NORTHERN TRUST

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WEEKLY ECONOMIC COMMENTARY

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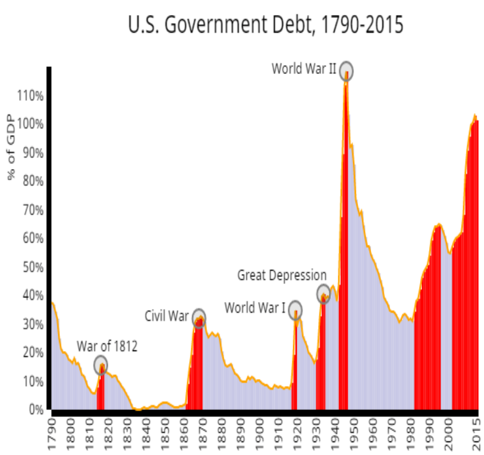
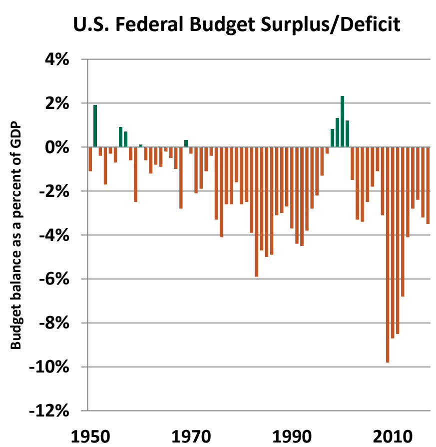
I invested time this past weekend preparing my income tax return. I actually enjoy the exercise, as it brings me closer to our personal finances and to the details of the U.S. tax code. The early indication is that we'll have to make an additional payment on the April 17 due date, so there is no rush to file.

There is hope that the recently enacted tax reform bill will make next year's filing season a little more pleasant for me and many other Americans. But the likely trajectory of government debt and deficits could make future Aprils very unpleasant. U.S. fiscal policy has become unmoored, and it will be difficult to steer it safely back to shore.

The debate over U.S. government debt is as old as the country itself. The Federalization of finance was highly controversial in the early days of the republic. (Alexander Hamilton staked his reputation and a lot of his capital on the issue.) The colonies had taken on massive debt to finance the Revolutionary War, and the decision to consolidate the borrowing was a risky bet on the future of the nation. Fortunately, it paid off.





Sources: U.S. Treasury, U.S. Census, OMB, Haver Analytics

For a long while thereafter, the Federal government typically ran deficits only during times of economic or military challenge. Accumulated indebtedness subsequently fell back during expansions and peace time.

That pattern began to change at the beginning of the 1980s. During the Reagan administration, the military budget was expanded in an effort to end the Cold War. The supply-side economists advising the President asserted that deficits didn't matter, if they were used to help the economy to grow. The economy did indeed grow during that decade, but so did budget shortfalls.

At about the same time, shifts in demographics meant the costs of Great Society programs like Social Security, Medicaid and Medicare began to grow more rapidly. Today, the three programs account for almost 50% of all Federal spending. And because the Federal budget is in deficit, some share of the interest on the national debt might be attributed to these entitlements.

The pattern of reducing debt during strong economic times was interrupted by the tax cuts implemented in the early 2000s. The rationale given was that budget surpluses belonged to the people, and should be remanded. Unfortunately, the government had been accumulating debts that also belong to all of us.

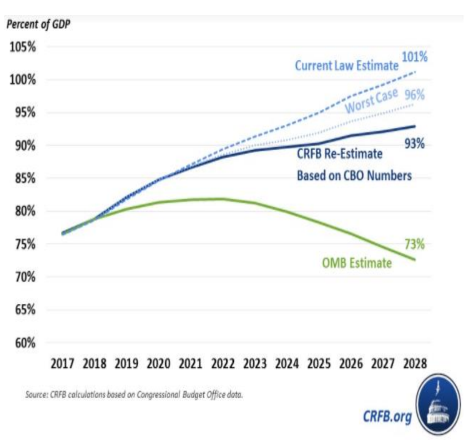
When the Great Recession hit, there was bipartisan support for using fiscal policy to put a floor under the worst economic shock in 70 years. Fortunately, an improving economy began producing additional revenue for the Treasury. On the spending side, Congress instituted automatic budget cuts in 2013. Together, these developments brought the annual deficit down to a low of 2.4% of gross domestic product (GDP) in 2015. Fiscal conservatives (like the members of the Tea Party) promised to push for budget balance and beyond.

