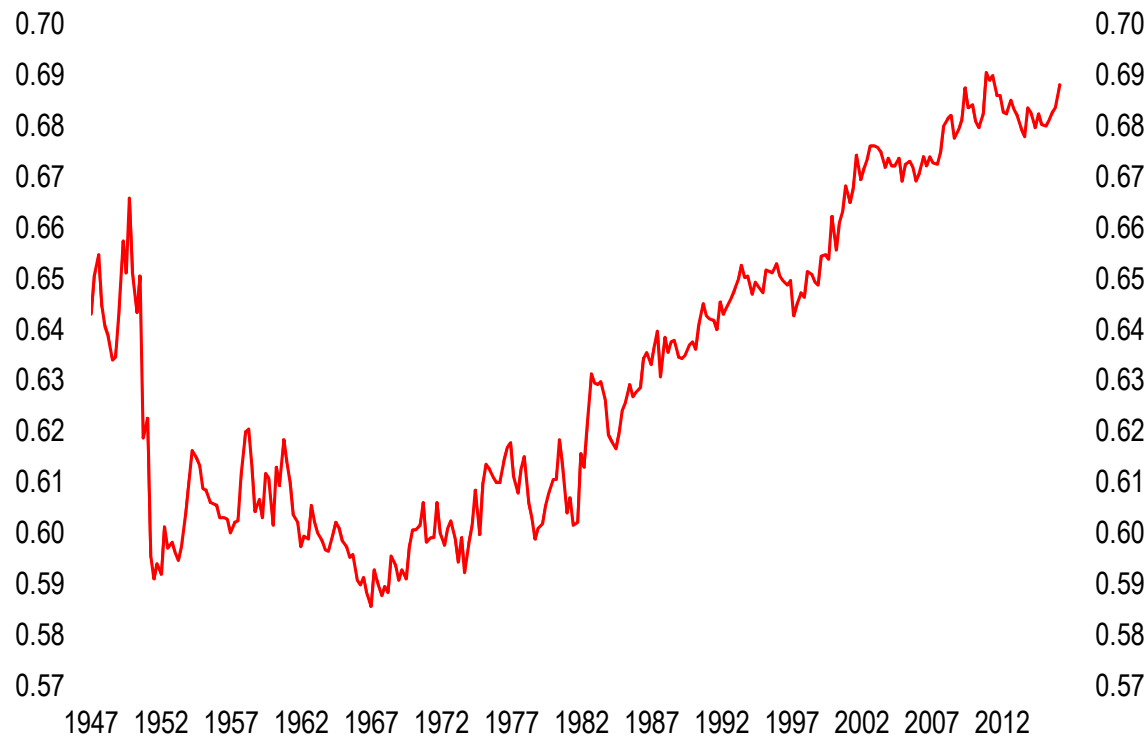
Debt burden (ratio to disposable income)



Sources: Haver Analytics; Federal Reserve Board. Updated through 2016 Q2.

Consumers Haven't Yielded High Ground

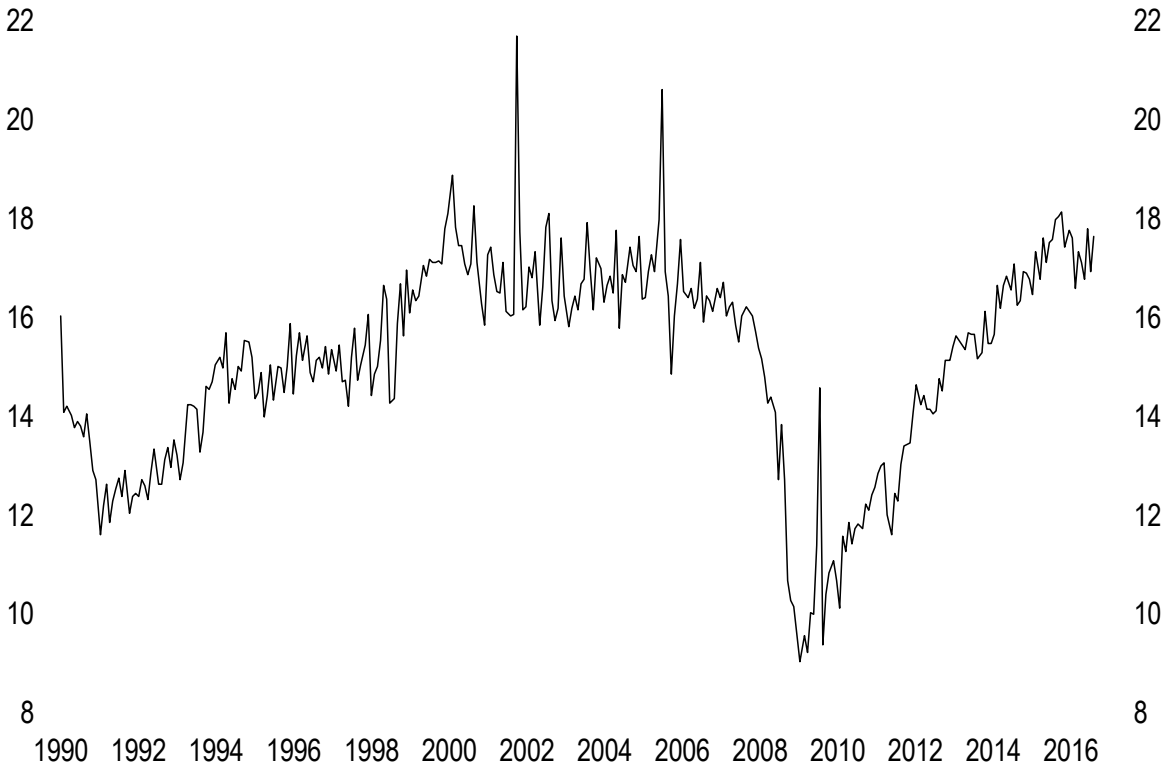
U.S. nominal consumer spending (ratio to nominal GDP)



Sources: Haver Analytics; U.S. Department of Commerce. Updated through 2016 Q2.

The Car Industry Is Humming

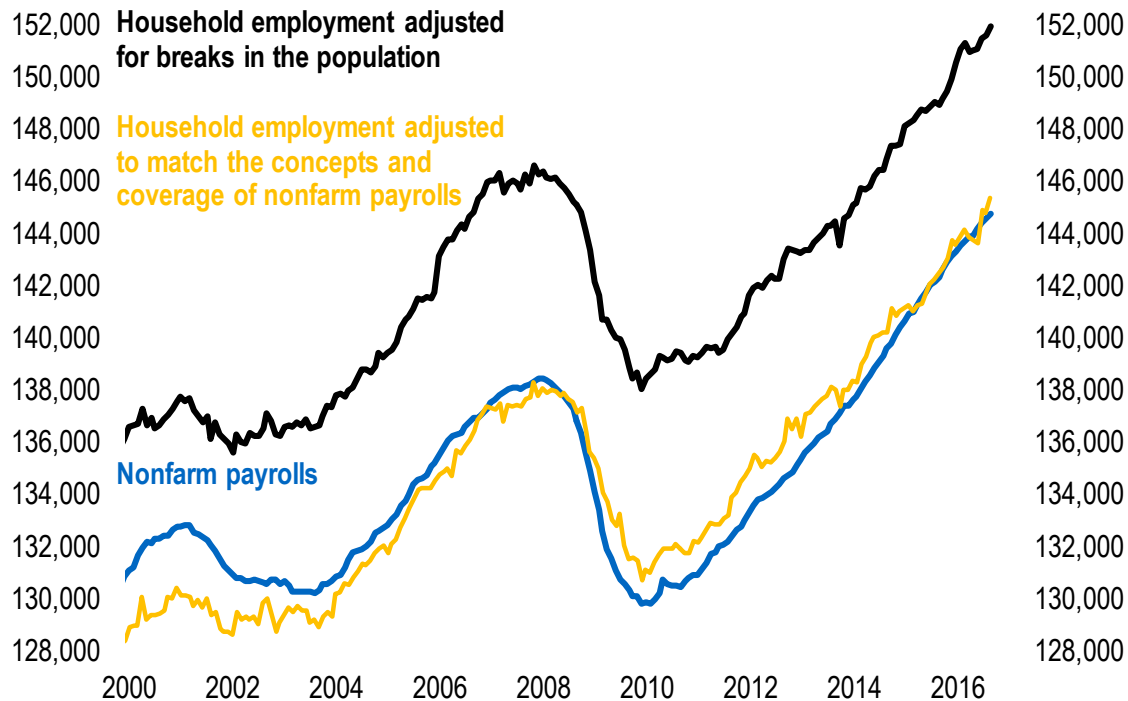
Light vehicle sales (millions at an annual rate)



Sources: Haver Analytics; U.S. Department of Commerce. Updated through September 2016.

Employment Is Up 15 Million Since 2009 ...

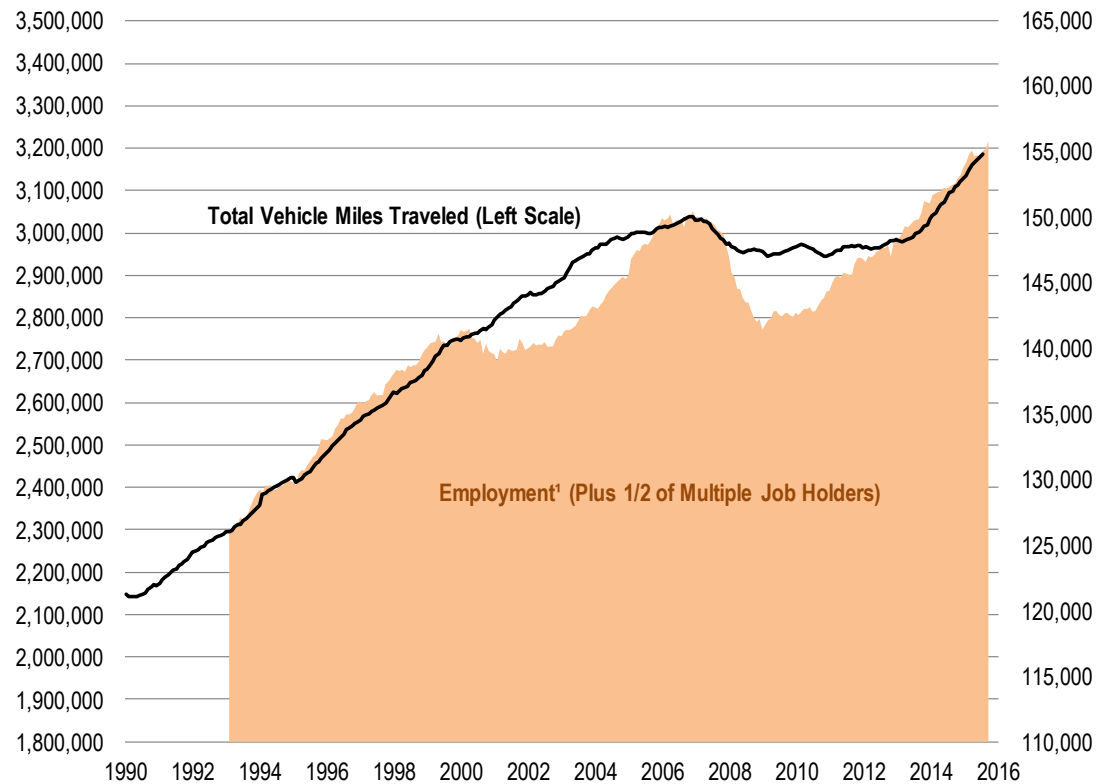
Selected employment measures (thousands)



Sources: Haver Analytics; U.S. Department of Labor. Updated through September 2016.

... P.S. That's Why Roads Are Jammed

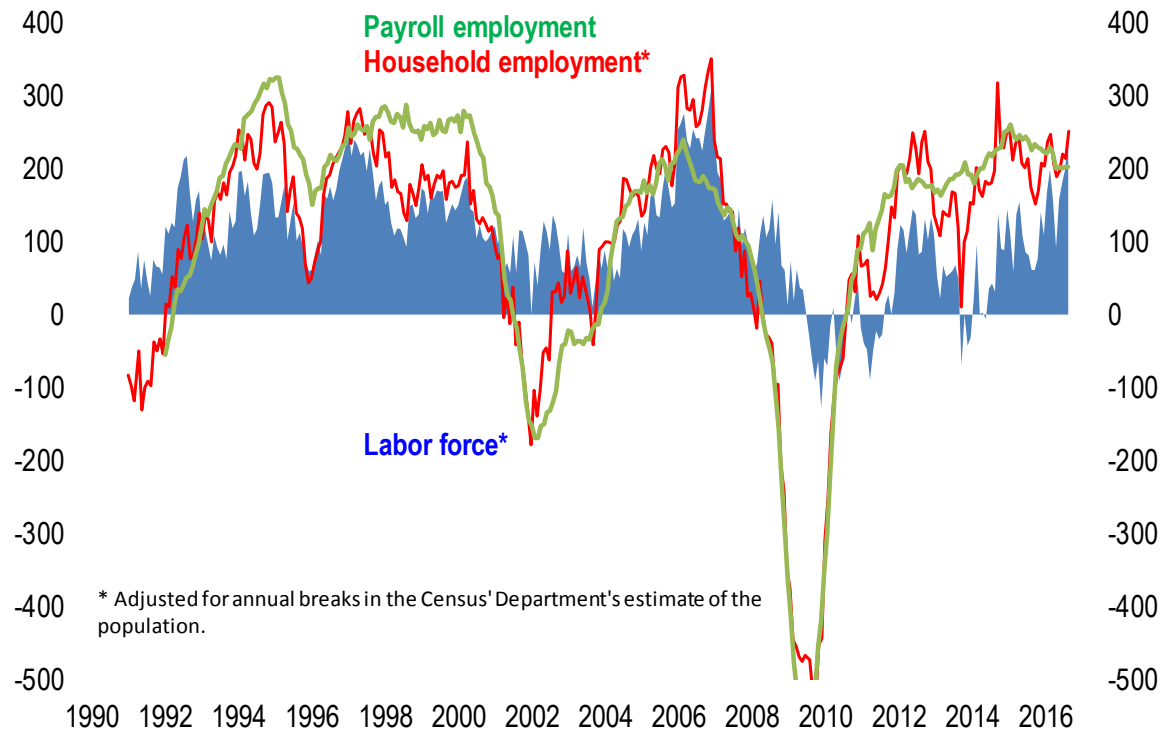
Total miles traveled in urban areas (millions of miles)



Source: Haver Analytics; Federal Highway Administration. Updated through July 2016 (miles traveled) and September 2016 (employment).

Labor Needs Have Eclipsed Supply ...

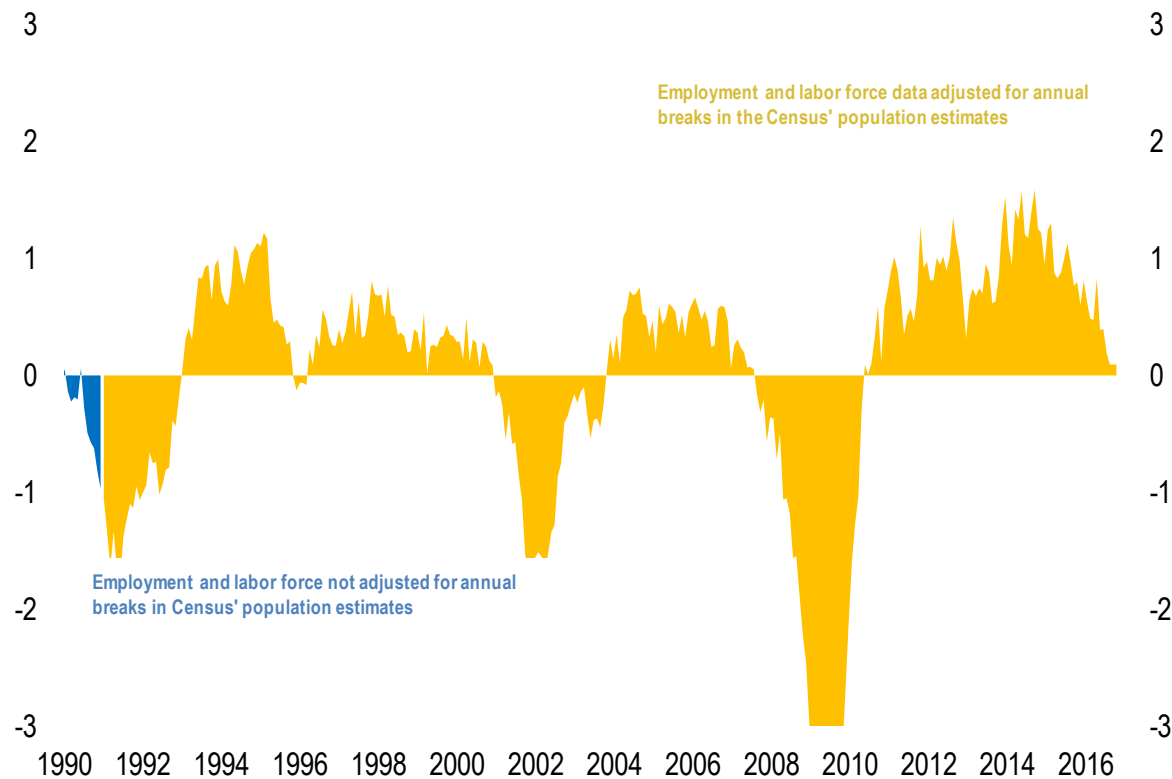
Employment and the labor force (percent change from 12 months earlier)



Sources: Haver Analytics; U.S. Department of Labor. Updated through September 2016.

... More Than In Other Recoveries

Employment growth less labor force growth¹ (percentage points)



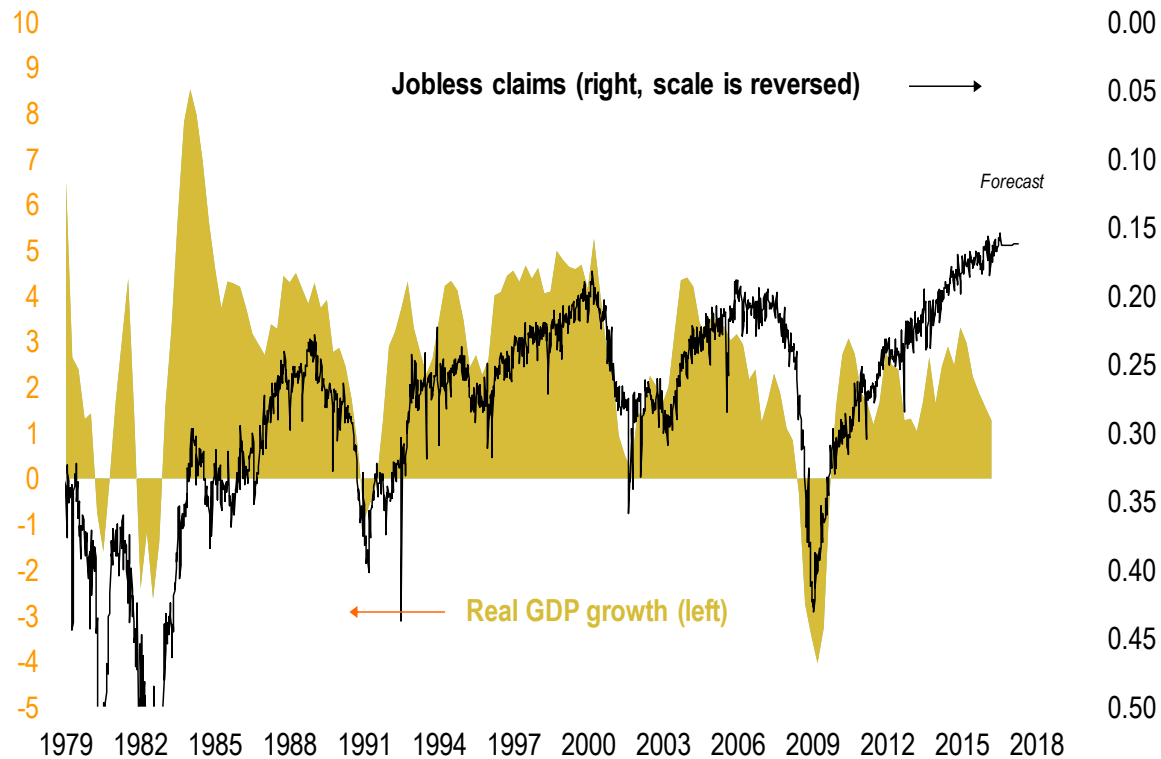
¹ Percent change from four quarters earlier.

Sources: Haver Analytics; U.S. Department of Labor. Updated through September 2016.

Layoffs Are Down to All-time Lows ...

Real GDP (% change from four quarters earlier)

Jobless claims (% of the labor force)

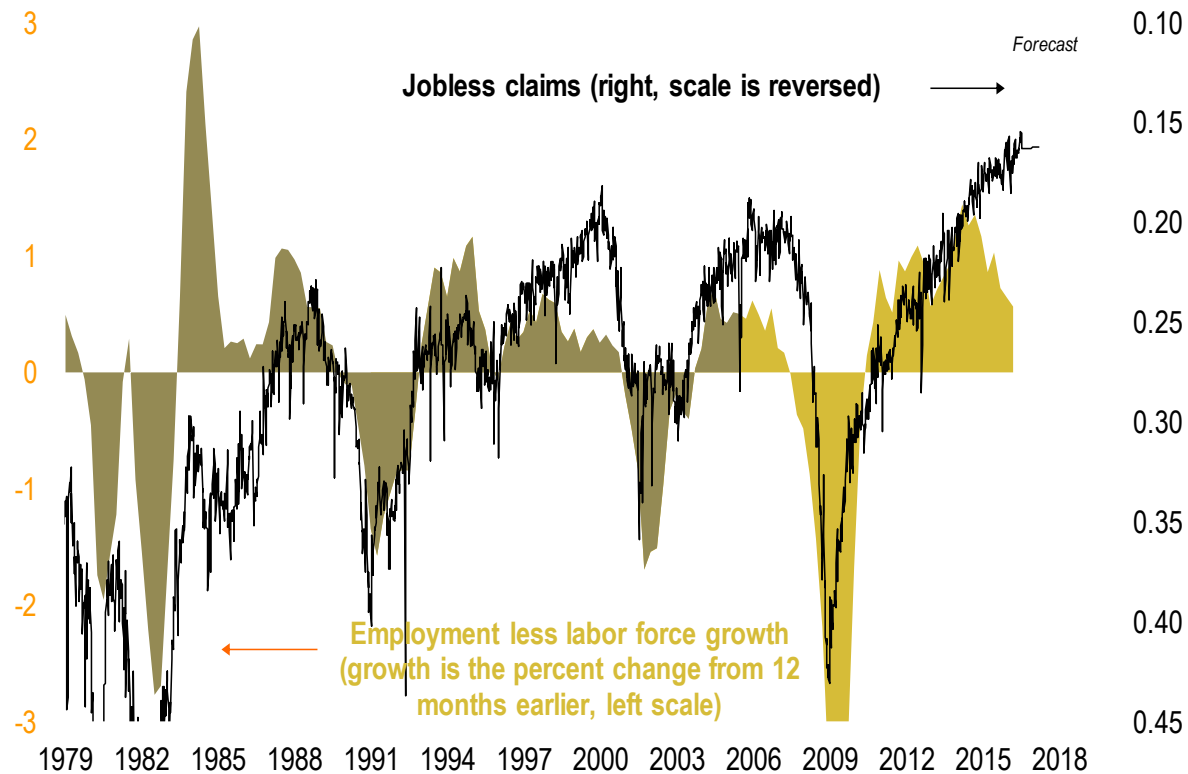


Sources: U.S. Deps. of Labor and Com. Updated through 2016 Q2 (GDP) and October 15, 2016 (jobless claims).

... Signaling Strong “Relative” Growth

Employment less labor force growth (pct pts)

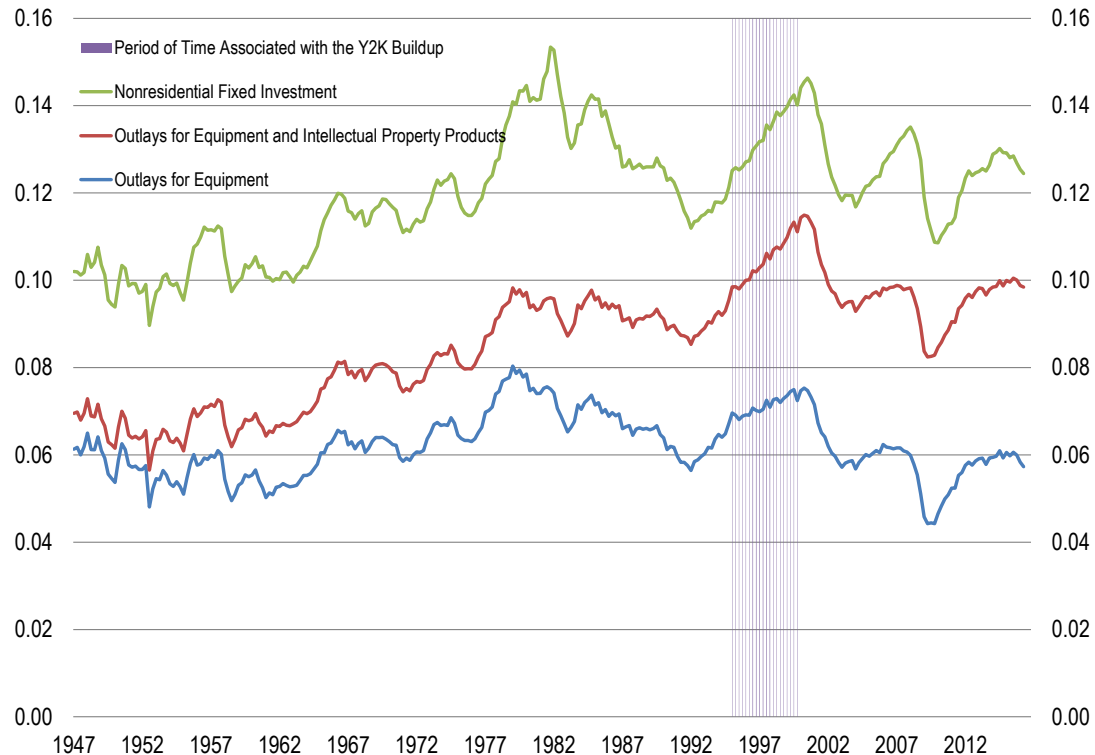
Jobless claims (% of the labor force)



Sources: U.S. Department of Labor. Updated through August 2016 (employment) and October 15, 2016 (jobless claims).

Cap Ex Is Only Slow in Absolute Terms

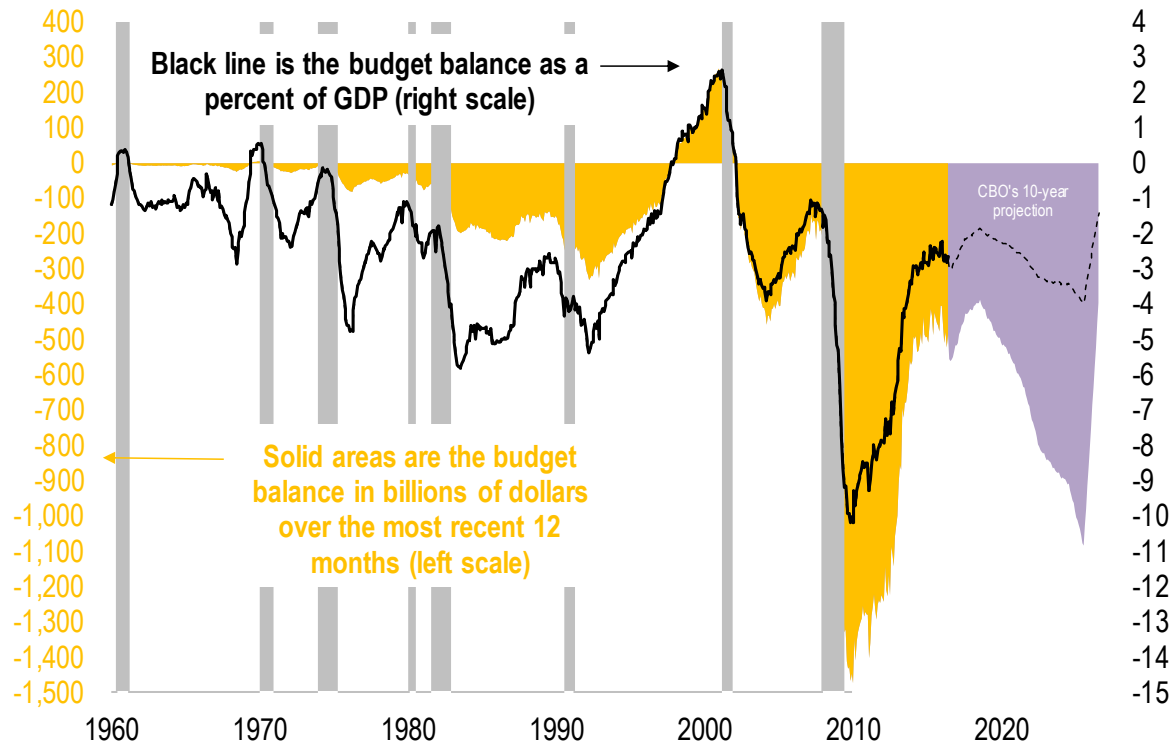
Business investment ratios (percentage of nominal GDP)



Sources: Haver Analytics; NBER-designated recession bars; U.S. Department of Commerce. Updated through 2016 Q2.

The Deficit Fell Back

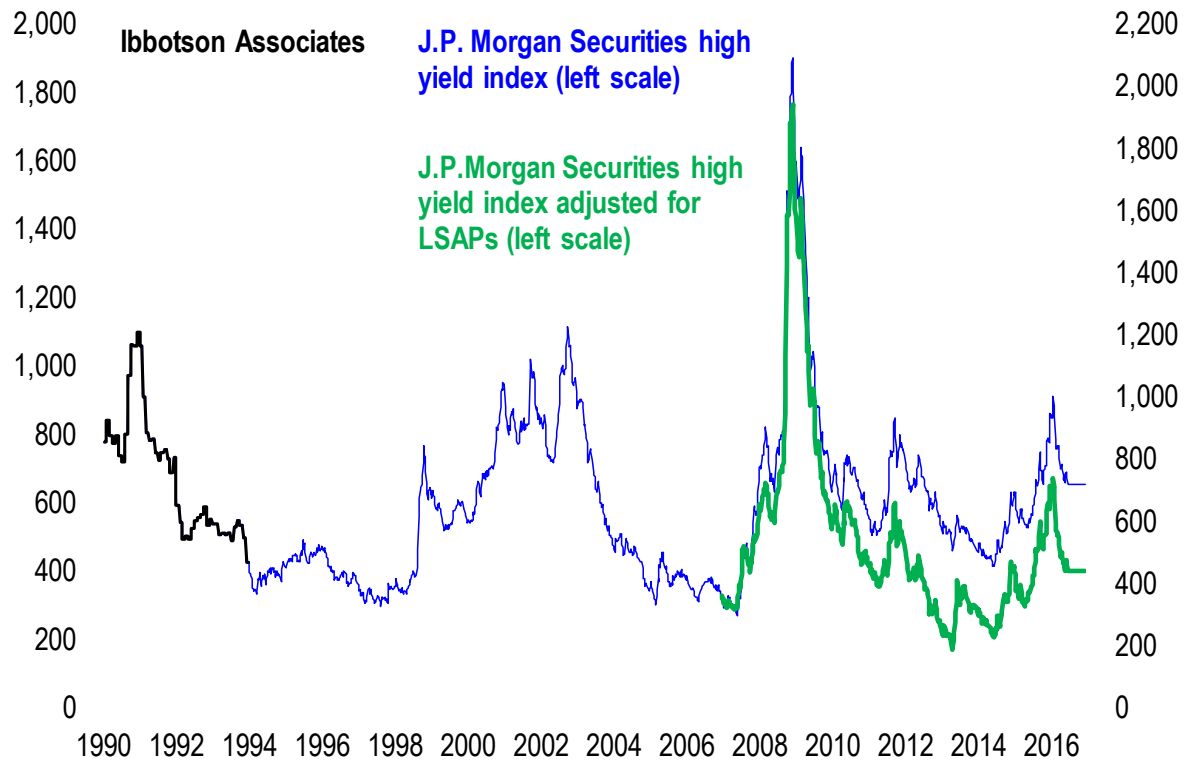
The federal deficit (billions of dollars over the most recent 12 months) (percent of nominal GDP)



Sources: Haver Analytics; U.S. Department of Commerce; CBO. Updated through July 2016.

Credit Spreads Are Back to Normal

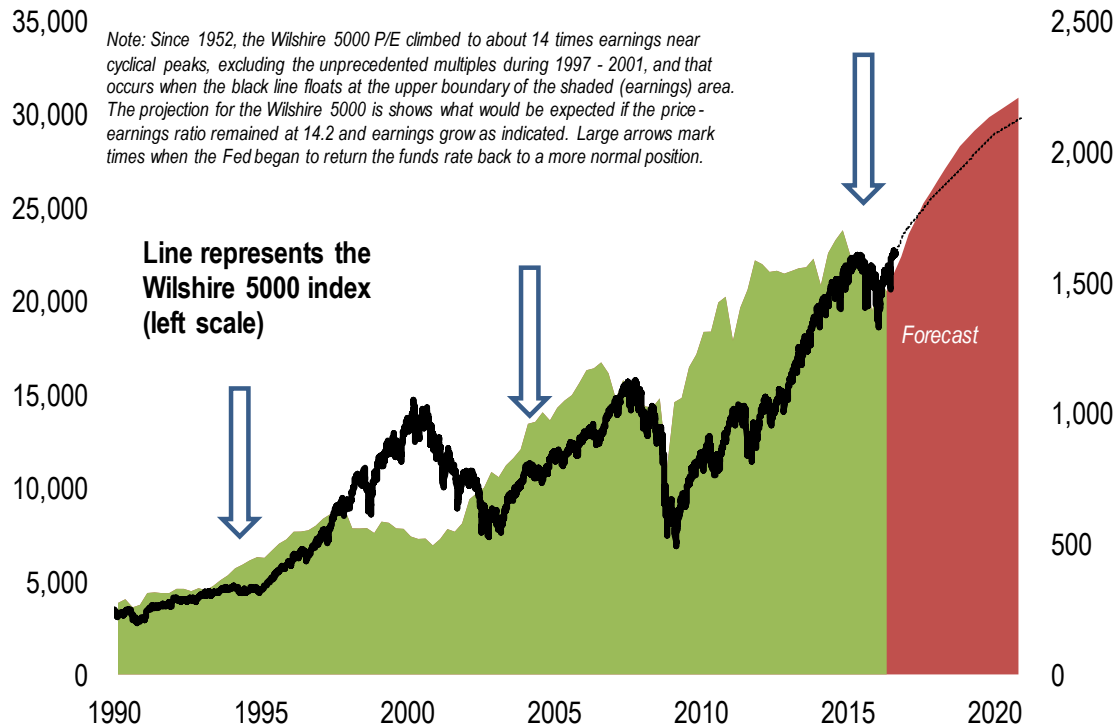
Noninvestment grade debt yield less 10-year Treasury yield (basis points)



Sources: Haver Analytics; Federal Reserve Board; J.P. Morgan. Updated through July 8, 2016.

Stock Valuations Are Back to Normal ...

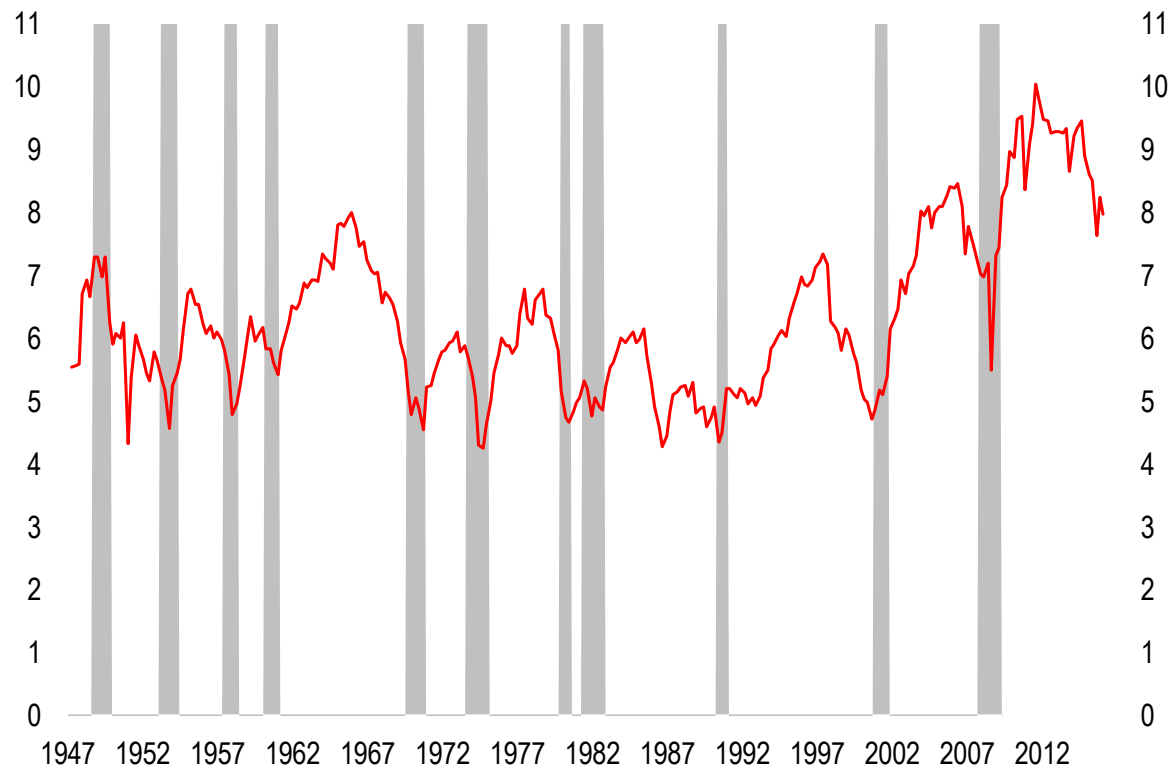
Wilshire 5000 (December 31, 1970 = 830.27) After-tax GDP profits (billions of dollars)



Sources: Haver Analytics; US Department of Commerce; Dow Jones. Updated through 2016 Q1 (profits) and September 8, 2016 (stocks).

... and That's Vs. Historically-High Profits

After-tax GDP profits of all U.S. businesses (percent of nominal Gross Domestic Income)



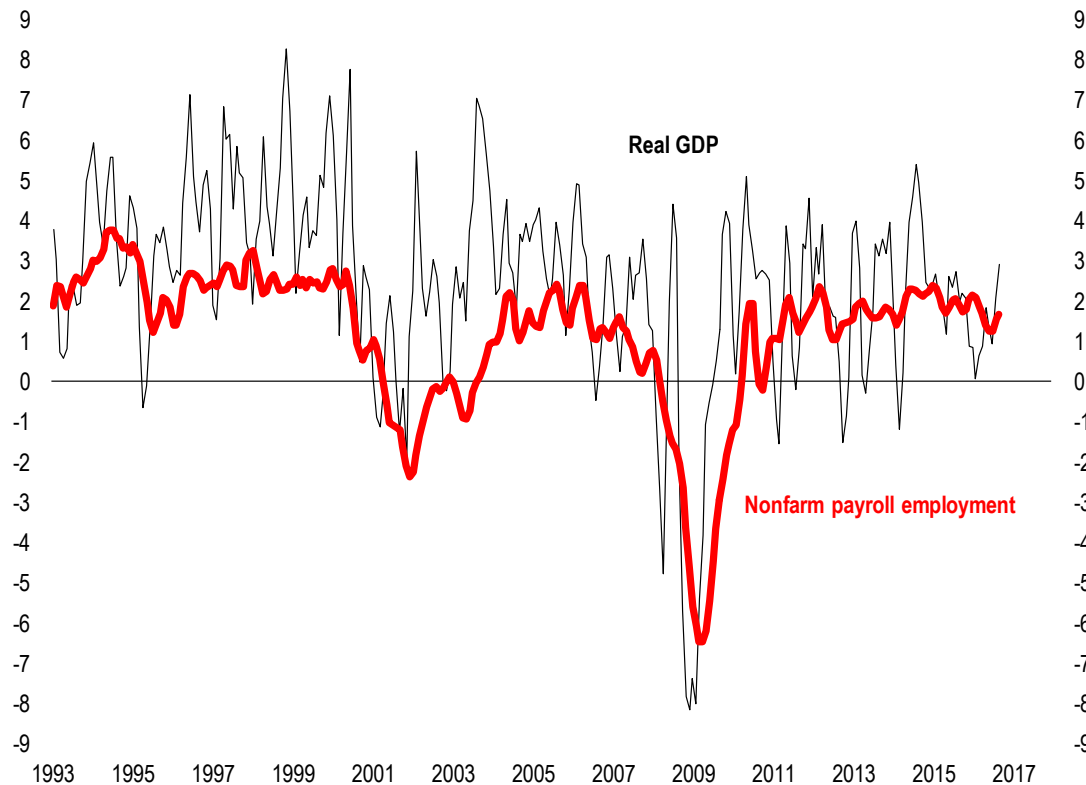
Sources: NBER-designated recession bars; U.S. Department of Commerce. Updated through 2016 Q2.

I.e., No One Waking From a Seven-Year Nap
Would Call That Anemic

... STILL GOING STRONG ...

The NIPA Are Too Clueless to Trust ...

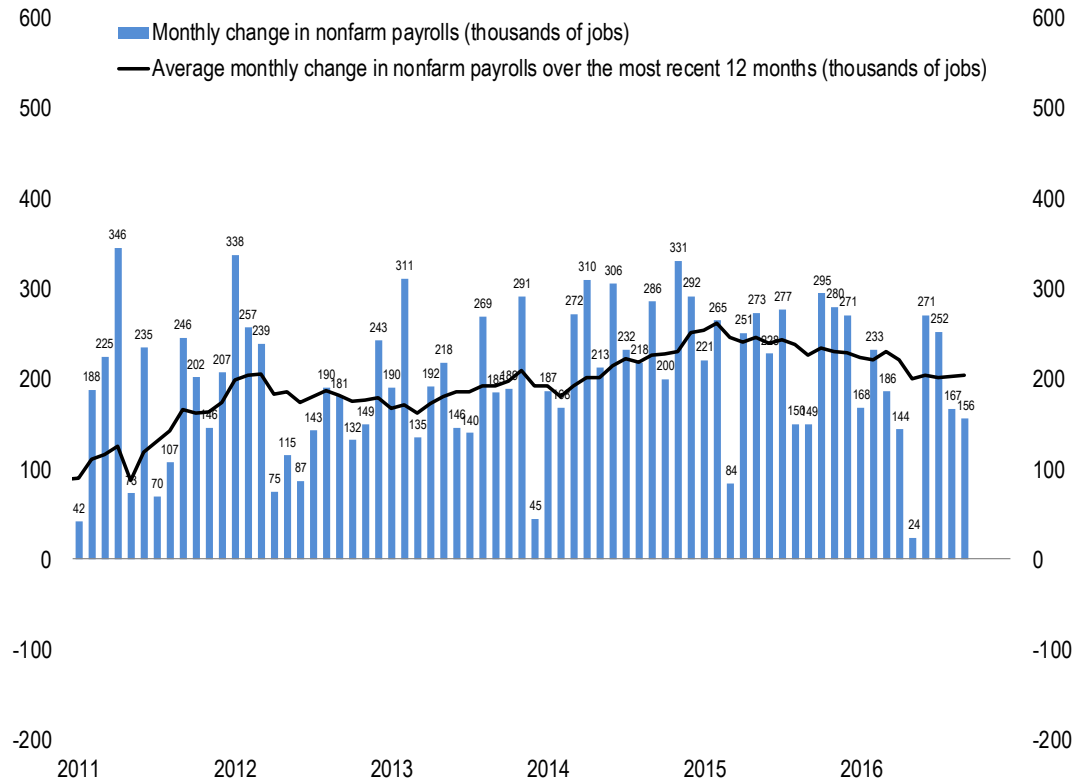
Real GDP and nonfarm payroll employment (ann. % ch from the previous qtr, smoothed)



Sources: Haver Analytics; U.S. Department of Commerce; U.S. Department of Labor. Updated through July 2016 (GDP) and September 2016 (employment).

Payrolls Know Something, Usually, ...

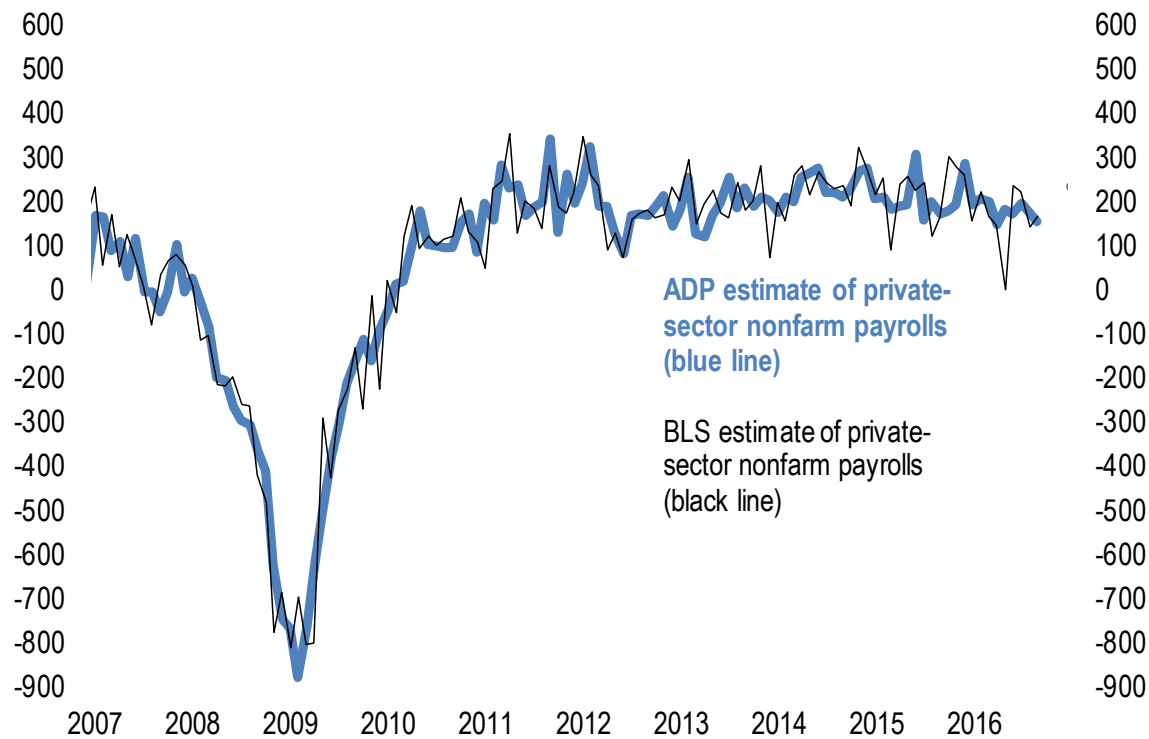
Nonfarm employment (monthly change in thousands)



Sources: Haver Analytics; U.S. Department of Labor. Updated through September 2016.

... but Aren't the Only Word on Jobs

Nonfarm private employment (change in the month in thousands)

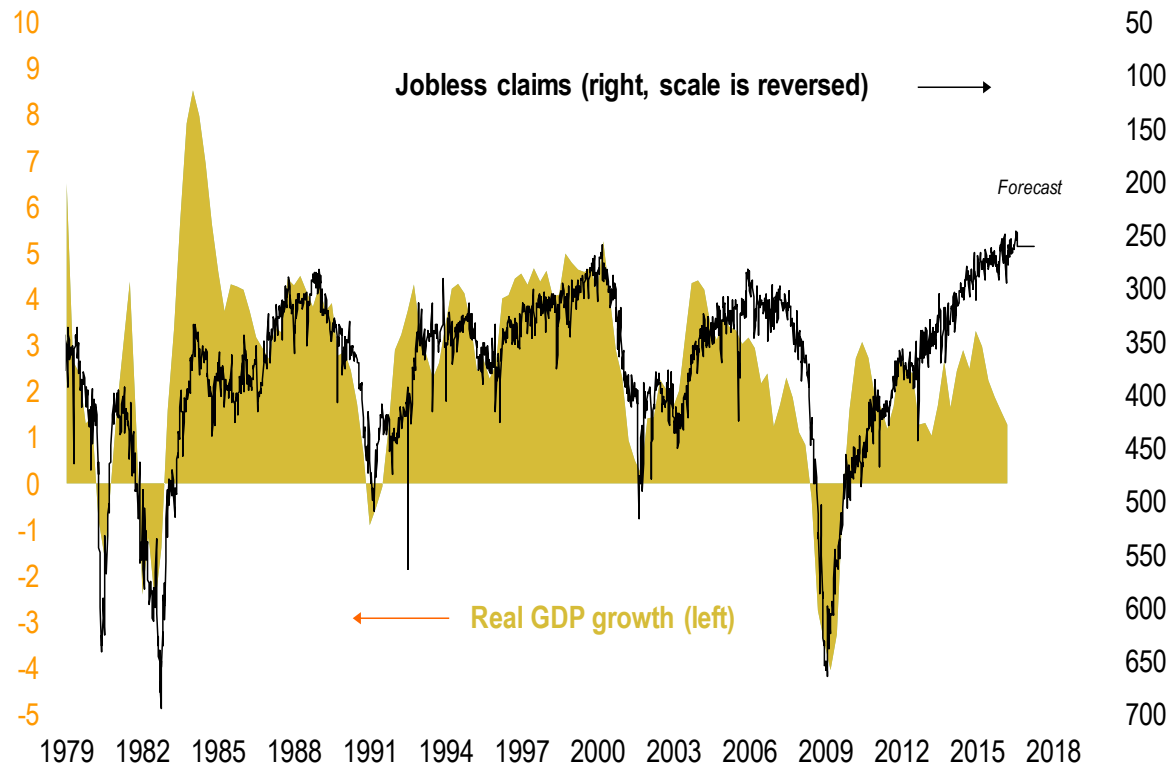


Sources: Haver Analytics; ADP; U.S. Department of Labor. Updated through September 2016.