After espousing austerity for many years, Congress has gone on a spending spree.

That austere spirit seems like a distant memory. Since December, Congress passed the biggest tax reduction in history and spending increases of $300 billion over the next two years. Peacetime stimulus of this magnitude when the economy is operating at full employment is unprecedented.

Annual deficits of $1 trillion now lie in the near future, and independent projections conclude that U.S. government debt could reach 100% of GDP in the next decade. Few developed countries are in that neighborhood: Italy and Greece are among them.

Projected U.S. Debt



Potential U.S. GDP Growth

Source: Bureau of Labor Statistics

Supporters of the recent largesse will note that it is intended to lift American economic growth to a permanently higher plane. The White House has assumed a real rate of 3% annually during the next 10 years; during the current expansion, the economy has increased by just 2% after allowing for inflation, which is the rate private forecasters expect going forward. The difference between these two levels on budget outcomes is immense.

While 3% real growth is certainly possible, it is unlikely. An economy's ability to expand is the combination of labor force increases and productivity growth. The former is presently constrained by demographics and a conservative immigration policy; the latter has been depressed for nearly 20 years.

The hope is that a stronger outlook will prompt businesses to increase their productive investment, adding to the "supply side" of the economy. Capital spending has, in fact, been rising a little more briskly since last summer. But the bulk of fiscal actions taken by the Congress recently will boost spending, which will test the limits of economic capacity.

Higher inflation could result, and that prospect has created some hesitation in the financial markets. The recent spree will also curtail the ability of fiscal policymakers to react if we enter a recession in the next few years, which could deepen the downturn.

We've taken a huge gamble on higher growth.

Some spending discipline could certainly change the picture, but that would be unlikely in an election year. Congress has been reluctant to tackle entitlements and military spending, which make up a large share of Federal spending. Interest on the national debt, another major category, cannot be reduced until other spending categories are.

Despite this worrisome outlook, the United States Treasury is still able to borrow at very reasonable interest rates. The global saving glut (see our article on the topic here) has generated a healthy appetite for government securities, and America is still seen as a good credit. We'll be relying on the kindness of foreigners even more heavily in the years ahead; the U.S. savings rate has fallen again, and the Federal Reserve is in the process of reducing its Treasury bond holdings.

So while we'd all wish for lower tax liabilities in the future, the burden that Congress has added since December will likely produce the opposite result. A two-month binge could produce a painful long-term hangover.

Alexa, How Is the Outlook for Inflation?

Traditionally, retail was a local experience. We would go to stores, hold products in our hands, and transact directly with a merchant. But that norm is changing. All over the world, e-commerce has altered the way we do business. This channel transition has had far-reaching implications; one of them might have an influence on global monetary policy.

In attempting to explain persistently low inflation across the world, some economists have suggested there is an "Amazon effect" at play. The theory is that e-commerce sites and portals that allow consumers to efficiently compare and purchase items have made it harder for merchants to raise prices. While the movement from bricks to clicks has been profound, there is little evidence to suggest that this evolution has had a major impact on inflation. But as e-commerce expands its penetration of consumers and product categories, its influence may become more powerful.

Amazon has grown relentlessly since launching as an online retailer of books and music to U.S. consumers in 1995. The goods for sale on Amazon expanded well beyond media, into housewares, apparel and (recently) groceries. Nearly half of U.S. households have a membership in Amazon Prime, which offers expedited delivery and other benefits.