But Jobless Claims Know Best ...

Real GDP (% change from four quarters earlier)

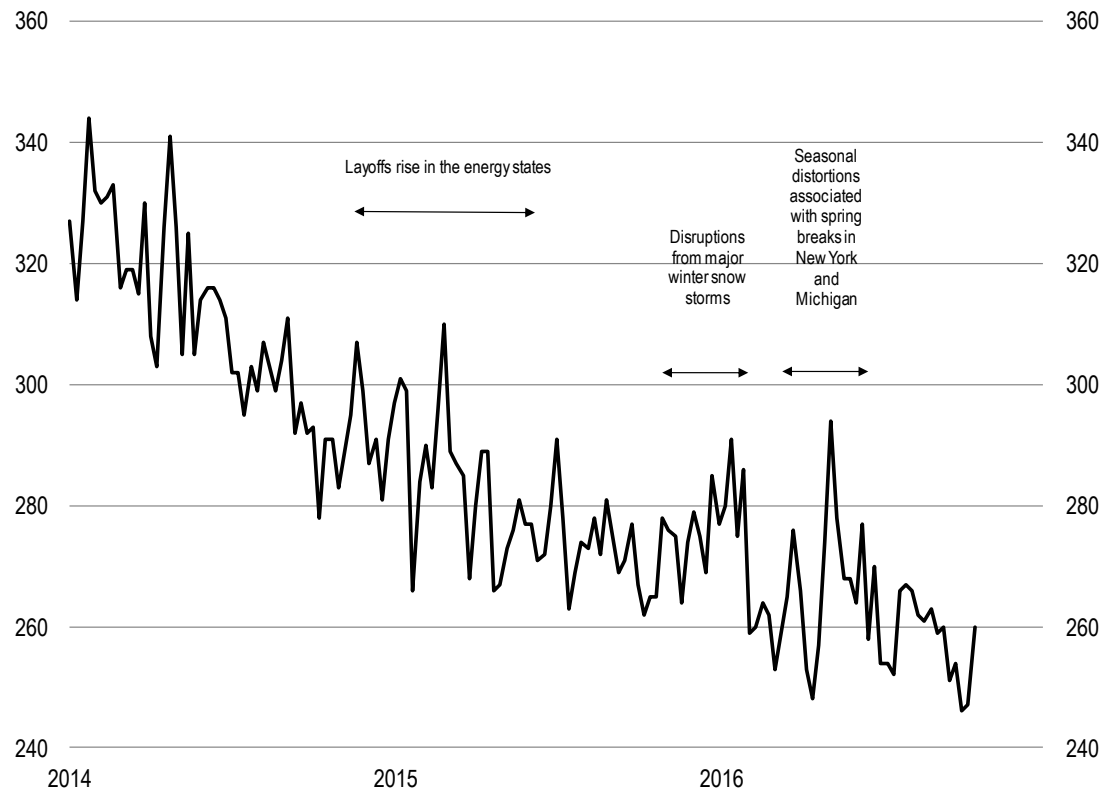
Jobless claims (thousands weekly)



Sources: U.S. Depts. of Labor and Com. Updated through 2016 Q2 (GDP) and October 15, 2016 (jobless claims).

... Timely, Accurate, Comprehensive, Granular

Applications for unemployment benefits (thousands, weekly)



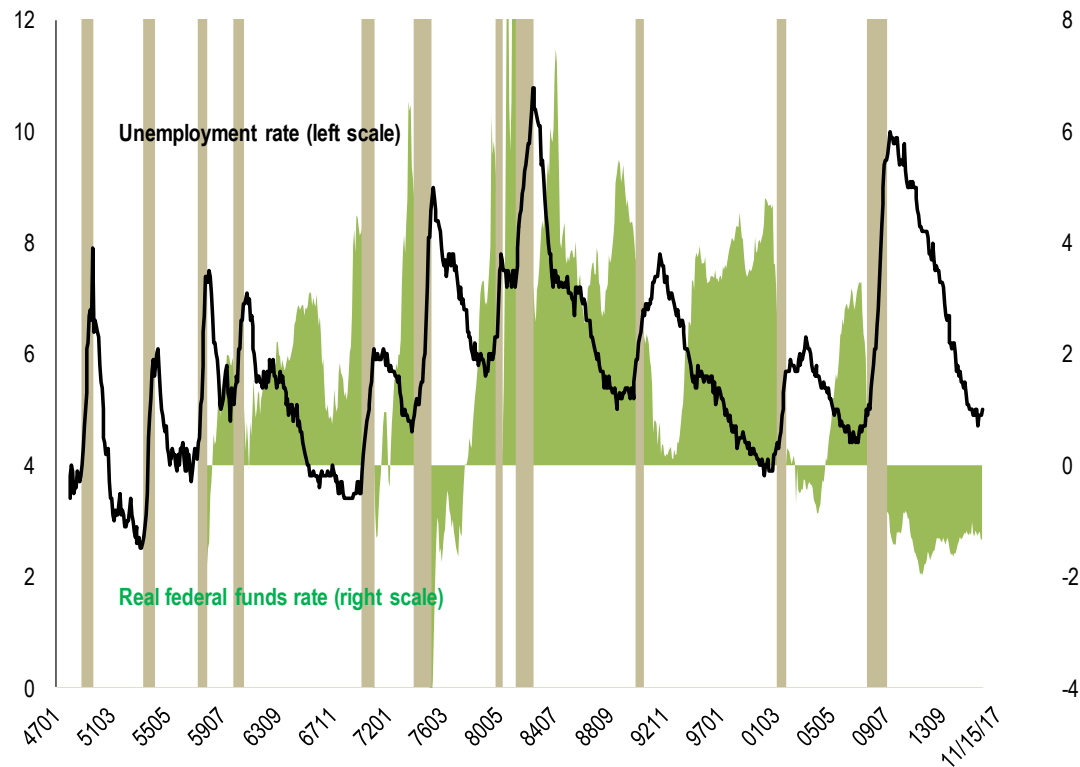
Sources: U.S. Department of Labor. Updated through October 15, 2016.

... AND FED MANDATES IN SIGHT

Official Measures Don't See Everything ...

Unemployment (% of the labor force)

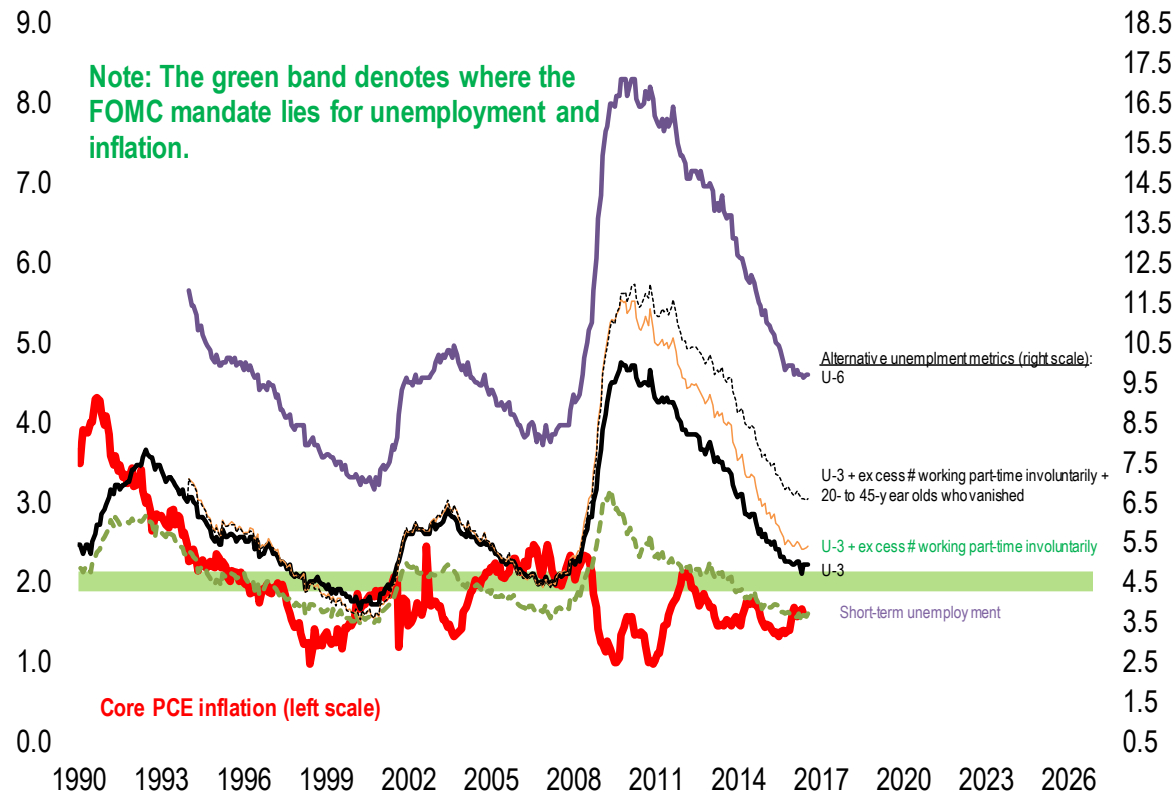
Real federal funds rate (percent)



Sources: Haver Analytics; Federal Reserve Board. Updated through September 2016 (unemployment) and October 7, 2016 (real funds rate).

... But All Unemployment Is Falling ...

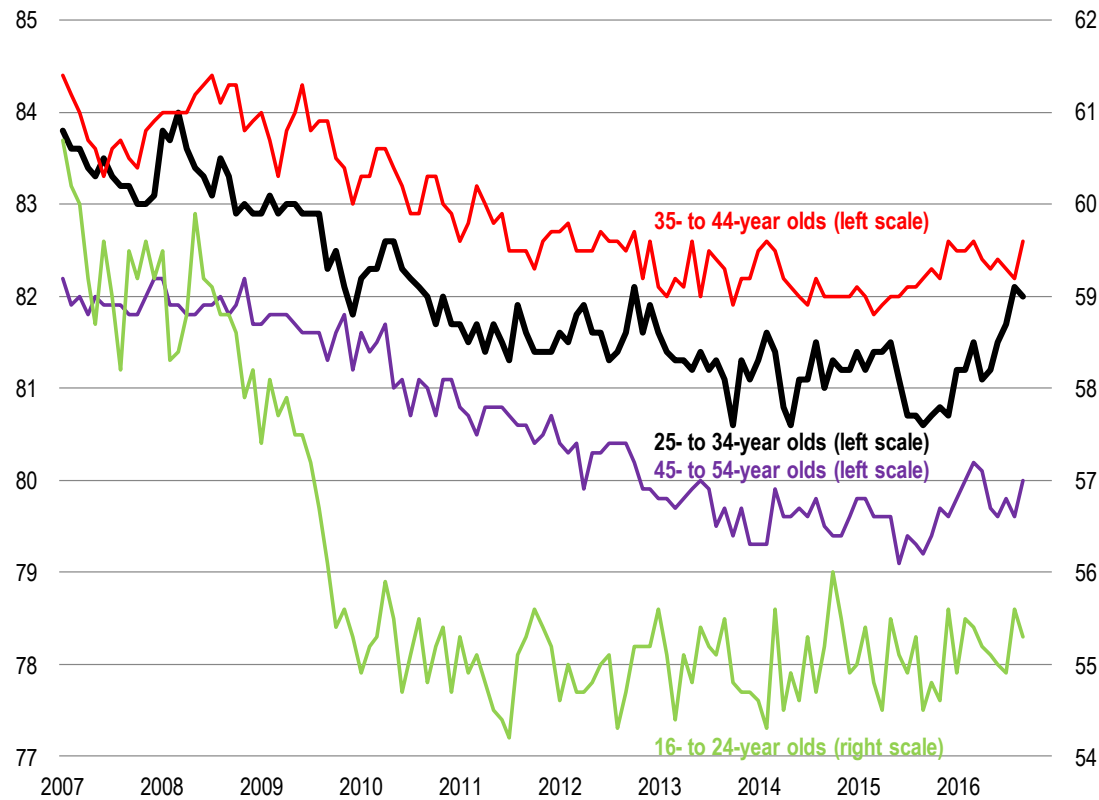
Core PCE inflation (% ch from 12 months earlier) Unemployment (% of the labor force)



Sources: Haver Analytics; U.S. Department of Commerce; U.S. Department of Labor. Updated through Jaugust 2016 (inflation) and September 2016 (unemployment).

... Maybe 2 to 2½ Million to Go ...

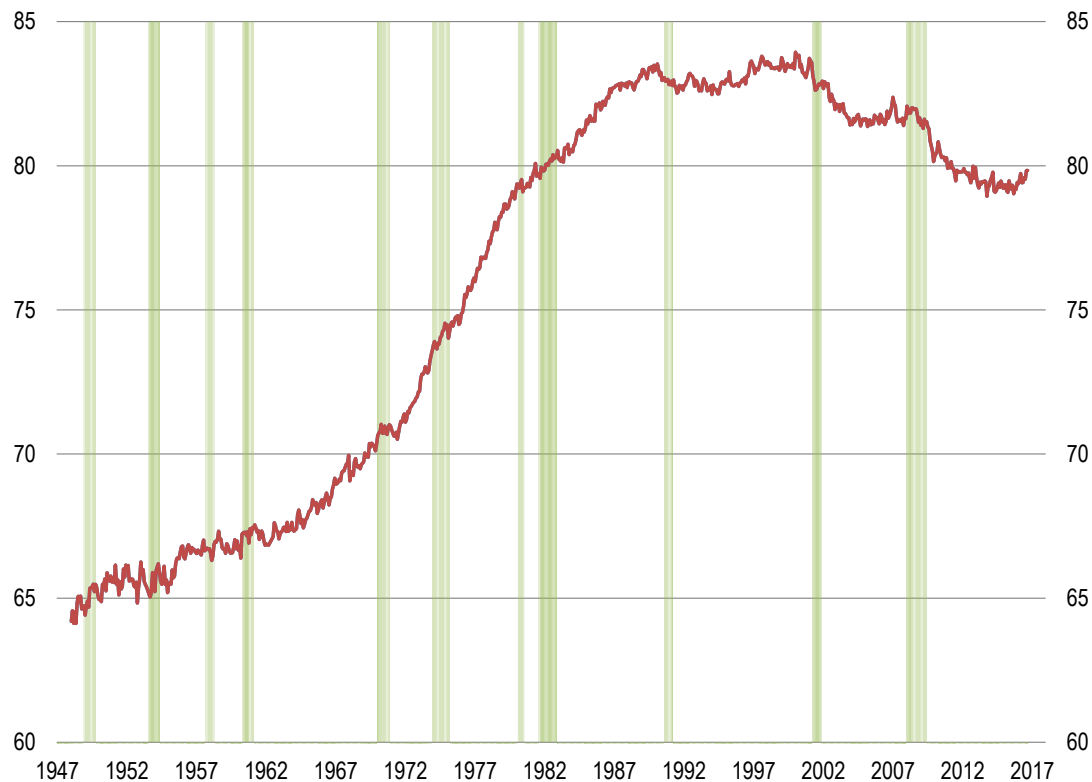
Participation rate for selected cohorts (% of the respective population)



Sources: Haver Analytics; U.S. Department of Commerce; U.S. Department of Labor. Updated through September 2016.

... for Those in Prime Working Years

Participation rate of 20- to 45-year olds (% of the respective population)



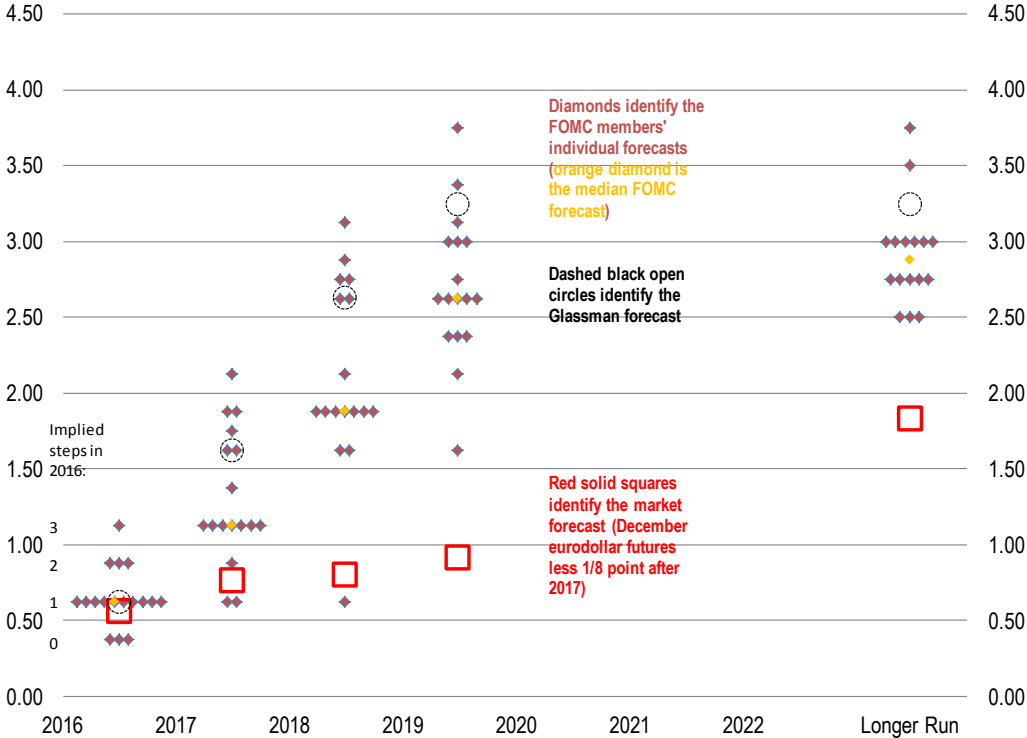
Sources: Haver Analytics; NBER-designated business cycles; U.S. Department of Labor. Updated through September 2016.

∴ NO CALL FOR EMERGENCY RATES

(“If 1.6 percent inflation and 4.9 percent unemployment were all you knew about the economy, would you consider a policy setting one tick above the zero lower bound still appropriate?”, Dennis Lockhart, President of the Federal Reserve Bank of Atlanta)

Actions Are Speaking Softer than Words

Forecasts of the federal funds rate (percent)



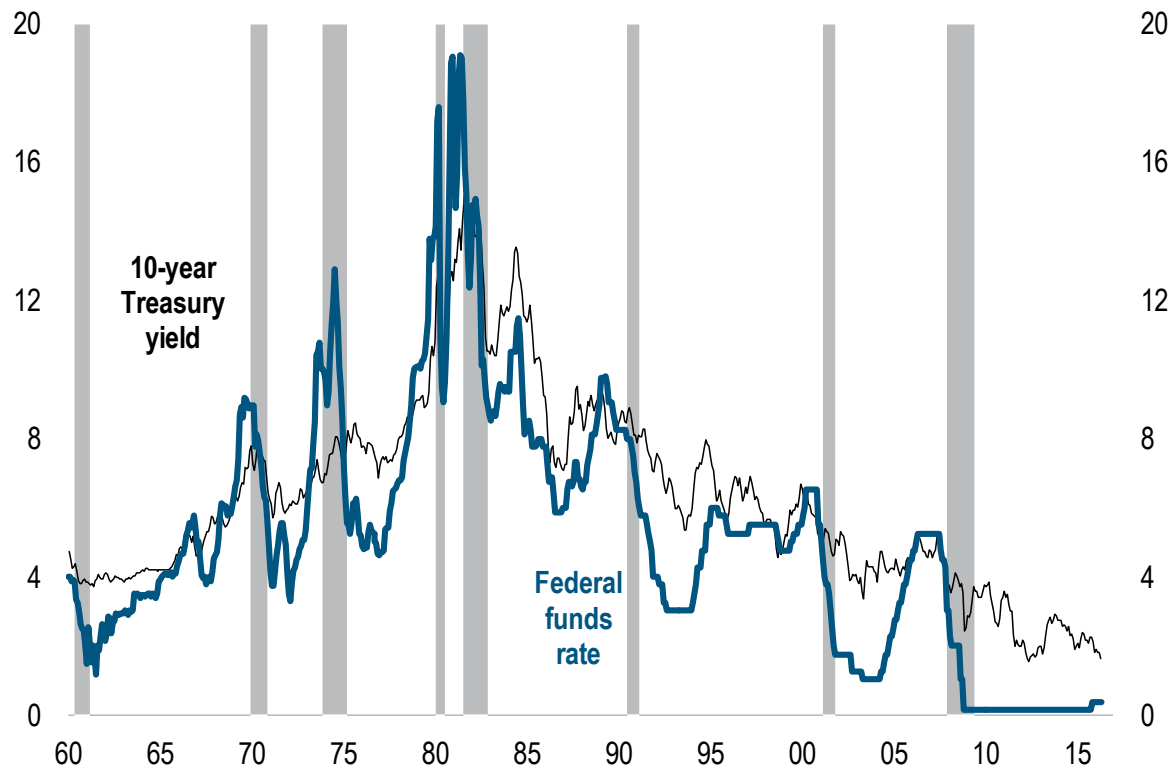
Sources: FRB; Bloomberg. Updated through September 21, 2016 (FOMC) and October 7, 2016 (futures).

P.S. Talk of New Tools Is About the Future ...

- 1) Lower equilibrium real rates, if for real, lowers the “neutral” bar;
- 2) A lower natural level of interest rates constrains the ability of central banks to stimulate the economy by steepening the yield curve, given the zero lower bound on interest rates;
- 3) Calls to raise the inflation target make sense in theory but ignore central bank credibility issues;
- 4) The re-inflation strategy (the inverse of opportunistic disinflation strategy said to describe the game plan of the 1980’s and 1990’s to bring inflation down) calls for central banks to aggressively fight weakness, limiting disinflation pressures, knowing that a recovery eventually will pull inflation up.

... and Options If Rates Get Too Low

Federal funds rate and the 10-year Treasury yield (percent)

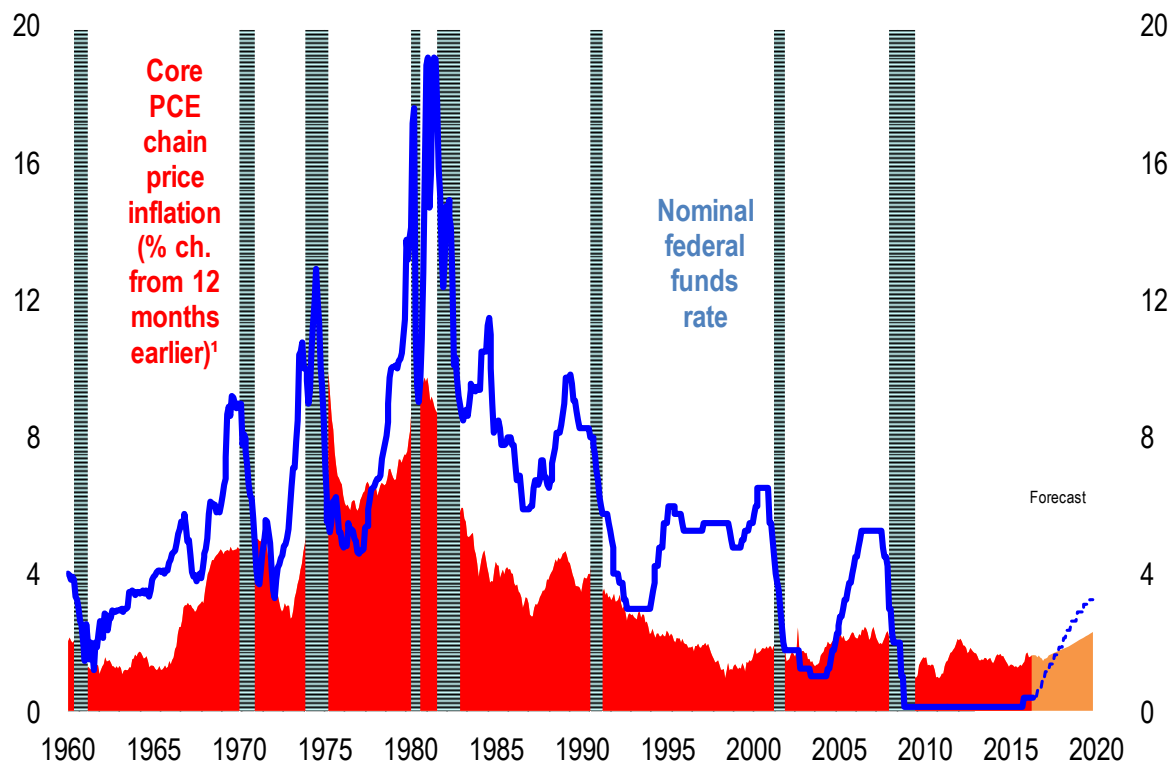


Sources: Haver Analytics; Federal Reserve Board. Updated through July 8, 2016.

TOO-LOW/TOO-LONG MAKES TROUBLE

“Normal” Means Above Inflation ...

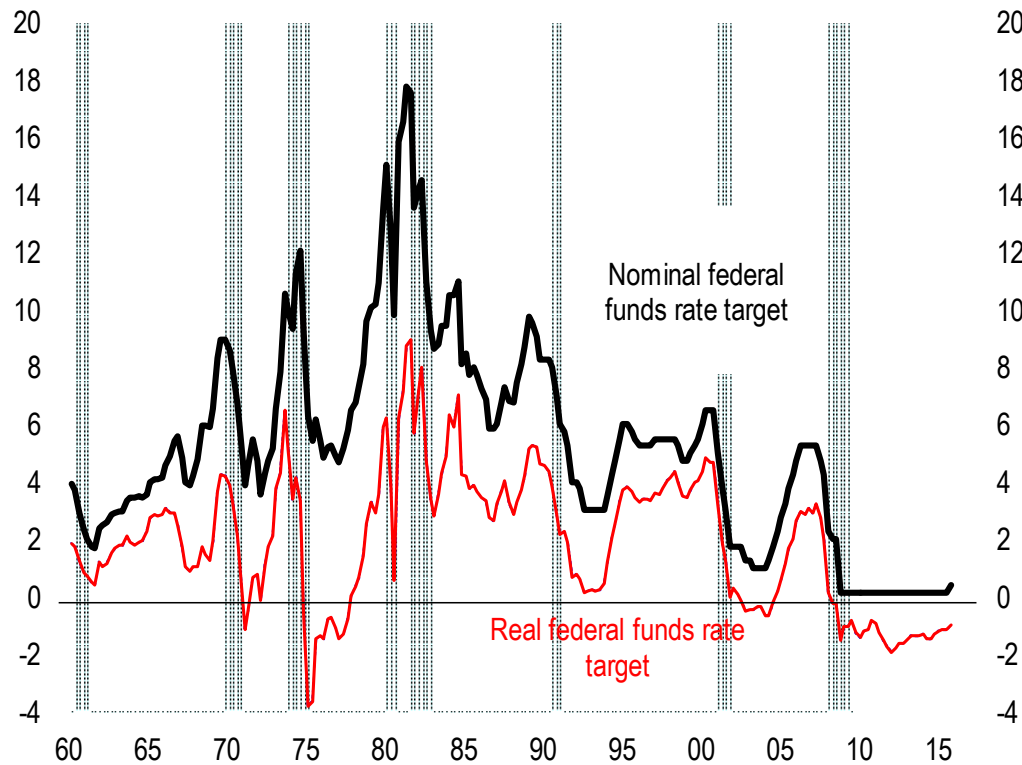
Nominal federal funds rate and core inflation (percent)



Sources: Haver Analytics; U.S. Department of Commerce; Federal Reserve Board. Updated through May 2016 (inflation) and July 8, 2016 (federal funds rate).

... Or, a Real Funds Rate of 1% to 2%

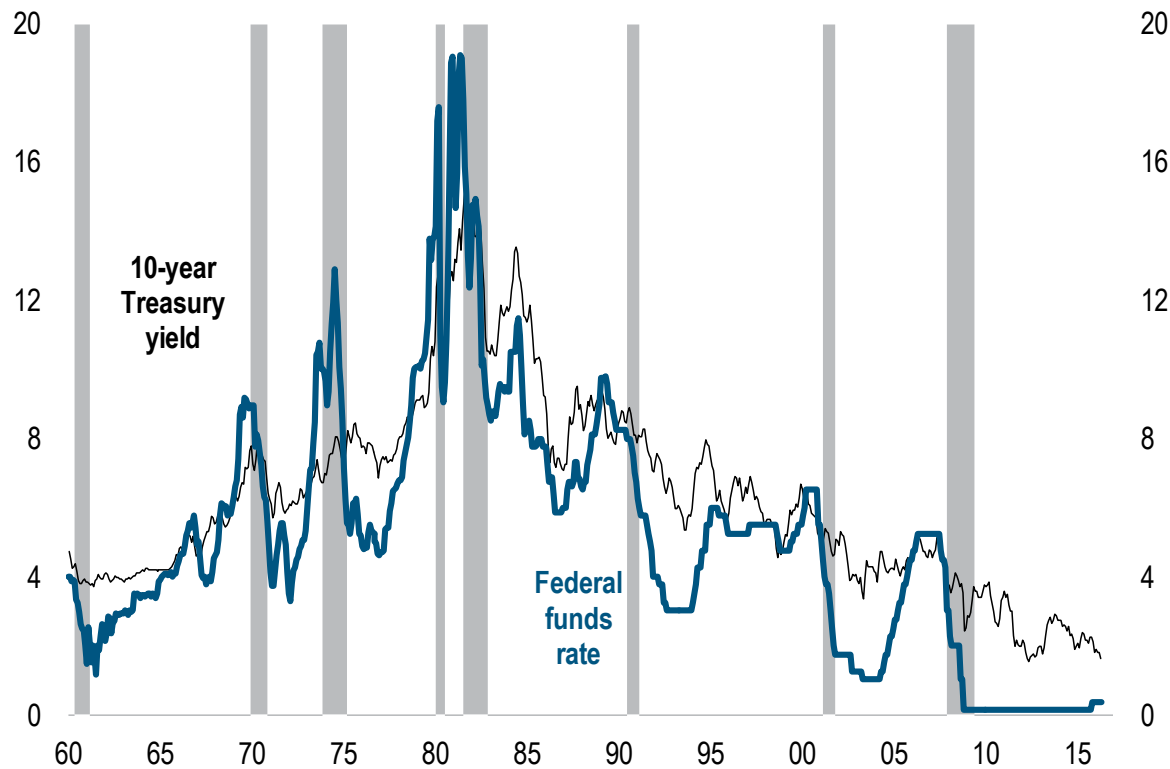
Nominal federal funds rate and real federal funds rate (percent)



Sources: Haver Analytics; U.S. Department of Commerce; U.S. Department of Commerce; Federal Reserve Board. Updated through January 2016 (inflation) and March 18, 2016 (federal funds rate).

P.S. The Yield Curve Perspective Is Broken ...

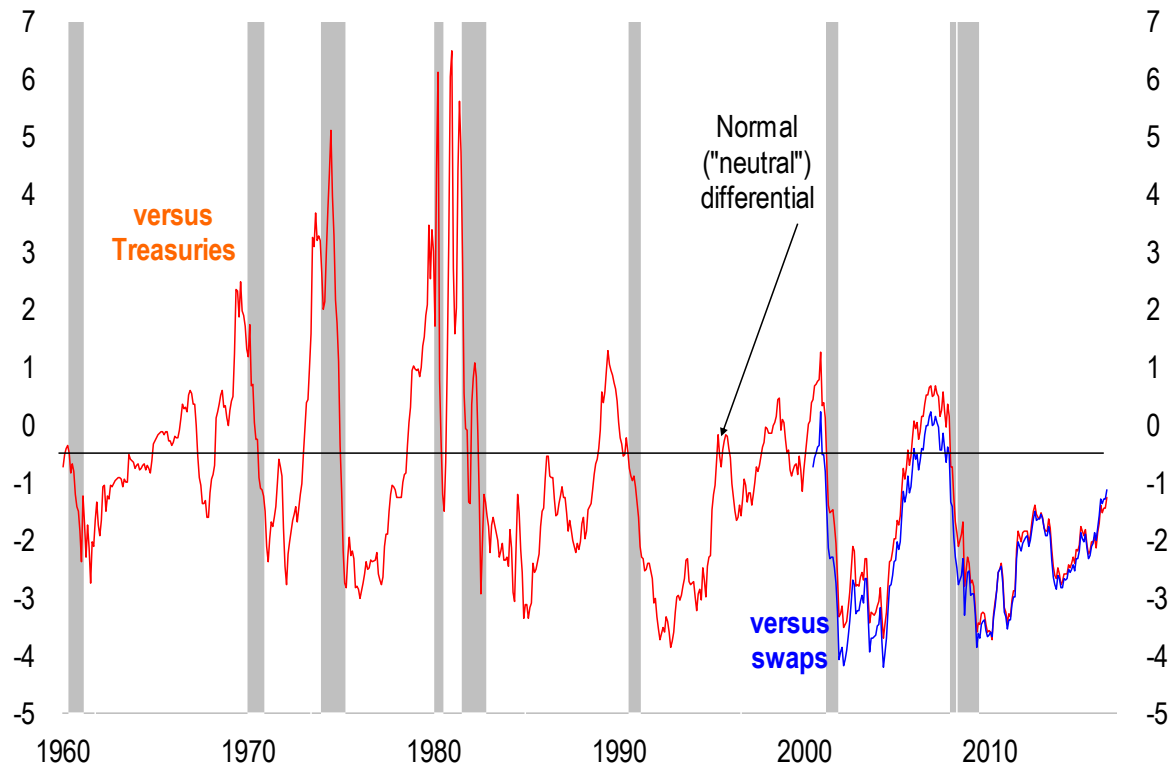
Federal funds rate and the 10-year Treasury yield (percent)



Sources: Haver Analytics; Federal Reserve Board. Updated through July 8, 2016.

... Distorted by Central Bank Asset Purchases

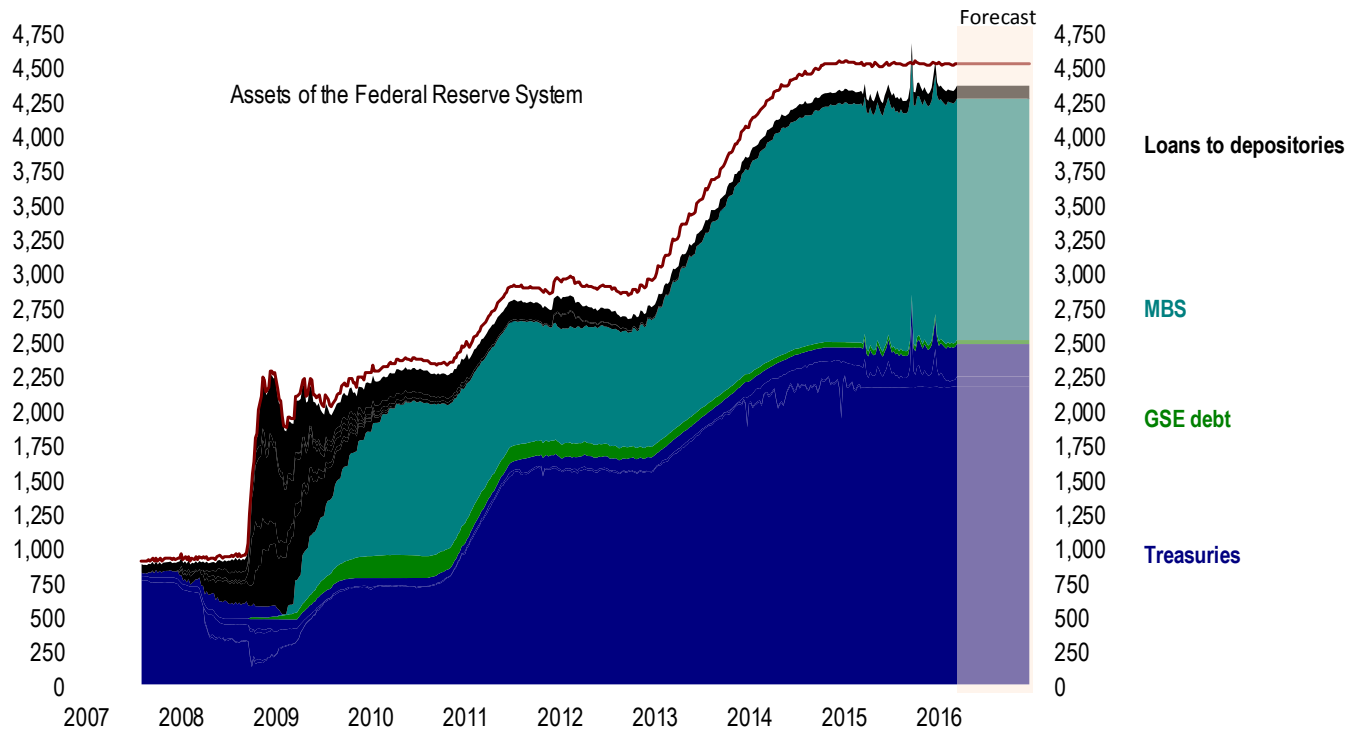
Federal funds rate less the 10-year Treasury and 10-year swap yields (percentage points)



Sources: Haver Analytics; Federal Reserve Board. Updated through July 8, 2016.

The Fed Removed \$3.5 Trillion ...

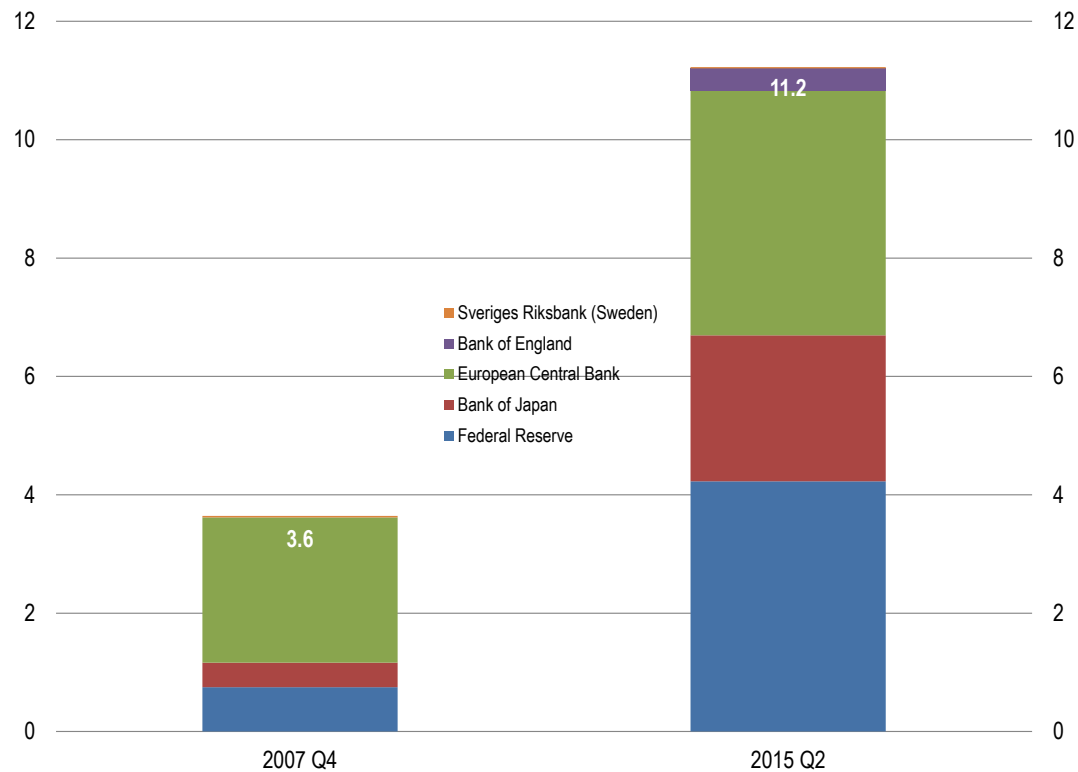
Assets held by the Federal Reserve (billions of dollars)



Sources: Haver Analytics; Federal Reserve Board. Updated through March 23, 2016.

... Others Are Buying \$2 Trillion Annually ...

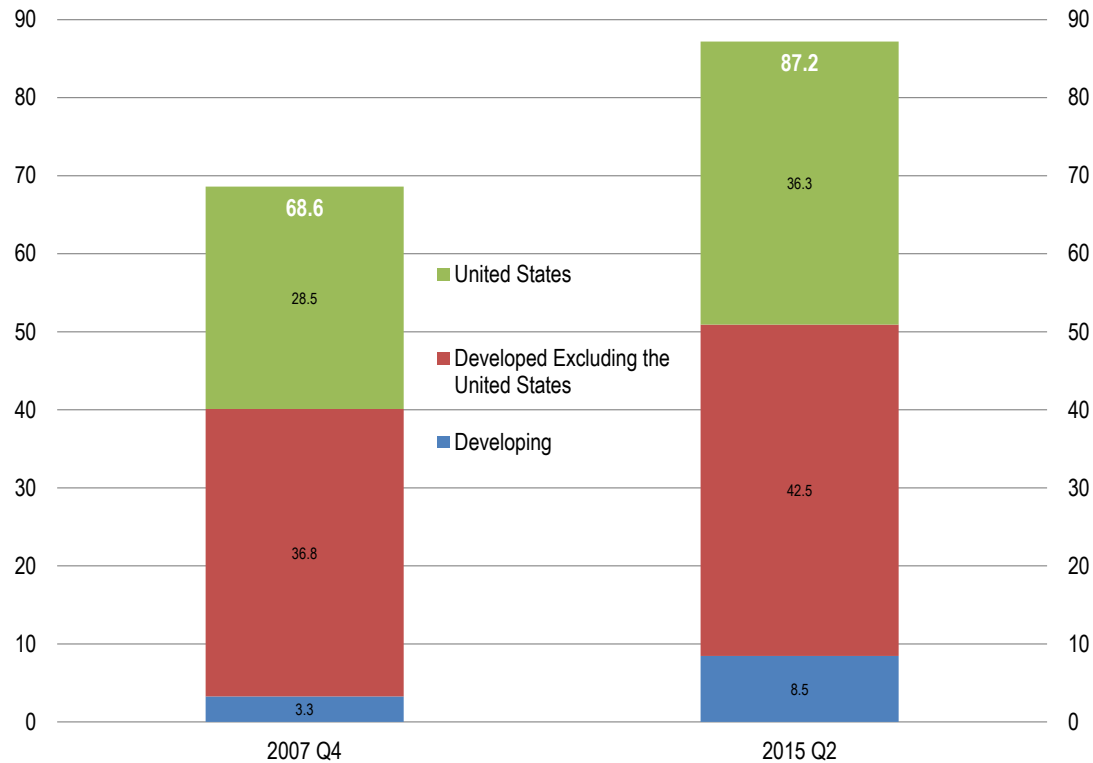
Assets held by key central banks (trillions of dollars)



Sources: Haver Analytics; Federal Reserve Board; ECB; Bank of Japan; Sveriges Riksbank. Updated through June 10, 2016.

... Leaving Little Supply for Investors

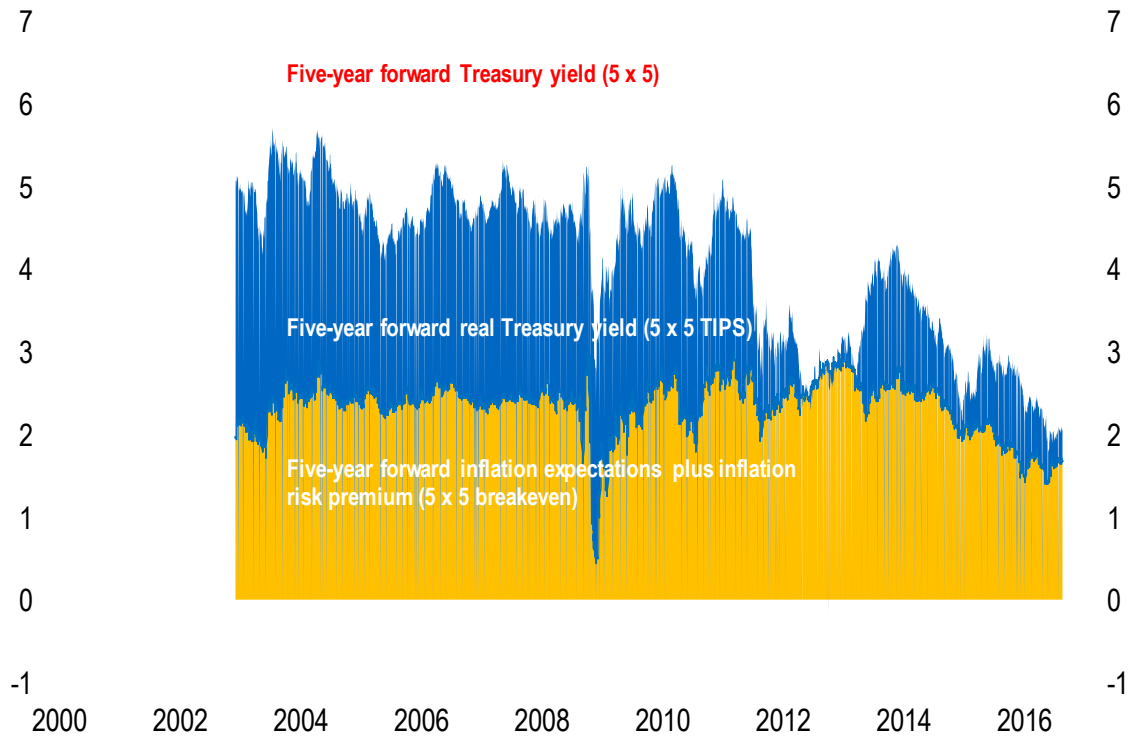
Global debt outstanding (trillions of dollars)



Sources: Haver Analytics; Bank for International Settlements. Updated through 2015 Q4.

Asset Buying Distorts Real Bond Yields ...

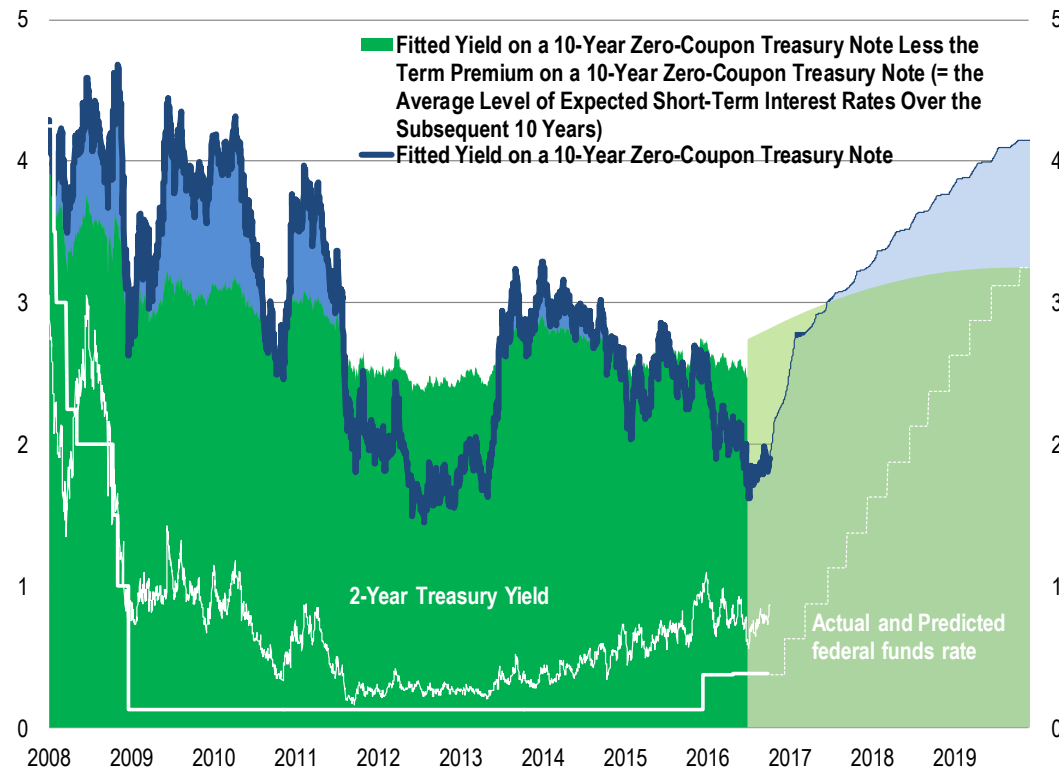
Components of the 5 x 5 nominal Treasury yield (percent)



Sources: Haver Analytics; Federal Reserve Board. Updated through October 7, 2016.

... Or, Shrinks the Term Premium

Components of the 5 x 5 nominal Treasury yield (percent)



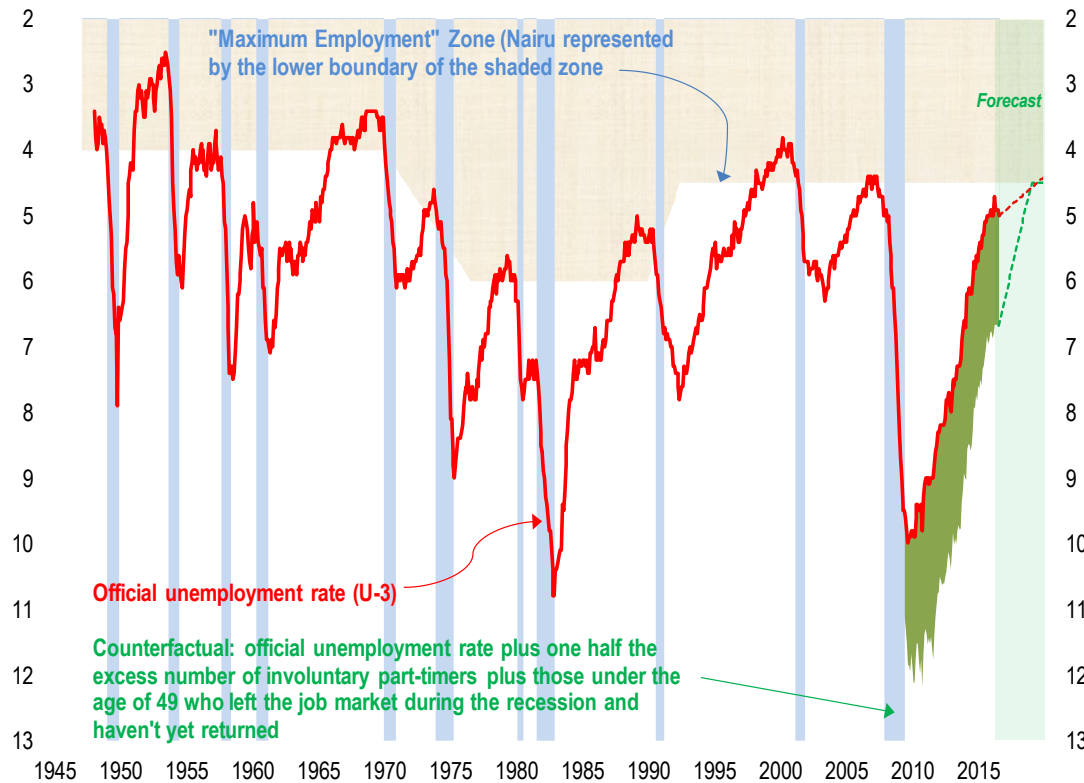
Sources: Haver Analytics; Federal Reserve Board. Updated through June 30, 2016 (term premium) and October 7, 2016 (federal funds rate).

IT'S RARE TO HOLD HIGH GROUND

(“...a failure to ... [gradually remove] accommodation could shorten, rather than lengthen, the duration of this recovery,” Eric Rosengren, President of the Federal Reserve Bank of Boston)

Business Cycle History Isn't Flattering

Unemployment (% of the labor force, scale reversed)

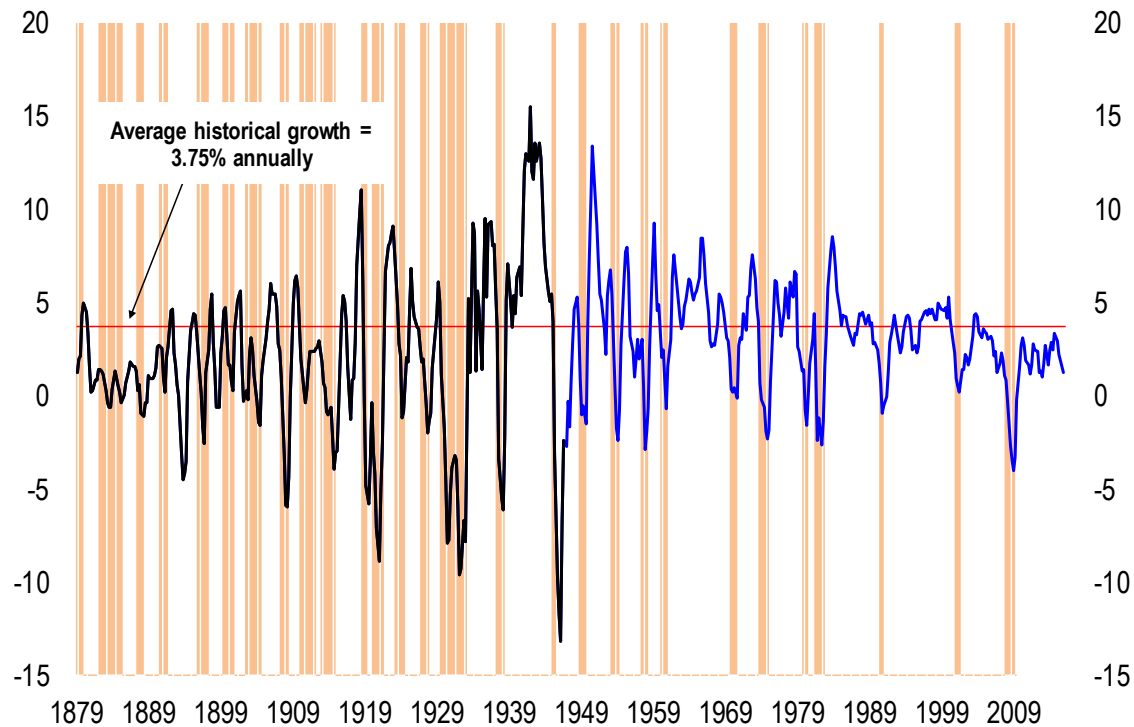


Sources: Haver Analytics; U.S. Department of Labor. Updated through September 2016.

**#3. THE FISCAL CHALLENGE
IS DAUNTING
(*WHERE GROWTH MATTERS*)**

Slow GDP ...

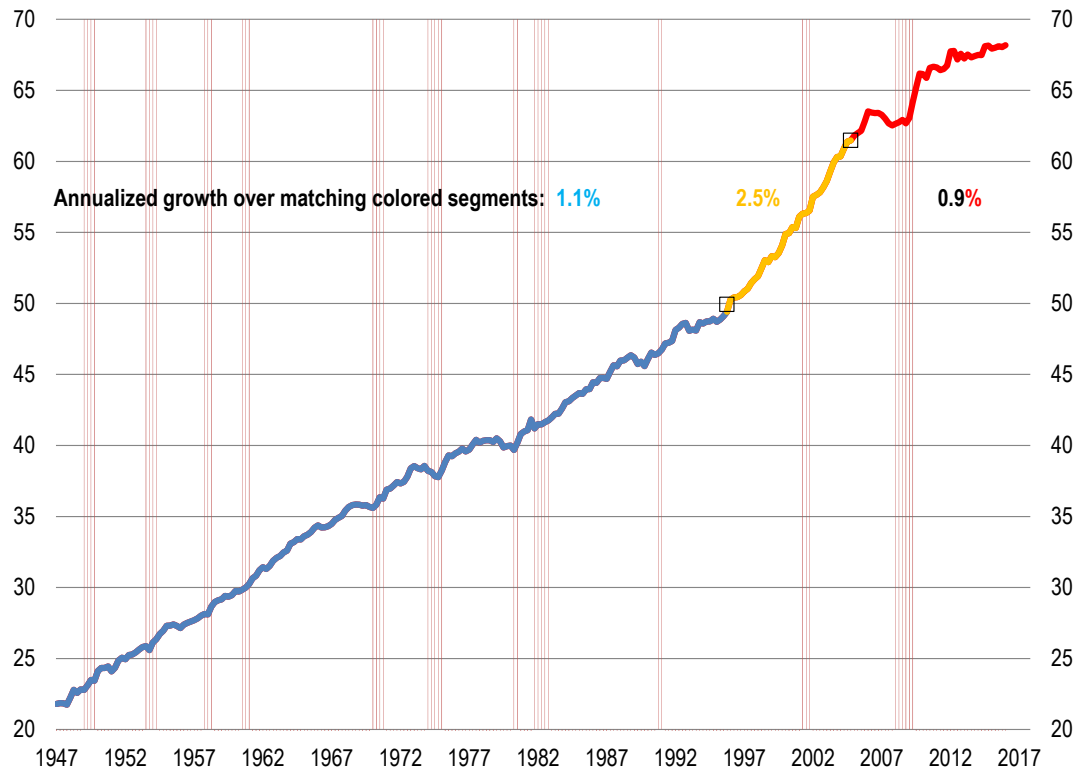
Real U.S. GDP growth (percent change from four quarters earlier)



Sources: Haver Analytics; U.S. Department of Commerce; NBER Macroeconomic database. Updated through 2016 Q2.

... If Due to Productivity ... Not Good

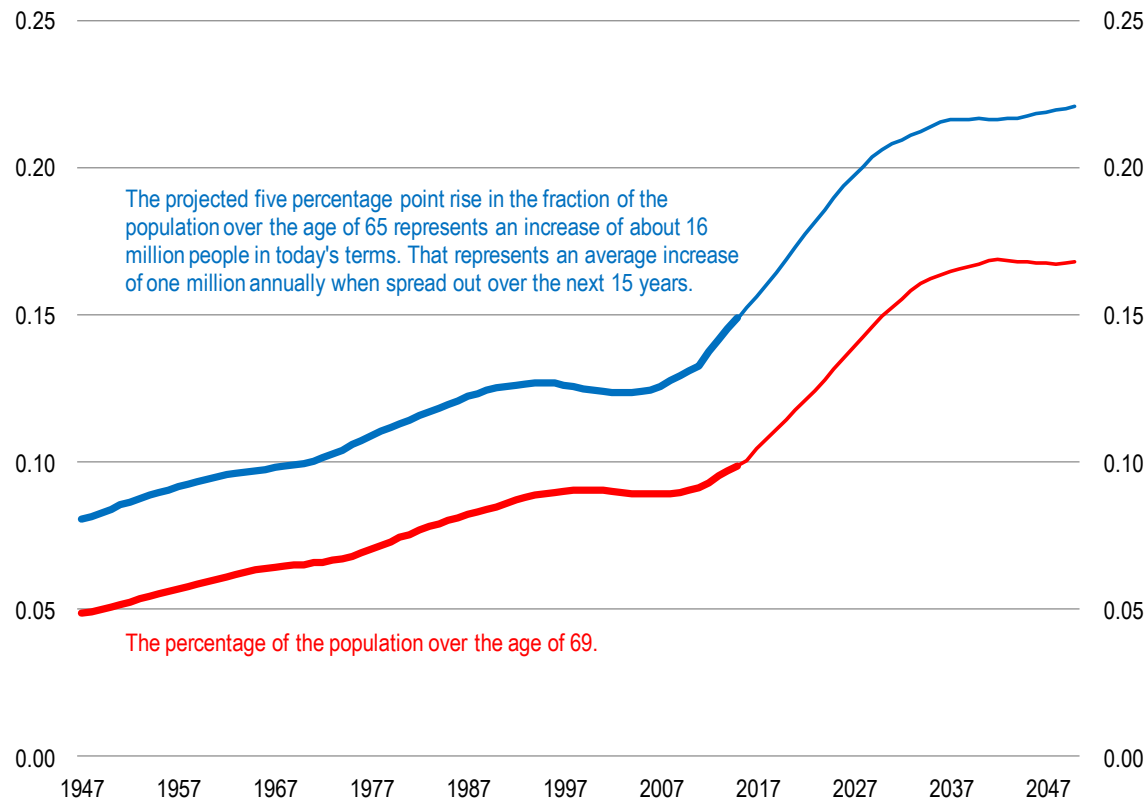
Labor productivity, real GDI per hour (2009 dollars per hour)



Sources: Haver Analytics; U.S. Department of Commerce. Updated through 2016 Q1.

... If Due to Demographics ...

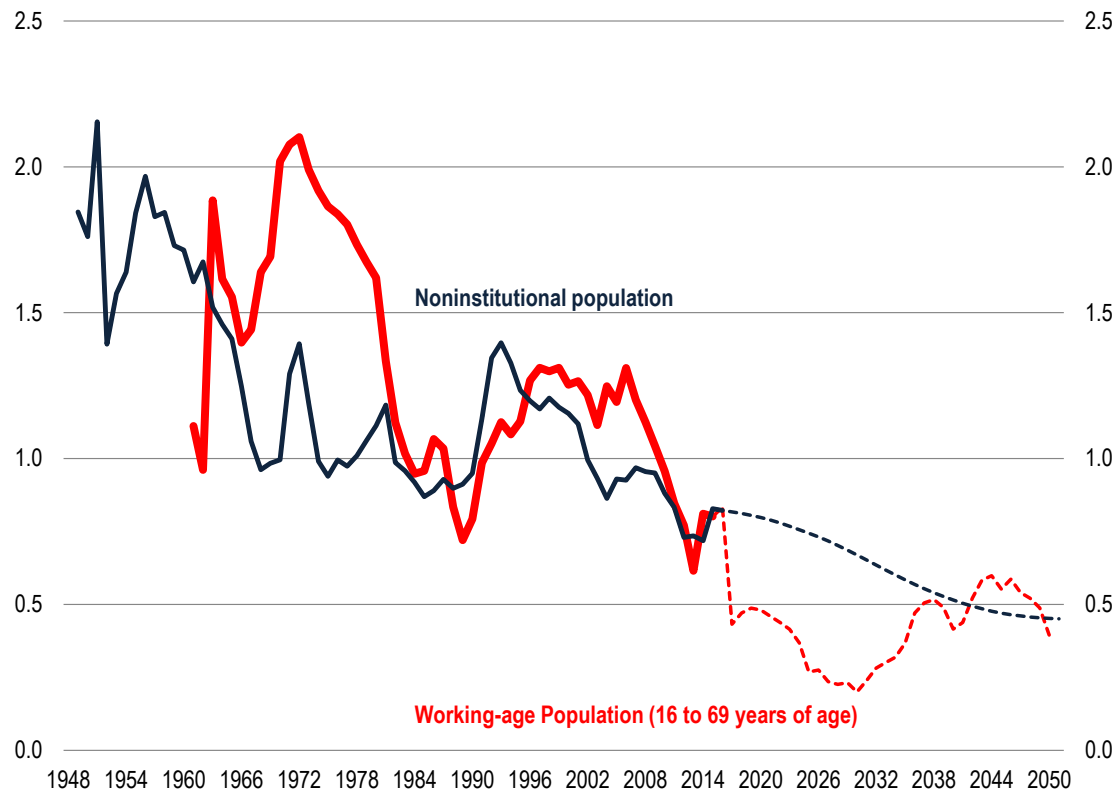
Selected elderly populations (percent of the population)



Sources: Haver Analytics; U.S. Department of Labor. Updated through January 2015.

... a Slower Working Population ...

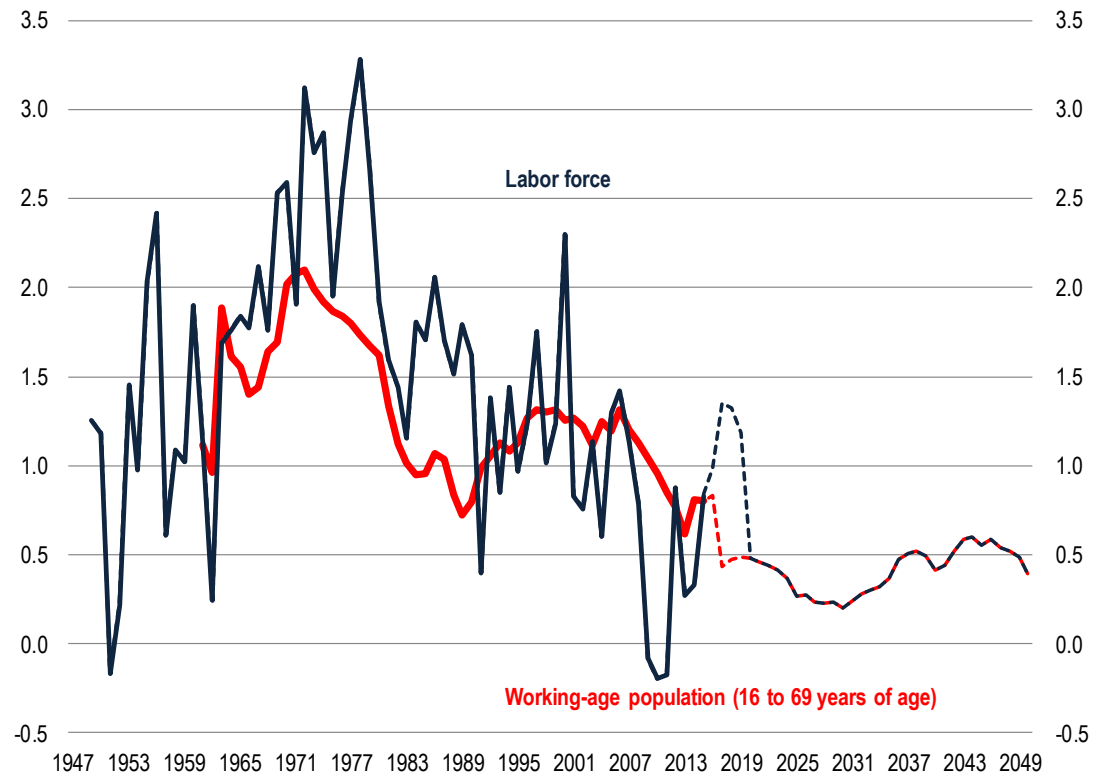
Noninstitutional population and the working age population (percent change annually)



Sources: Haver Analytics; Federal Reserve Board; U.S. Treasury. Updated through June 2015.

[P.S. Cyclical Drags Exaggerated Things]

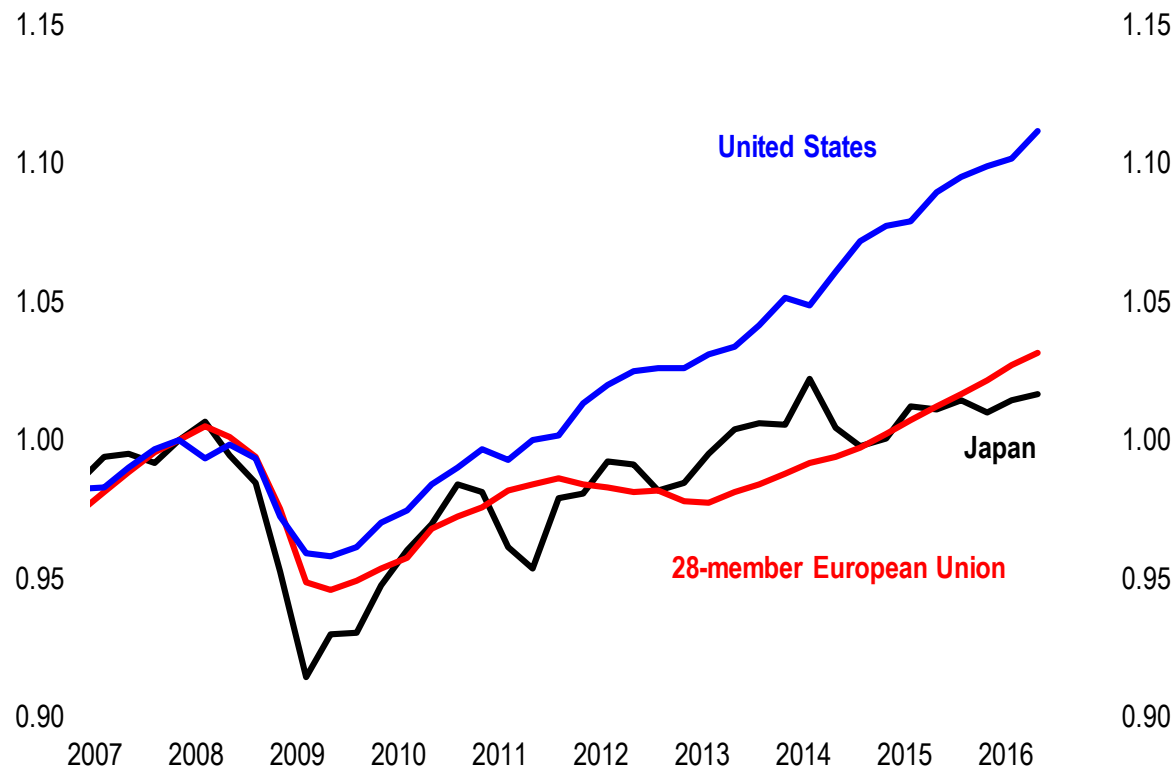
Labor force and the working age population (percent change annually)



Sources: Haver Analytics; Federal Reserve Board; U.S. Treasury. Updated through September 2015.

... Irrelevant, Because ...

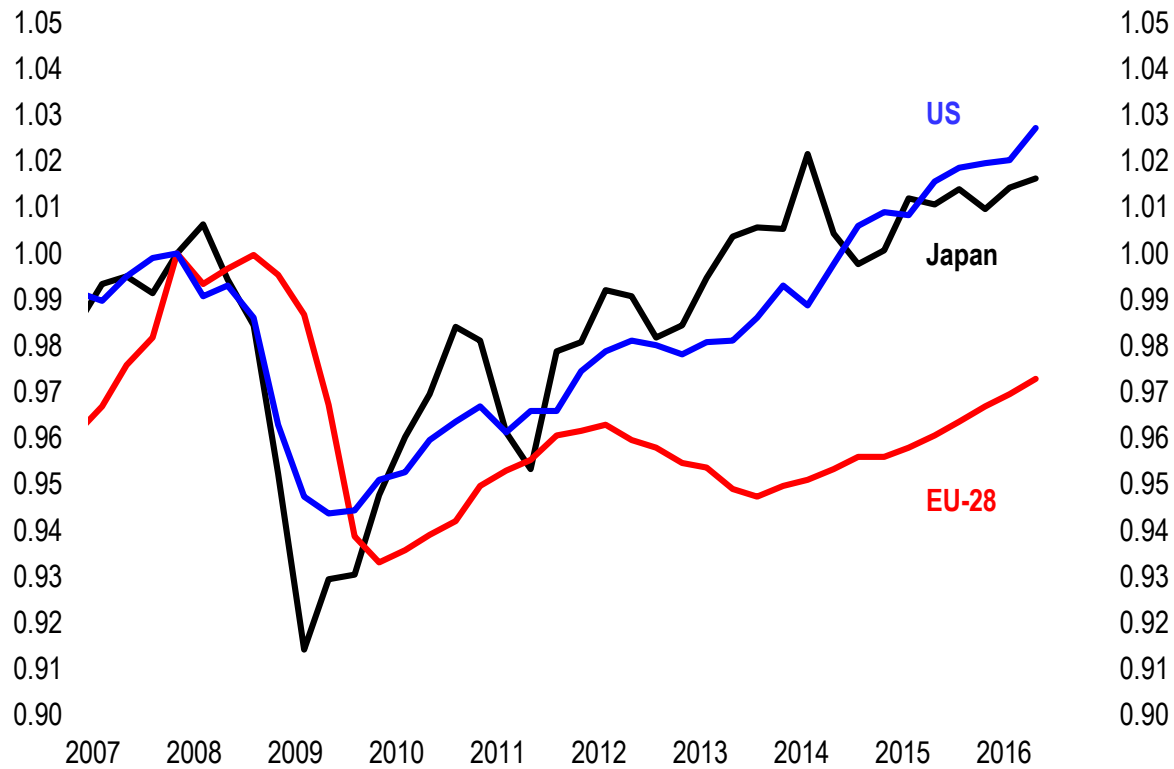
Real GDP (ratio to 2007 Q4)



Sources: Haver Analytics; U.S. Department of Commerce; selected international agencies. Updated through 2016 Q1.

... It's GDP Per Capita that Counts

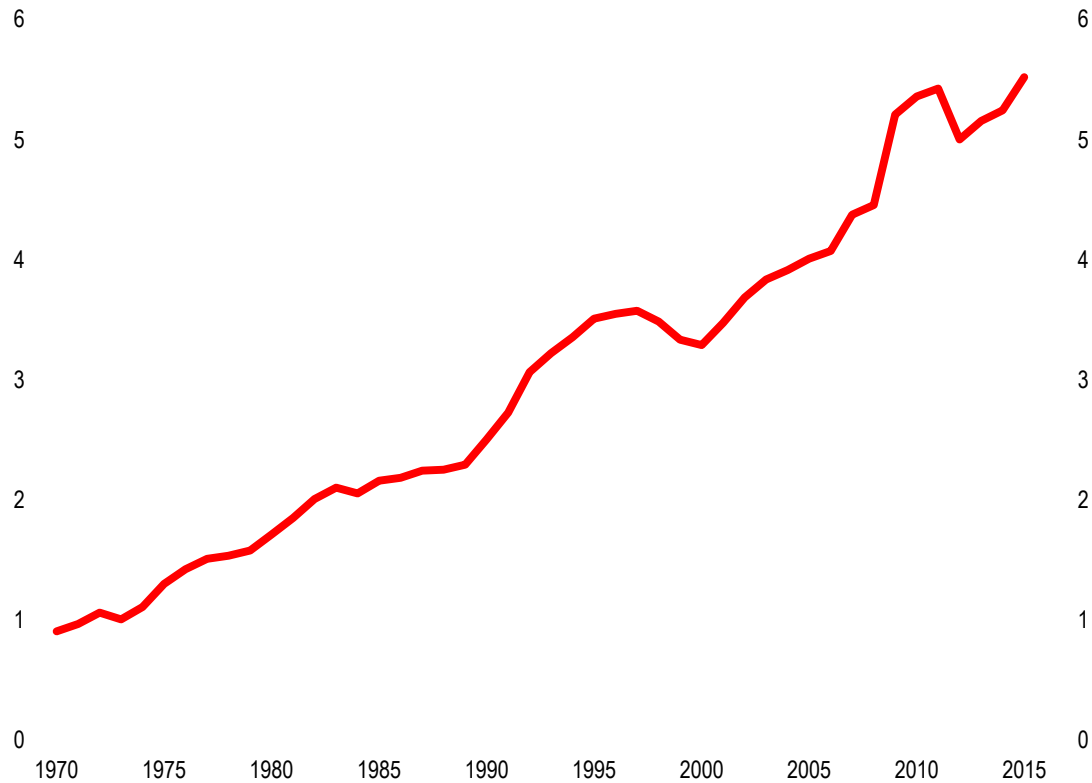
Real GDP per capita (ratio to 2007 Q4)



Sources: Haver Analytics; U.S. Department of Commerce; selected international agencies. Updated through 2016 Q1.

But Slow GDP and Big Promises ...

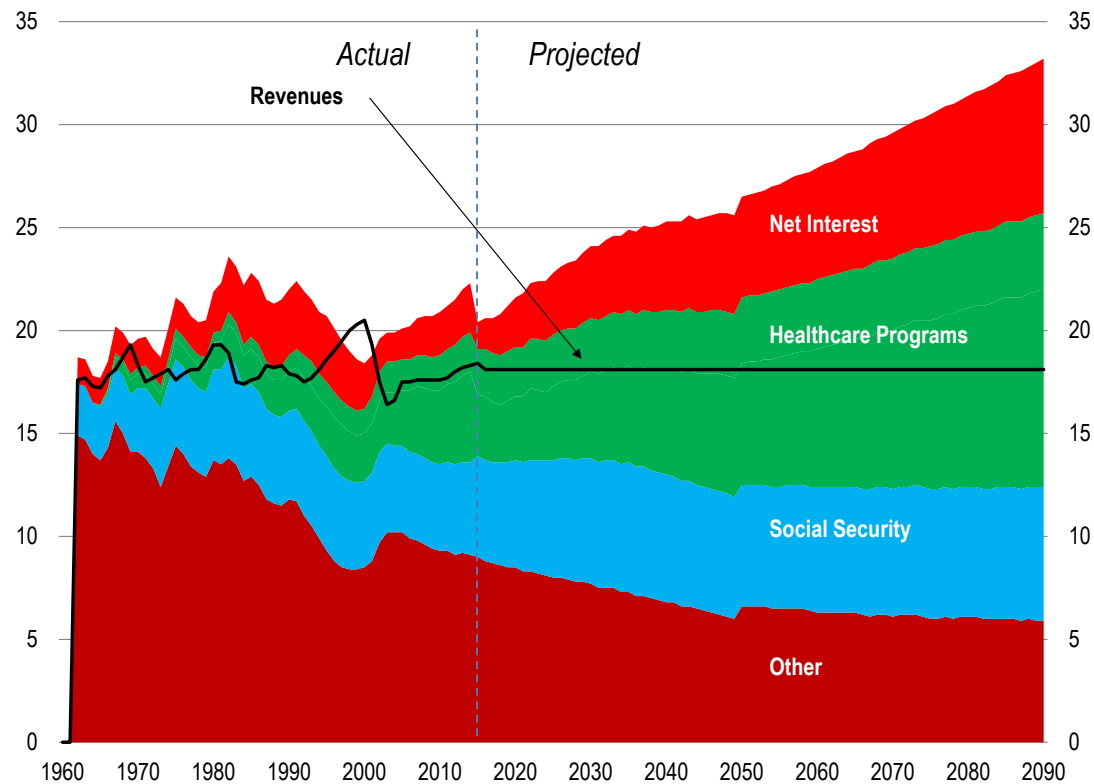
Federal healthcare spending (percentage of GDP)



Sources: Haver Analytics; Congressional Budget Office. Updated through 2015.

... [The CBO's Pessimistic Story ...

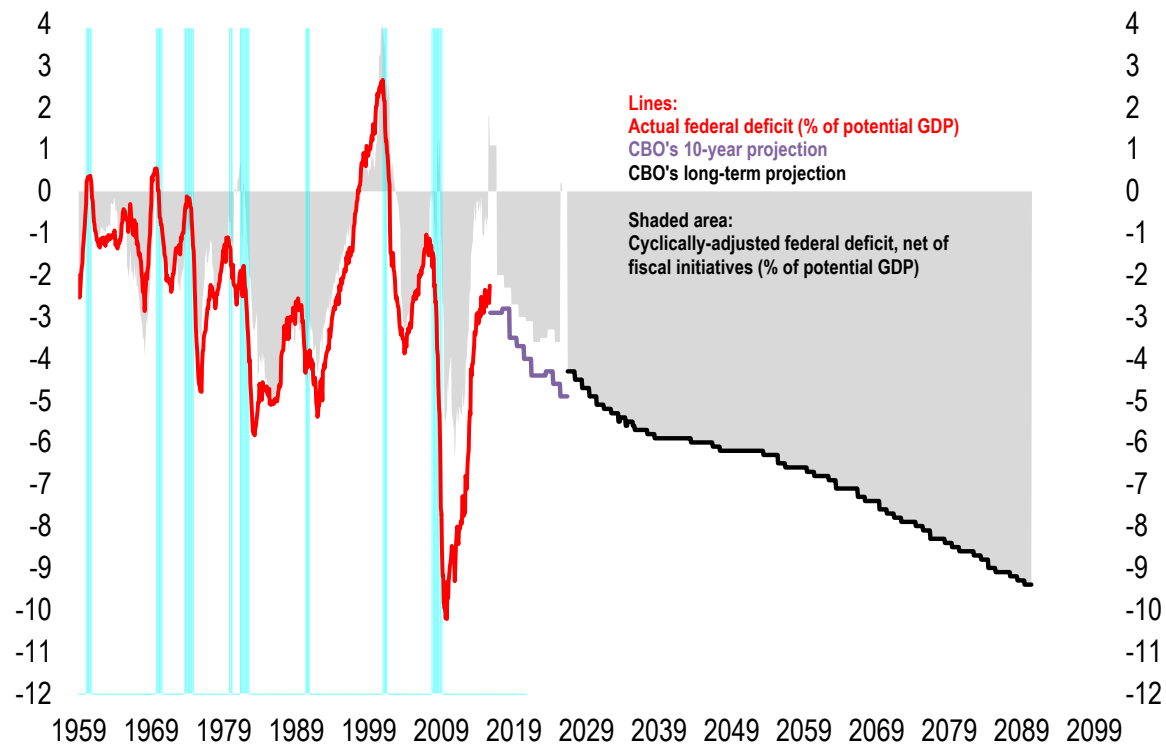
Long-term revenue and spending projections (percent of GDP)



Sources: Haver Analytics; Congressional Budget Office. Updated through 2015.

... of a Growing Structural Deficit] ...

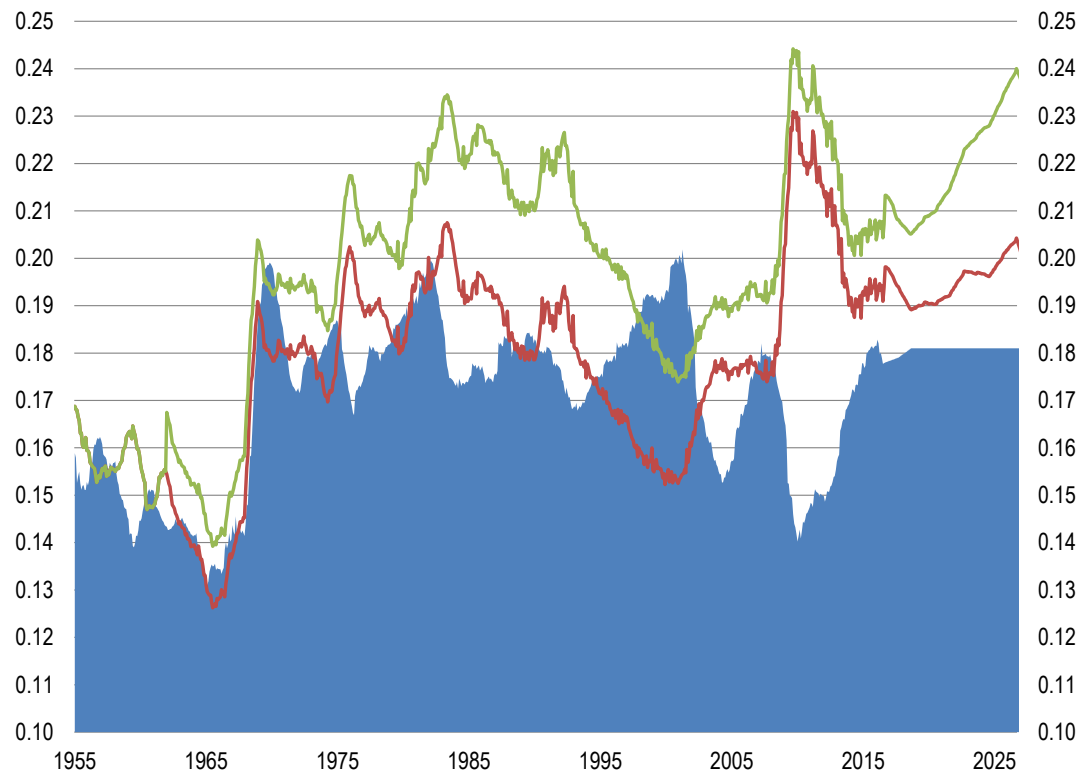
Actual and structural federal budget balance (percent of nominal GDP)



Sources: Haver Analytics; Congressional Budget Office. Updated through January 2016.

... [The CBO's Pessimistic Story ...

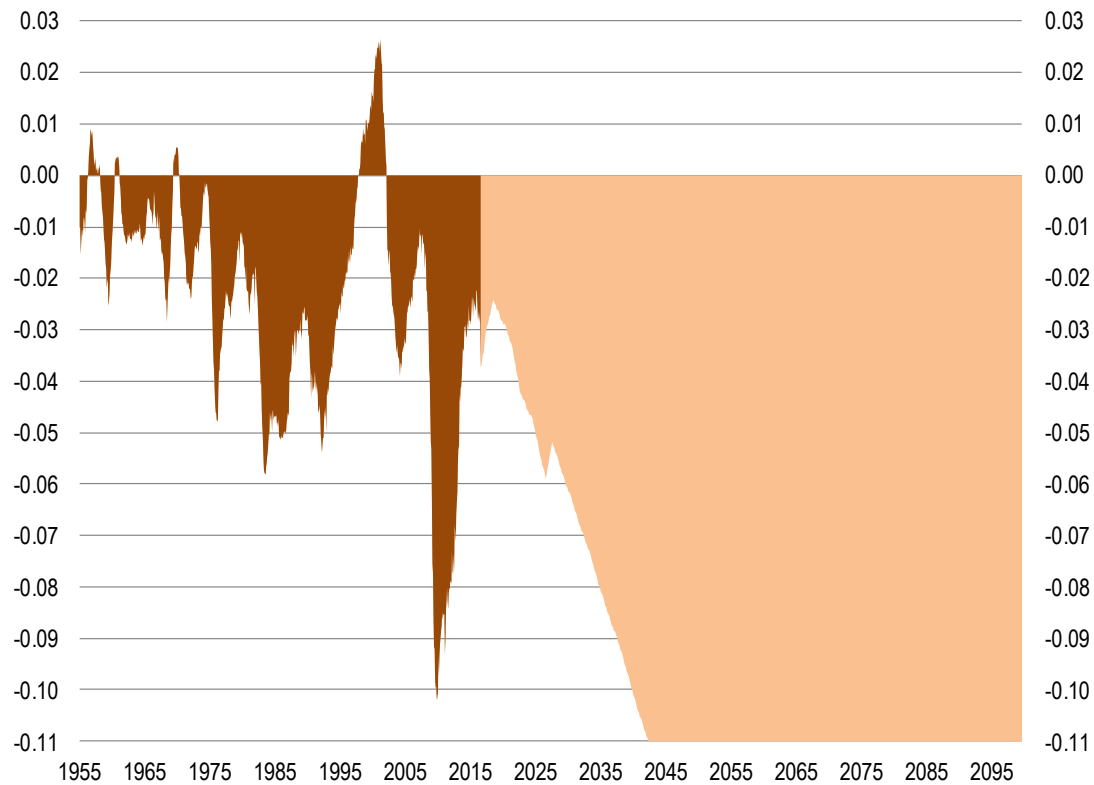
Long-term revenue and spending projections (percent of GDP)



Sources: Haver Analytics; Congressional Budget Office. Updated through 2015.

... [The CBO's Pessimistic Story ...

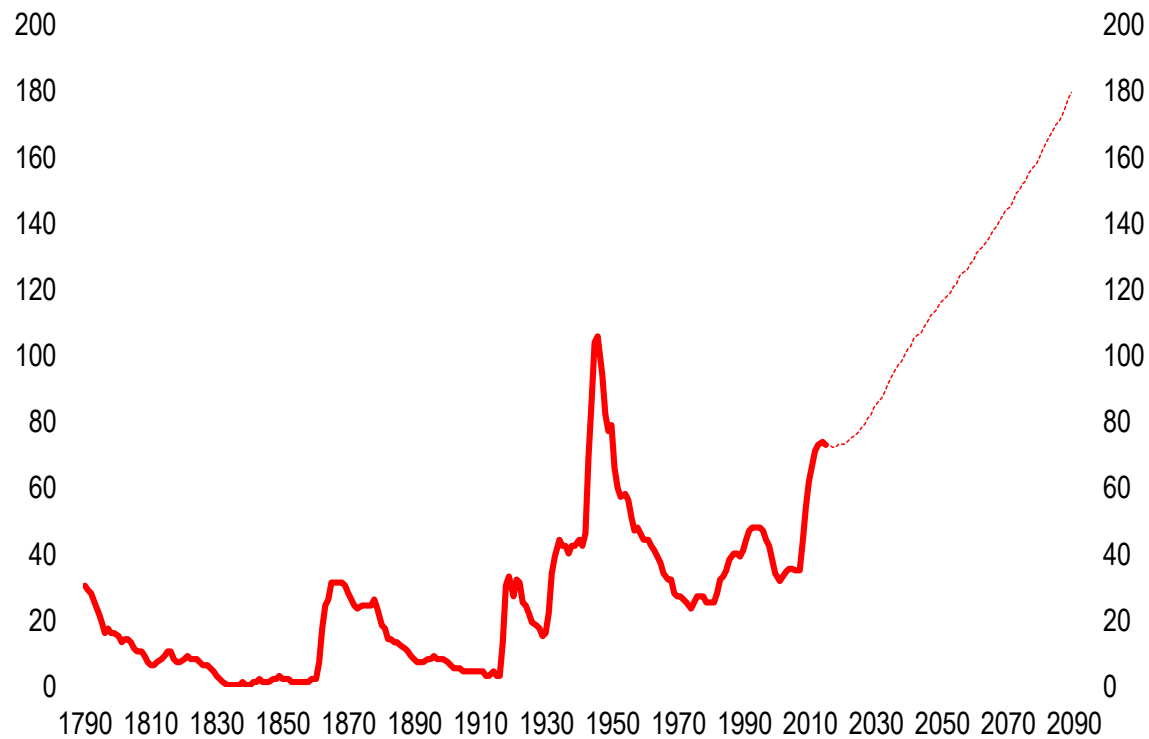
Long-term revenue and spending projections (percent of GDP)



Sources: Haver Analytics; Congressional Budget Office. Updated through 2015.

... Are Hard to Finance

Federal debt (ratio to GDP)

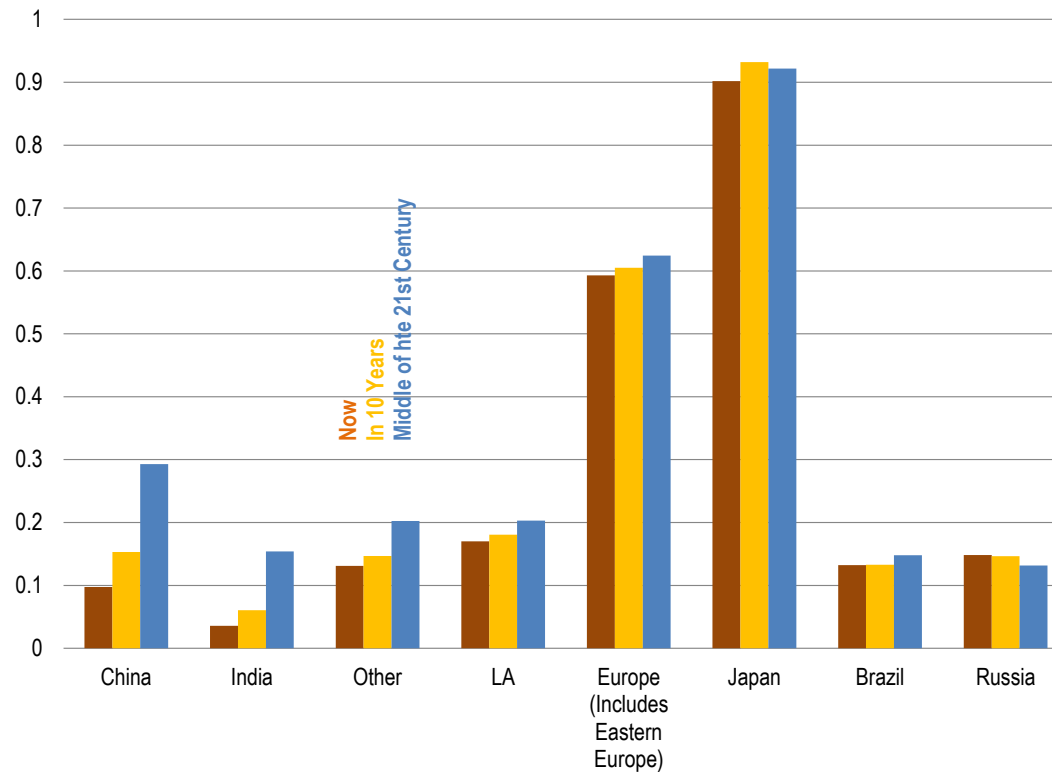


Sources: Haver Analytics; Federal Reserve Board; U.S. Treasury. Updated through September 2015.

CONCLUSION

Impoverished Giants Share Our Aspirations

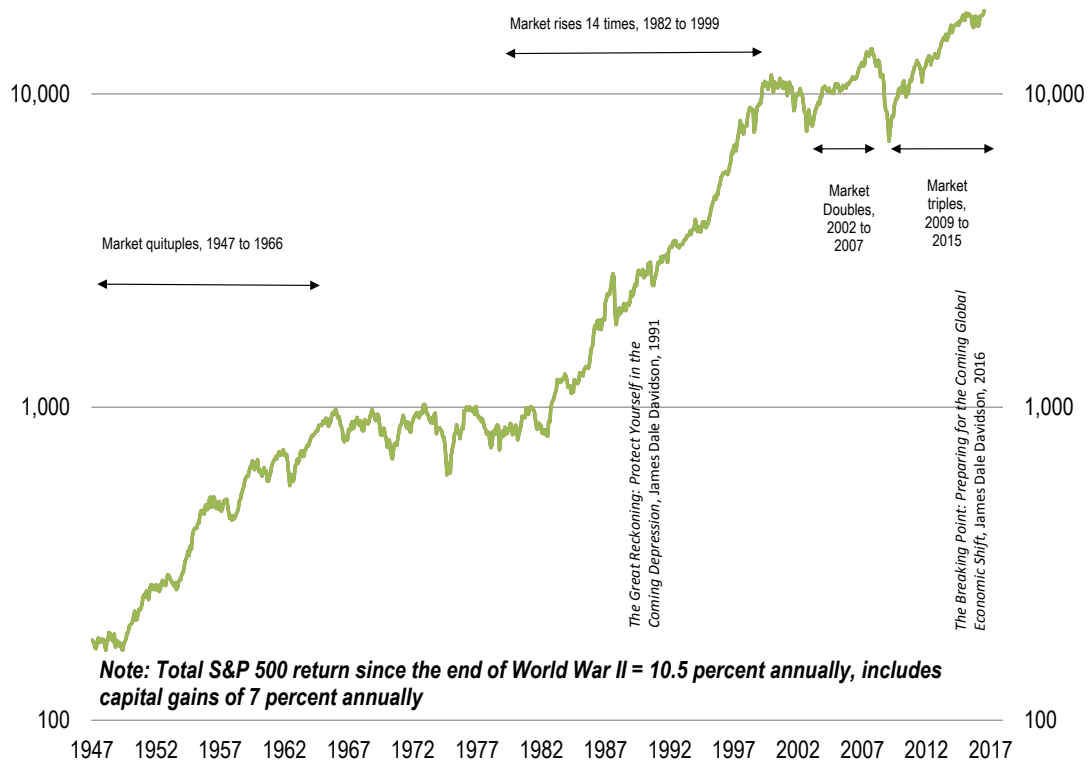
Relative real GDP per capita (ratio to U.S. real GDP per capita, 2009 dollars, PPP basis)



Sources: Haver Analytics; ADP; U.S. Department of Commerce; various international statistical organizations. Updated through 2016 Q1.

Asset Values Are About the Future

Dow Jones Industrial Average (May 25, 1896 = 40.94, log₁₀ scale)

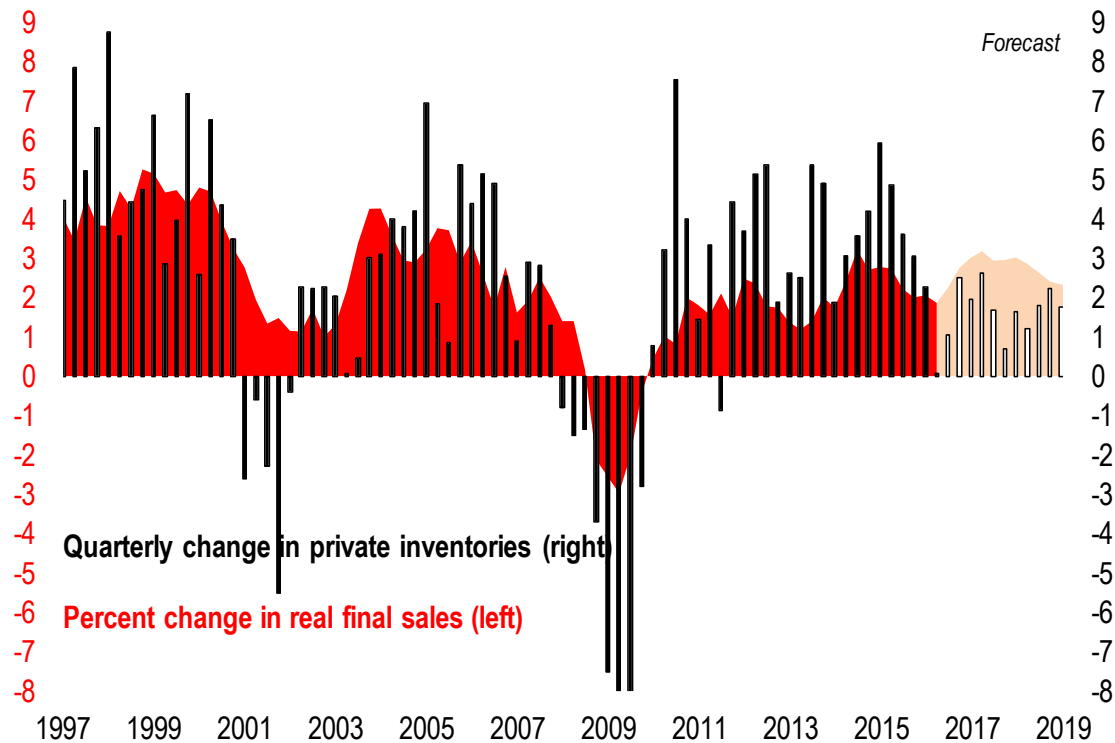


Sources: Haver Analytics; US Department of Commerce; Dow Jones. Updated through 2016 Q1 (profits) and August 12, 2016 (stocks).

APPENDIX I. “RECESSION” TALK IS NOISE

Inventory Swings Amplify ...

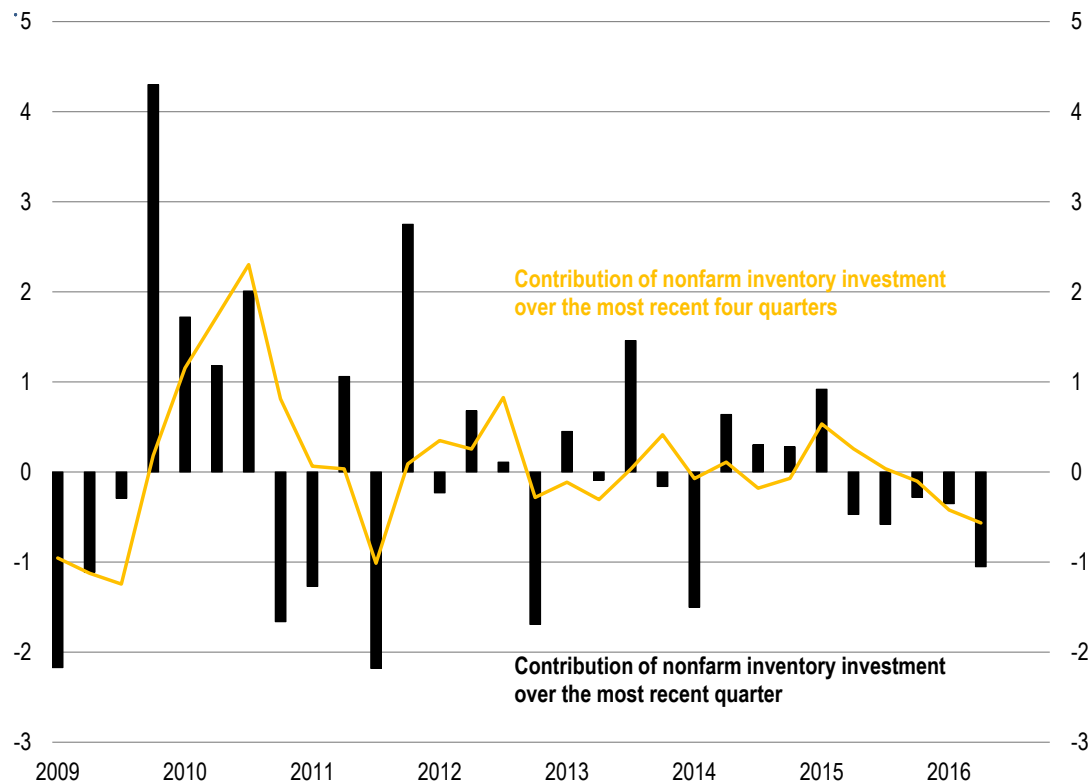
Real nonfarm inventories (% ch ann rate vs prev qtr) Real final sales (% ch vs 4 qtr earlier)



Sources: Haver Analytics; U.S. Department of Commerce. Updated through 2016 Q2.

... Small Demand Shifts

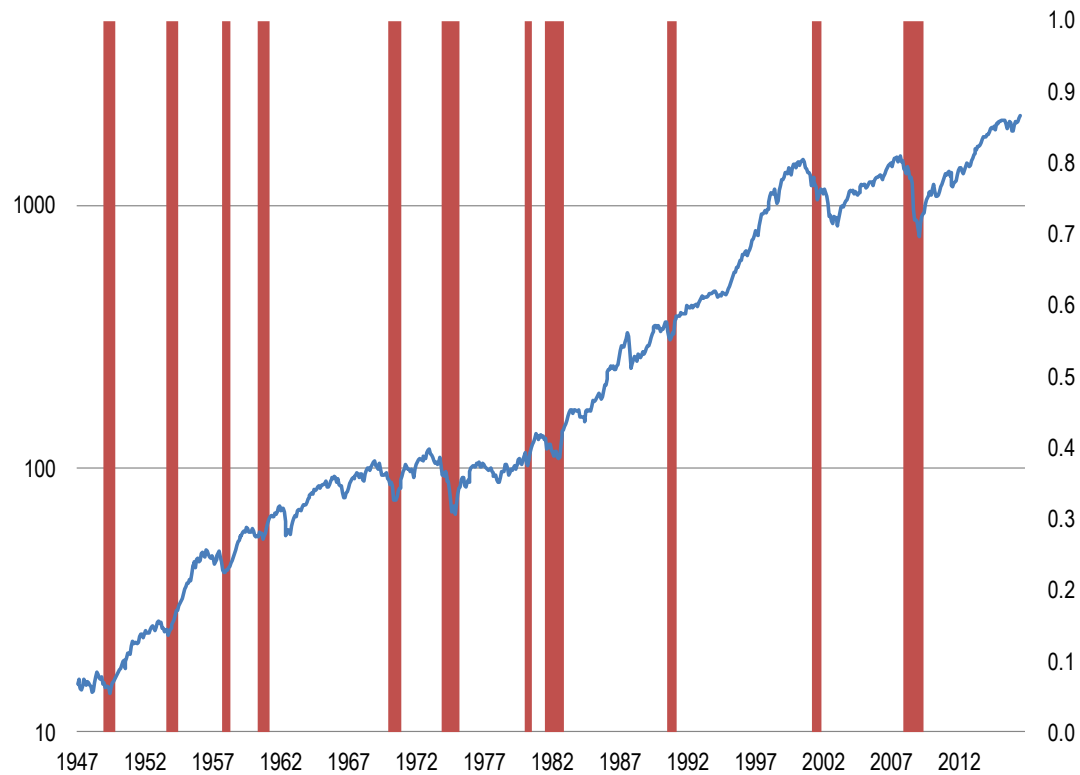
Contribution of real nonfarm inventory investment to real GDP (percentage points)



Sources: Haver Analytics; U.S. Department of Commerce. Updated through 2016 Q2.

Not All Market Scares Are About Recession

S&P 500 Index (1941 – 43 = 10, log₁₀ scale)



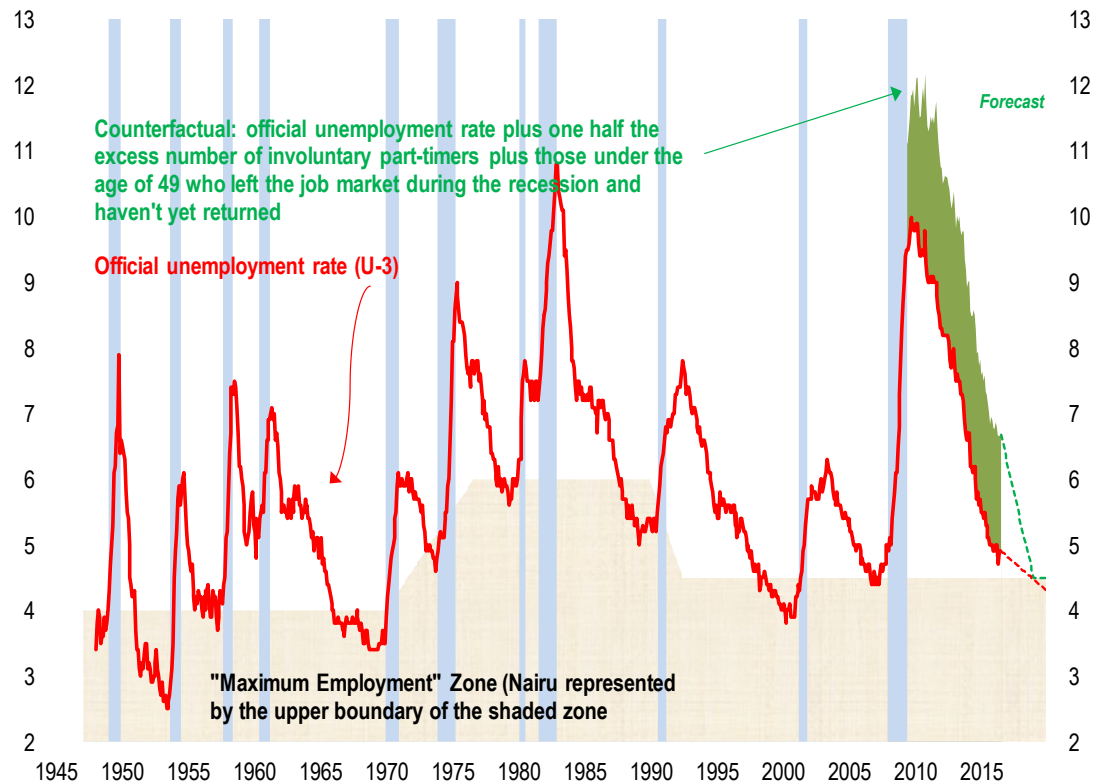
Sources: Haver Analytics; Dow Jones. Updated through August 10, 2016.

Recessions Aren't About the Clock ...

Business Cycle Bottom		Business Cycle Peak		Duration of Expansion		Duration of the Following Downturn	
(Month)	(Year)	(Month)	(Year)	(Months)	(Years)	(Months)	(Years)
December	1854	June	1857	30	2.5	18	
December	1858	October	1860	22	1.8	8	
June	1861	April	1865	46	3.8	32	
December	1867	June	1869	18	1.5	18	
December	1870	October	1873	34	2.8	65	
March	1879	March	1882	36	3.0	38	
May	1885	March	1887	22	1.8	13	
April	1888	July	1890	27	2.3	10	
May	1891	January	1893	20	1.7	17	
June	1894	December	1895	18	1.5	6	
June	1897	June	1899	24	2.0	18	
December	1900	September	1902	21	1.8	23	
August	1904	May	1907	33	2.8	13	
June	1908	January	1910	19	1.6	24	
January	1912	January	1913	12	1.0	23	
December	1914	August	1918	44	3.7	7	
March	1919	January	1920	10	0.8	18	
July	1921	May	1923	22	1.8	14	
July	1924	October	1926	27	2.3	13	
November	1927	August	1929	21	1.8	43	
March	1933	May	1937	50	4.2	13	
June	1938	February	1945	80	6.7	8	
October	1945	November	1948	37	3.1	11	
October	1949	July	1953	45	3.8	10	
May	1954	August	1957	39	3.3	8	
April	1958	April	1960	24	2.0	10	
February	1961	December	1969	106	8.8	11	
November	1970	November	1973	36	3.0	16	
March	1975	January	1980	58	4.8	6	
July	1980	July	1981	12	1.0	16	
November	1982	July	1990	92	7.7	8	
March	1991	March	2001	120	10.0	8	
November	2001	December	2007	73	6.1	18	
June	2009	August	2016	85	7.1		

... and This Expansion Is Still Young ...

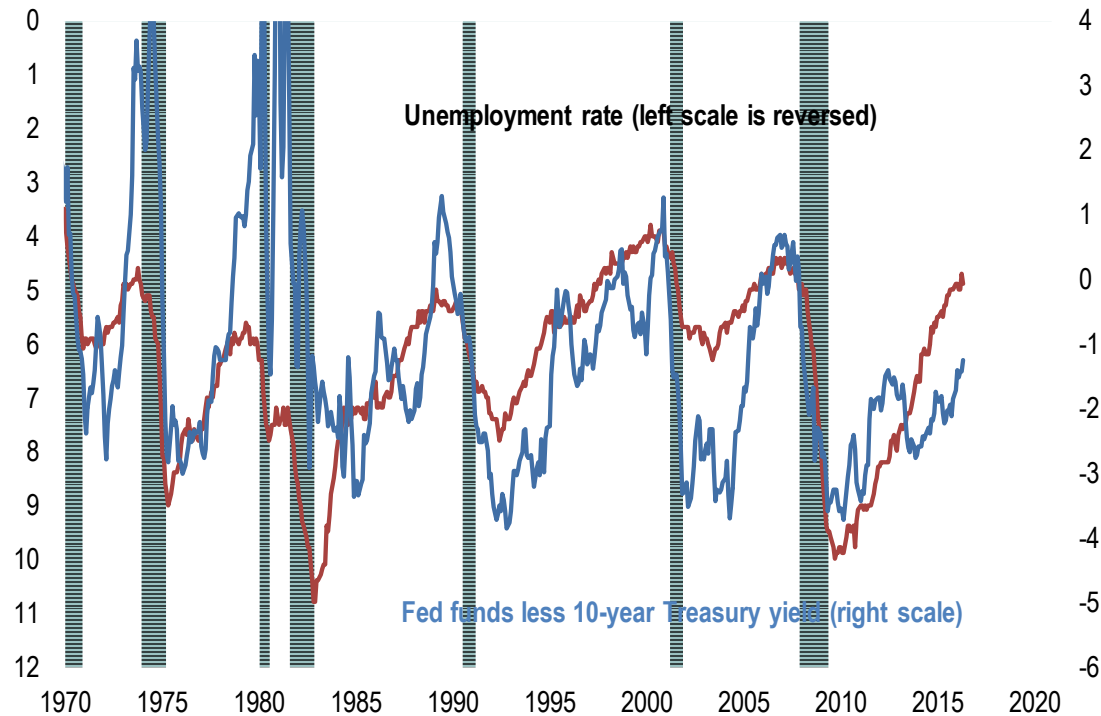
Unemployment (% of the labor force)



Sources: Haver Analytics; U.S. Department of Commerce; U.S. Department of Labor. Updated through August 2016.

... As the Fed's Posture Implies

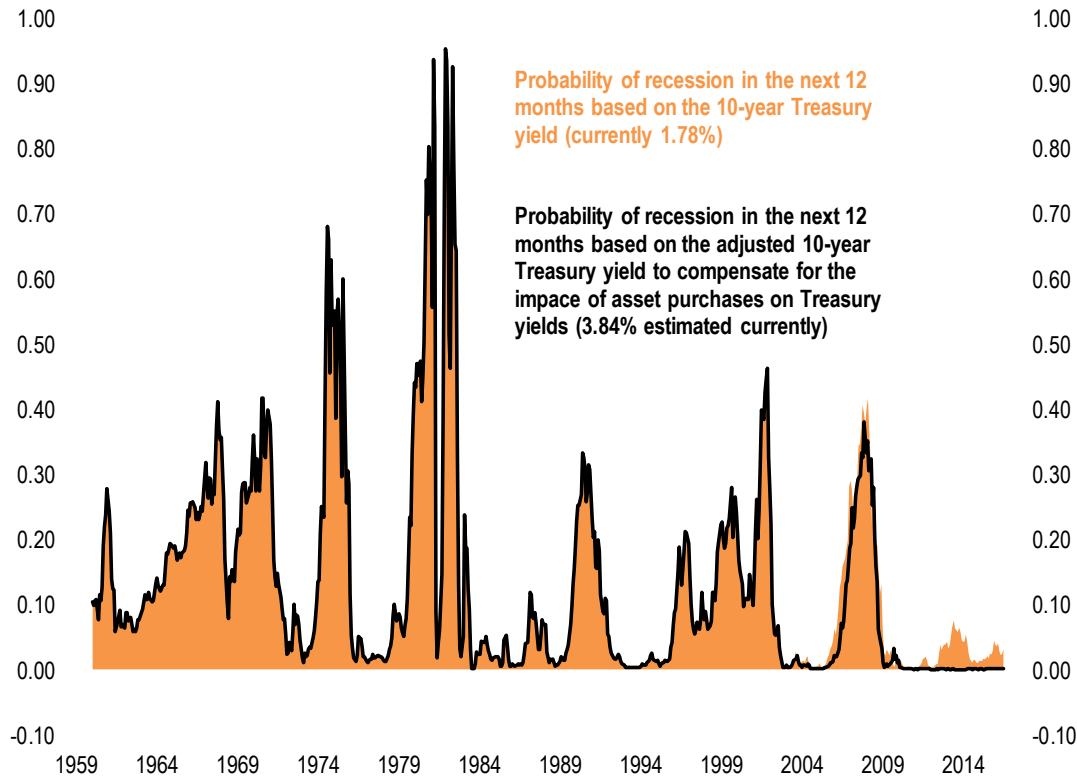
Unemployment rate (% of the labor force) Fed funds rate less 10-year Tr yield (pct pts)



Sources: Haver Analytics; Federal Reserve Board; U.S. Department of Labor. Updated through August 12, 2016 (yield curve) and July 2016 (unemployment).

That's Why Recession Probability Is Low

Probability of recession in the next 12 months based on the yield curve



Sources: Haver Analytics; Federal Reserve Board. Updated through August 12, 2016.

APPENDIX II. IMPLICATIONS OF THE 2016 ELECTION

Bucket Lists

	<u>Hillary Clinton*</u>	<u>Donald Trump*</u>
Unfunded policies	\$150 bln	\$100 bln
Tax cut		\$4,500 bln
Interest on debt	\$50 bln	\$700 bln

**Estimated effect on the deficit*

Donald Trump ...

CORPORATE TAX PROPOSALS

- Reduce corporate tax rate from 35% to 15%;
- Lower rate presumably applies to business income otherwise taxed at individual rates;
- Deemed repatriation of foreign earnings at 10% tax rate;
- Retains research credit; repeals most other corporate tax expenditures;
- Potential (elective) full expensing of improvements by manufacturers;
- Taxpayer must give up deduction for interest;
- Otherwise, may keep depreciation and interest expense deductions.

INDIVIDUAL TAX PROPOSALS

- Across-the-board rate reduction;
- Similar to GOP “Better Way” plan, with rates of 12%, 25%, and 33%;
- Generally retains structure of capital gains tax rates (0%, 15%, and 20%);
- Presumably offers 15% maximum tax rate on business income available to corporations;
- Limit overall deductions to \$100,000 for single filers and \$200,000 for married couples;
- Standard deduction increased to \$15,000 for single filers and \$30,000 for married couples
- Replace deduction for personal exemptions with child-care tax benefits;
- Eliminate the alternative minimum tax;
- Tax carried interest as ordinary income;
- Repeal estate tax;
- In exchange, carryover basis at death will apply to estates valued over \$10 million;
- Disallow contributions of appreciated assets to private charities established by decedent or related persons.

Hillary Clinton

INDIVIDUAL TAX PROPOSALS

- Add another marginal tax rate for high-income taxpayers (taxable income in excess of \$5 million);
- Increase from 39.6% to 43.6%;
- Maximum capital gains tax rate would increase from 20% to 24%;
- Enact the “Buffett Rule” tax, a minimum 30% on individuals with adjusted gross income of \$1 million or more;
- Restore the estate tax to 2009 parameters;
- Maximum tax rate of 45% (up from 40%) and exemption of \$3.5 million per estate (down from \$5.45 million);
- Impose a sliding scale maximum long-term capital gains tax rate, based on holding period;
- Two years or less at ordinary income tax rates;
- More than two years, up to three years, 36%;
- More than three years, up to four years, 32%;
- Reduced by four percentage points for each additional year;
- Lowest rate is 20% at more than six years;
- All rates increased by 4% for high-income taxpayers;
- Caps the value of all itemized deductions at 28%;
- Tax carried interest as ordinary income.

And Post-2016 National Election Realities

#1. A divided electorate begets a divided government.

#2. A recovering economy quiets calls for new stimulus.

#3. An unsustainable federal fiscal position limits options.

... or, economic reality drives the agenda more than campaign promises.

#1. A Divided Electorate Begets ...

America's divided electorate ...

The Electoral College (270 votes needed) tilts to Clinton, according to Charlie Cook:

Democrats = 293 (188 solid, 50 likely, 55 lean Democrat)

Republicans = 196 (98 solid, 59 likely, 22 lean Republican)

Toss-up states account for 66 electors

P.S. Only two states (Maine and Nebraska) apportion Electoral College votes. Throughout history, only 1% of (“faithless”) electors not have voted as pledged. There is no federal provision requiring electors to vote as pledged but half of the states have laws that enforce this.

But the popular vote is very divided.

... a Divided Congress ...

America's unique system of checks and balances ...

Congress, with 100 Senators and 435 members in the House of Representatives, likely will remain divided, reflecting the electorate.

The Senate (currently with 44 Democrats, 2 Independents, 54 Republicans) could flip to a slim non-filibuster-proof majority of Democrats (Ds need 4 to regain control):

10 Democrat seats: 8 solid Democrat, 1 likely Democrat (Co), 1 tossup (Nv)

24 Republican seats: 11 solid Republican, 3 likely Republican (Ak, Ga, Ia), 2 lean Republican (Az, Oh), 6 tossup (Fl, In, Mo, NH, NC, Pa), 2 lean Democratic (Il, Wi)

The House of Representatives likely held by Republicans:

177 solid Democratic seats, 4 tossups

202 solid Republican seats, 24 lean Republican, 21 tossups

Two-year window, because in 2018:

25 Democratic seats up

8 Republican seats are up

Source: Charlie Cook

... With Its Own Agenda (R's “Better Way”)

FACTORS MOTIVATING TAX REFORM

- Nominal U.S. corporate tax among the highest in the world
- International competitiveness
- Distorted treatment of investment income earned by U.S. businesses
 - Deferral if in foreign subsidiaries
 - Subpart F income
 - Repatriation of foreign earnings
 - Reinvestment in U.S. property
 - Foreign tax credits
 - Transfer pricing standards
- Complexity of the Internal Revenue Code
- Frequent changes to tax provisions
- Continued reliance on temporary/expiring tax provisions
- Compliance burdens resulting from complexity
- Use of Internal Revenue Code to meet social and economic goals (substitute for grant programs)
 - Retirement and investment incentives
 - Treatment of health care benefits, including Affordable Care Act provisions
 - Education incentives
 - Adoption incentives/subsidies
 - Capital gains incentives

CORPORATE TAX PROPOSALS

- Reduce corporate tax rate to 20%
- Repeal section 199 (domestic production) deduction
- Full expensing of capital improvements
- No current deduction for “net investment interest”
- Modify (but retain) the research credit
- Permit net operating losses to be carried forward indefinitely
- Retain last-in, first-out (“LIFO”) inventory methods
- Repeal corporate alternative minimum tax
- Provide for lower rate of tax on business income taxed to individuals, e.g., sole proprietorships, S corporations, and partnerships

INTERNATIONAL TAX PROPOSALS

- Switch from world-wide to territorial system:
- Border adjustment system taxes sales to United States customers, whether the taxpayer is foreign or domestic
- Conversely, the system exempts sales to foreign customers are exempt, whether the taxpayer is foreign or domestic
- Represents move toward consumption tax
- The “toll tax” has two parts:
 - An 8.75% tax on accumulated foreign earnings held in cash or cash equivalents; and
 - A 3.5% tax on other accumulated foreign earnings.

INDIVIDUAL TAX PROPOSALS

- Reduce tax rates across the board
- Maximum tax rate of 33% (down from 39.6%)
- Lower tax rates for business income taxable at individual rates
- Repeal individual alternative minimum tax
- Permit a 50% deduction for net capital gains, dividends, and interest income
- Larger standard deduction and enhanced child and dependent tax credit—replaces five current provisions
- Continue earned income tax credit
- Simplify benefits for higher education
- Retention/modification of other tax benefits:
 - Mortgage interest deduction
 - Unspecified incentives for charitable giving
 - Tax incentives for savings and retirement
- Repeal other exemptions, deductions, and credits
- Repeal the estate tax

Comparison of individual tax rates

Current Law

10%

15%

25%

28%

33%

35%

39.4%

The GOP “Better Way”

0%/12%*

25%

25% on “small business income”

33% on other income

**Treats increased standard deduction as an effective 0% tax rate.*

Example filing jointly or qualifying widow(er)

If taxable income is:

Not over \$18,550

Over \$18,550 but not over \$75,300

Over \$75,300 but not over \$151,900

Over \$151,900 but not over \$231,450

Over \$231,450 but not over \$413,350

Over \$413,350 but not over \$466,950

Over \$466,950

The tax will be:

10% of taxable income

\$1,855 plus 15% of the excess over \$18,550

\$10,367.50 plus 25% of the excess over \$75,300

\$29,517.50 plus 28% of the excess over \$151,900

\$51,791.50 plus 33% of the excess over \$231,450

\$111,818.50 plus 35% of the excess over
\$413,350

\$130,578.50 plus 39.6% of the excess over
\$466,950

#2. A Recovered Economy

Whatever is said on the campaign trail about the current state of the economy, there is no clear and present danger that needs to be addressed, in contrast to the days that followed the elections of 1976, 1980, 1992, 2000, and 2008, the economy is close to full employment and looking promising (reality check, jobs, fiscal trends, stocks, the Fed's posture).

Despite slow GDP growth, the economy has emerged from the worst downturn since the Great Depression and done so in the span of seven years, a remarkable feat. The signs of this include, the decline in unemployment, 15 million rise in employment, congested roads, healthy auto sector, narrowed fiscal deficit, and normal valuations in the equity market.

Footnote: 1960 (Kennedy/Johnson) a mild recession; 1964 (Johnson) Kennedy legacy; 1968 (Nixon) Viet Nam; 1972 (Nixon/Ford); 1976 (Carter) a recession; 1980 (Reagan/Bush) inflation, recession, Iran hostage; 1984 (Reagan/Bush); 1988 (Bush) Reagan legacy; 1992 (Clinton) mild recession; 1996 (Clinton); 2000 (Bush); 2004 (Bush); 2008 (Obama) recession; 2012 (Obama)

#3. A Troubled Fiscal Outlook

Slow potential growth makes it more difficult to pay for the safety net ...

Slow growth hasn't prevented recovery, so policies aimed at boosting demand but not our growth potential would strain resources and spur inflation.

But slow economic growth, because it is a reflection of supply-side factors (productivity and demographics) and not anemic demand makes it more difficult to pay for the promises negative consequences for the future, because it makes it more difficult to pay for the public-sector promises we thought we could afford based on our history of economic performance and so puts a growing burden on the working-age population.

P.S. How does infrastructure investment fit into this? Some argue for more infrastructure spending to boost demand. The case for infrastructure spending has a microeconomic justification (return on investment) not a macroeconomic one (to spur aggregate demand).

A growing structural deficit limits fiscal options ...

The national debate about budget matters over the past decade was distracted by the cyclical (temporary) rather than the structural (underlying) fiscal deficit. Cyclical pressures (recession) drove the deficit up to 10% of GDP in 2009 and that is now back to 2½% of GDP. A structural imbalance now will widen the deficit even if the economy stays fully employed, according to the Congressional Budget Office. This is a top concern for many in Congress, including House Speaker Paul Ryan.

The sobering arithmetic behind the CBO's dire projection of the structural deficit:

If revenues remain at the current 18% of GDP (the historical average) ...

Federal spending rises from 20% currently to 33% of GDP in coming decades (non-interest spending from 19% to 26%):

Social Security rises from 4.9% of GDP to 6.5%, by 1.6 percentage points

Medicare rises from 3% of GDP to 9.6%, by 6.6 percentage points

Medicaid rises from 2.2% of GDP to 3.7%, by 1.5 percentage points

Net interest rises from 1.3% to 8% (or more)

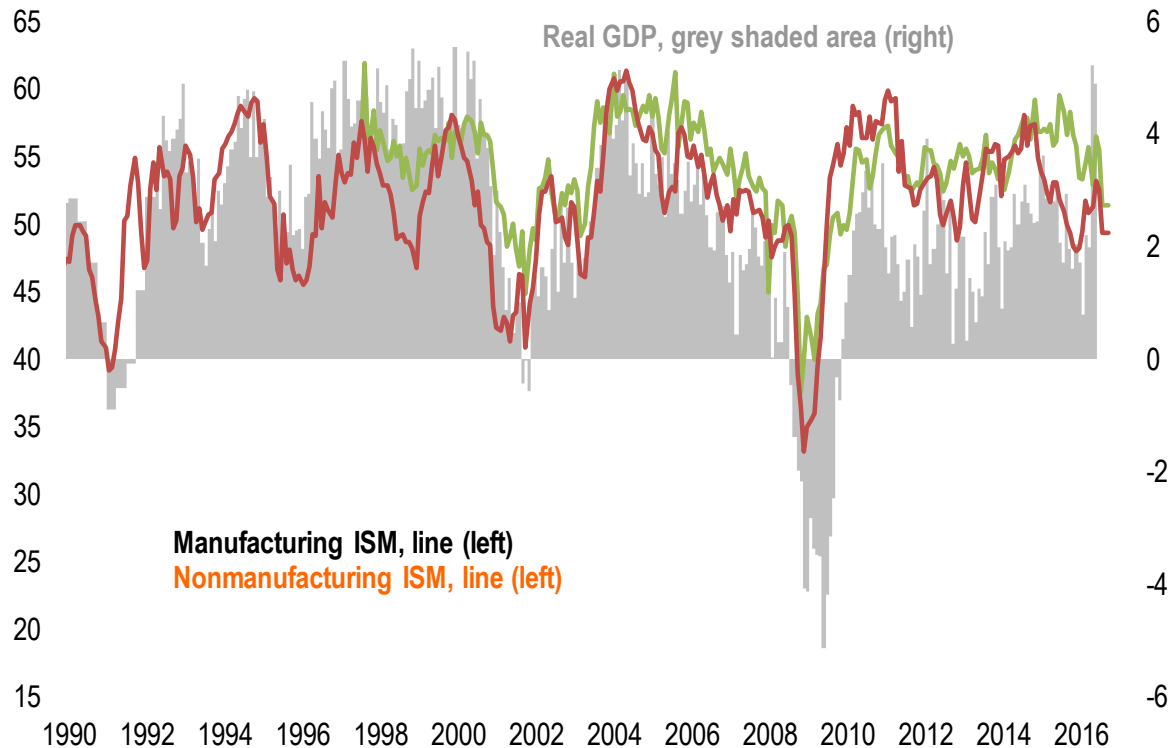
These projects come in part from an assumption of slow (2%) growth, reflecting demographics and productivity.

APPENDIX III. MID-STREAM OF THE OIL SHOCK

Oil's Collapse Hurts Some but Because ...

ISM indexes (50 = neutral)

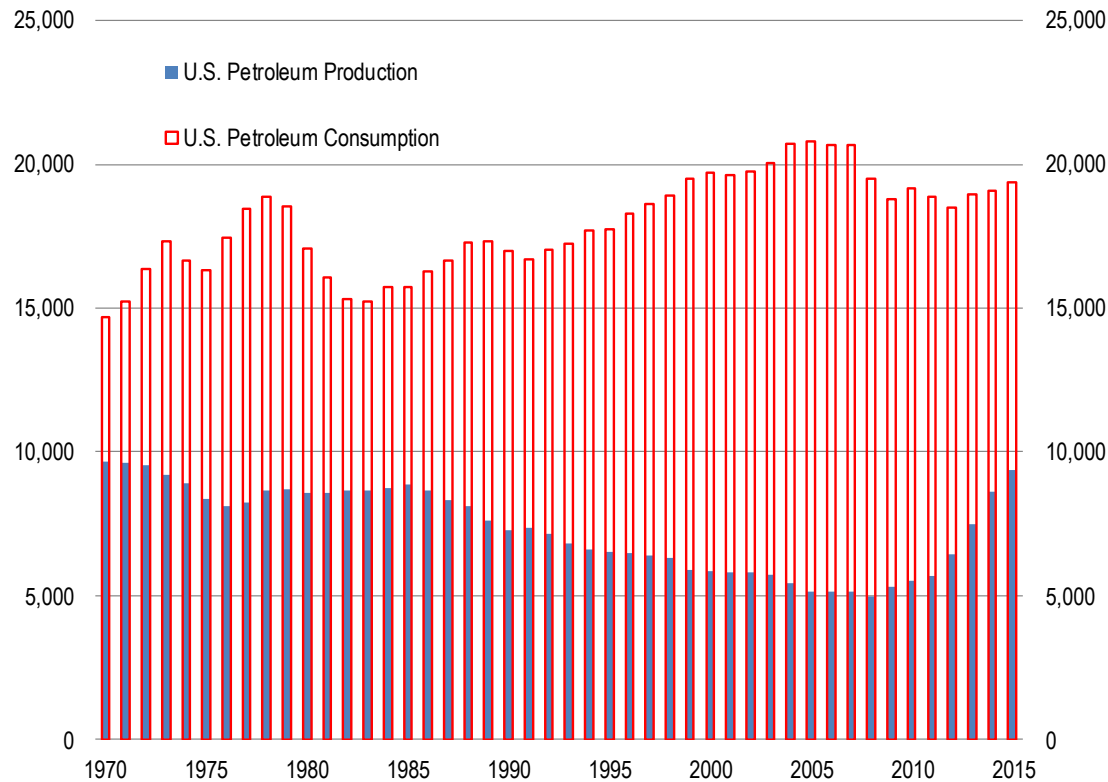
Real GDP (percent change from 12 months earlier)



Sources: Haver Analytics; U.S. Department of Commerce; Institute of Supply Management. Updated through September 2016 (ISM) and July 2016 (GDP).

... We Use More Oil than We Produce ...

U.S. petroleum demand and supply (thousands of barrels daily)

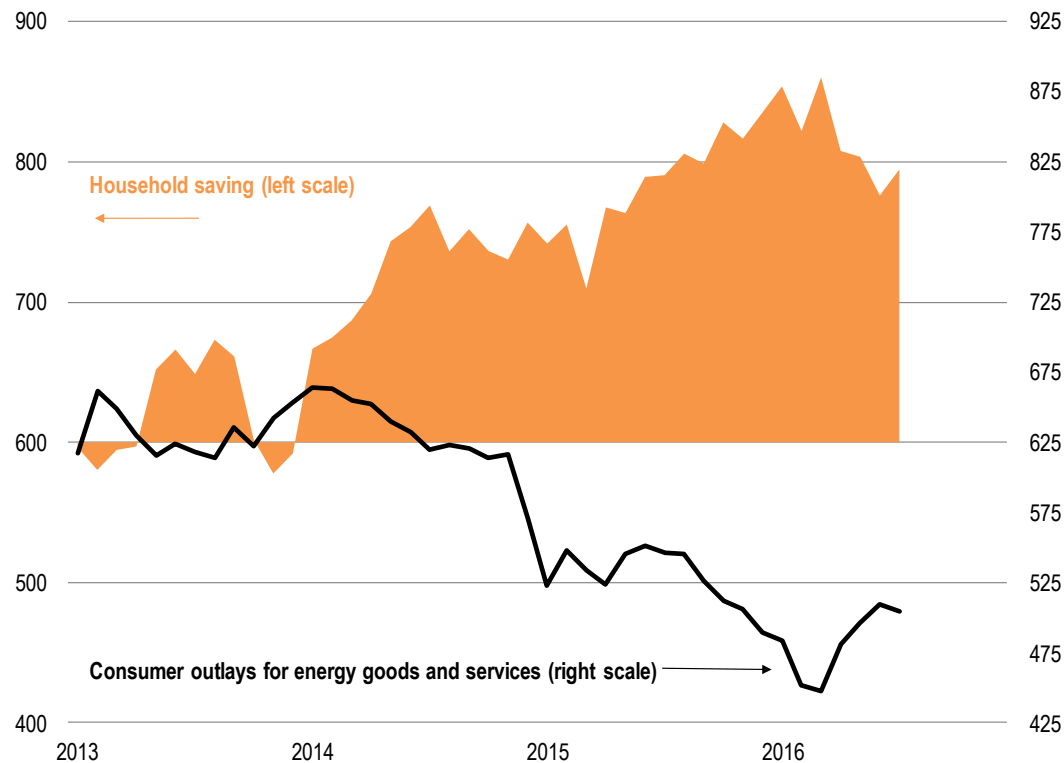


Sources: Haver Analytics; Oil & Gas Journal. Updated through 2015.

... Many More Benefit but are Still Saving

Saving (\$ billions, annualized)

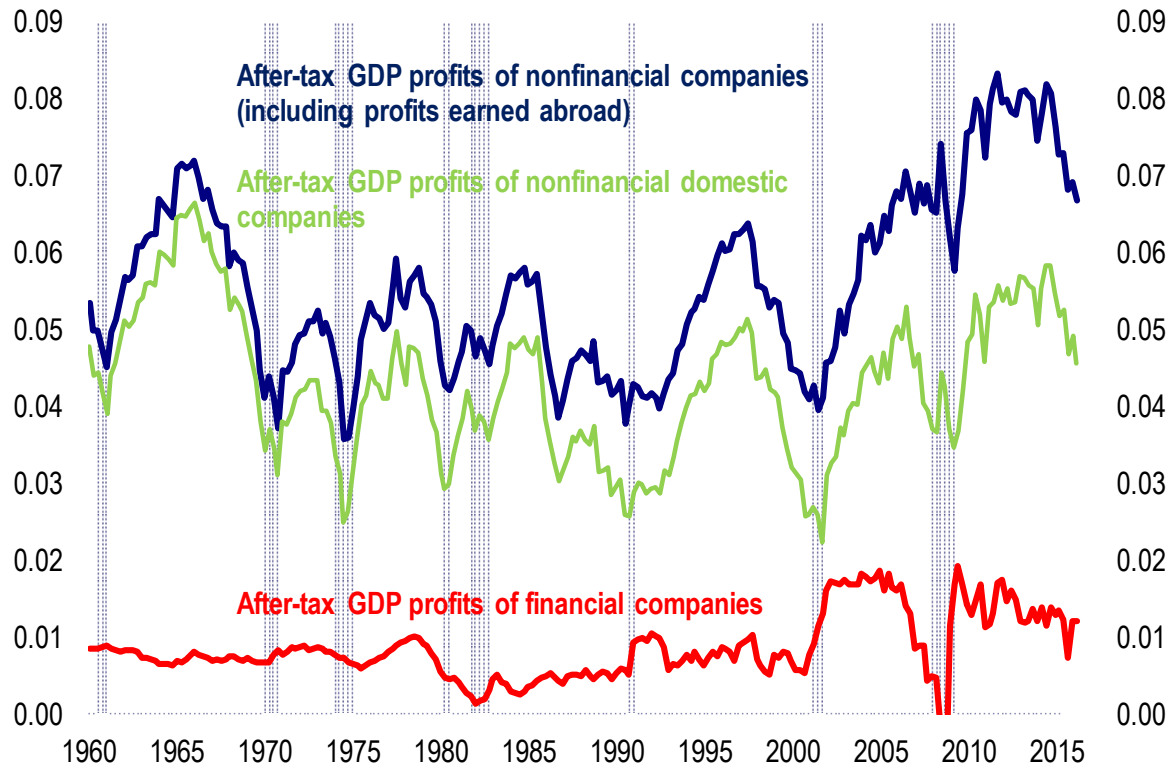
Energy outlays (\$ billions, annualized)



Sources: Haver Analytics; U.S. Department of Commerce. Updated through July 2016.

That's Visible in This Dichotomy Too ...

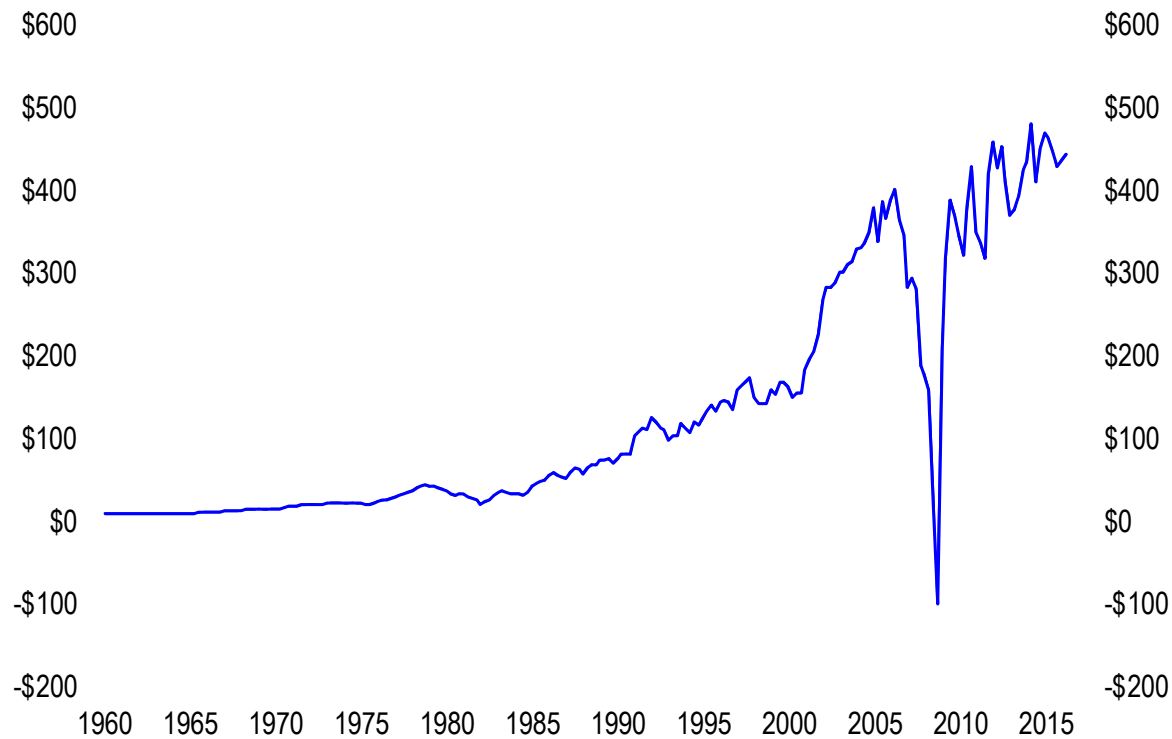
After-tax GDP profits of all U.S. businesses (percent of nominal Gross Domestic Income)



Sources: NBER-designated recession bars; U.S. Department of Commerce. Updated through 2016 Q2.

... the Strong Financial Sector ...

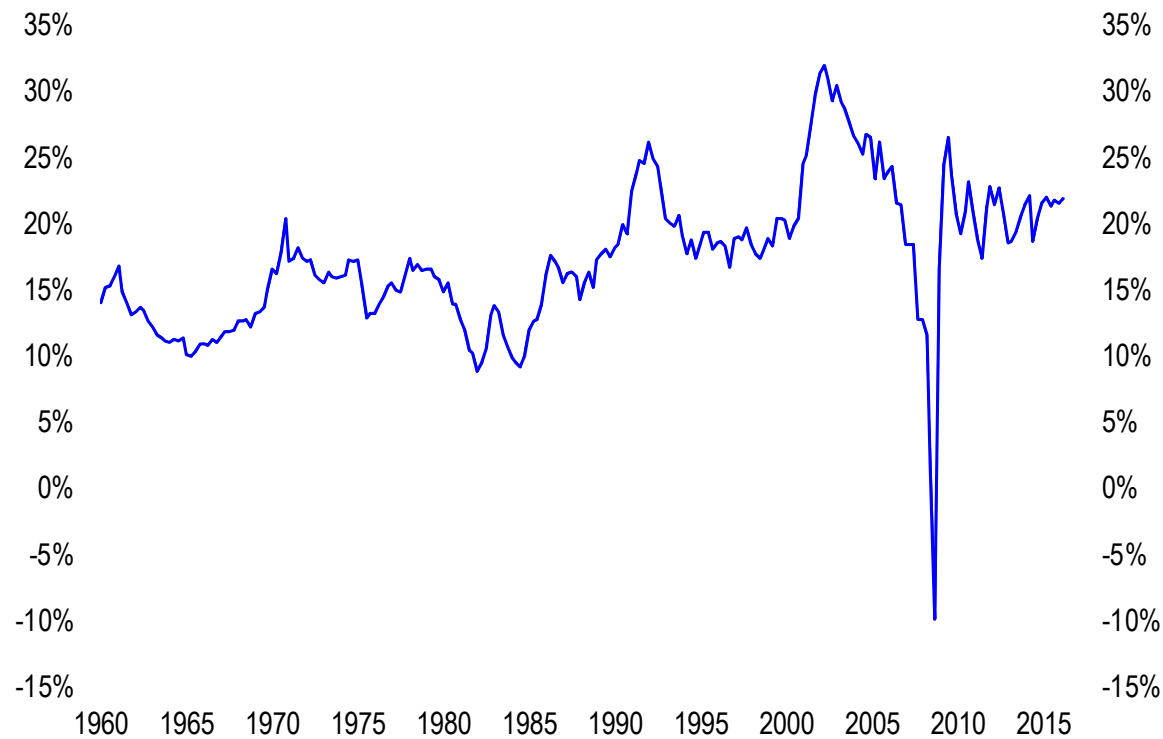
After-tax GDP profits of the financial sector (billions of dollars)



Sources: Haver Analytics; U.S. Dep. of Commerce. Updated through 2016 Q2.

... Relative to Profits ...

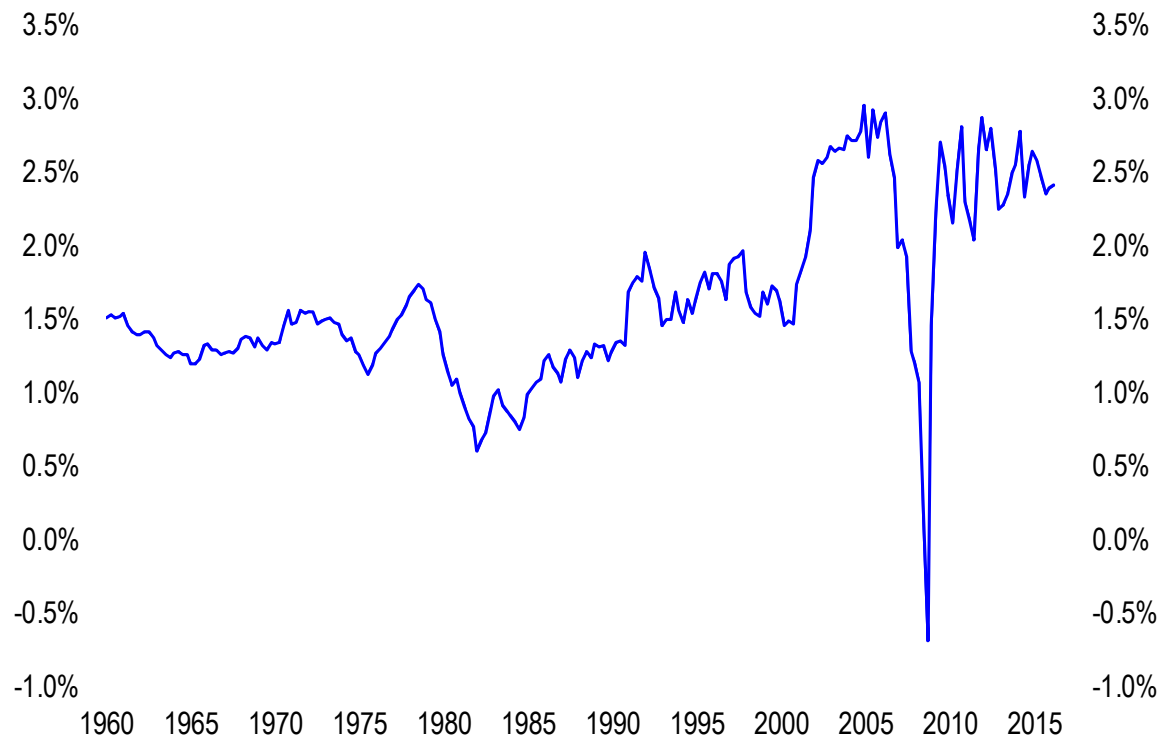
After-tax GDP profits of the financial sector (percent of all profits)



Sources: Haver Analytics; U.S. Dep. of Commerce. Updated through 2016 Q2.

... and Relative to the Economy

After-tax GDP profits of the financial sector (percent of nominal GDP)



Sources: Haver Analytics; U.S. Dep. of Commerce. Updated through 2016 Q2.

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