Amazon has established itself as a major player not only in major advanced economies but also in emerging markets. Amazon has separate retail websites in at least 15 countries. Much as Amazon has succeeded by replicating its business model in other parts of the world, we expect its effect on local economies to follow trends like we have observed in the United States.

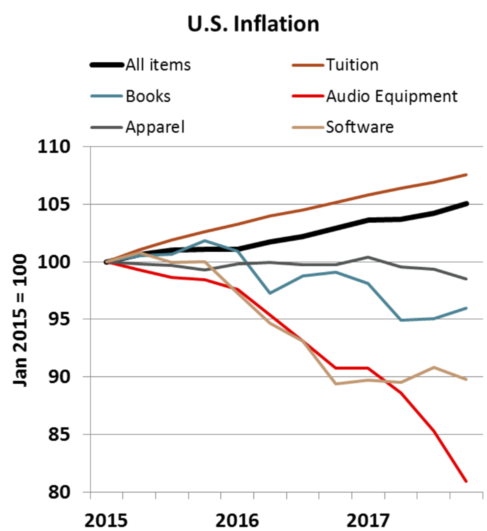
While Amazon is a large online retailer, it is far from the only one. Alibaba serves more than 500 million customers worldwide, and major traditional merchants across the globe have scrambled to upgrade their web sites. Total global online sales totaled an estimated $2.3 trillion last year, double the level of four years ago. Forecasts suggest that this total will double again over the coming four years.

E-commerce platforms not only enable rapid product research but also transparency. Shoppers can compare prices across different portals to get the best bargain. While this was once an online activity, a consumer in a store can now use a smartphone to search for online deals in real time, then either complete the purchase online or use this information to extract a lower price from the merchant. This enhanced ability of consumers to compare before buying has constrained retailers' ability to charge higher prices online and in stores.

This effect has not escaped the attention of policymakers. In September, Janet Yellen suggested that online retailers limit the ability of corporations to raise prices in line with demand. The Bank of Japan also reportedly sees e-commerce as one of the reasons prices in Japan have stagnated.

Low prices drive consumers toward online retailers, increasing their efficiency.

Examining online sales and inflation by category yields some interesting insights. Globally, fashion and travel-related products or services have greatest online purchase rate. Some other popular categories include books/music/stationery, IT & mobile, and consumer electronics. Interestingly, data from the United States demonstrates that the consumer price index (CPI) for categories readily sold online is also drifting lower.



Sources: Statista, Bureau of Labor Statistics

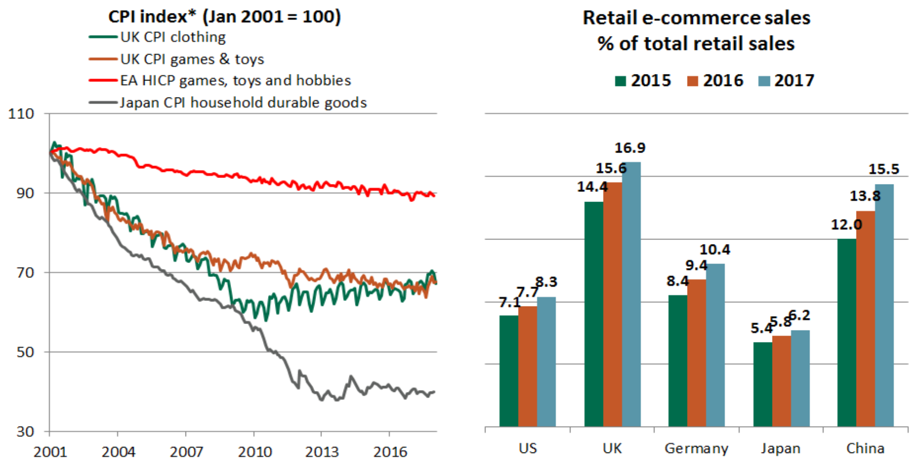
Take these observations with some caution, however. Some of the products that have become most popular online are also those most affected by globalization and technological advance, two other factors cited as governors on inflation.

For example, apparel manufacturing has moved increasingly to emerging markets, where labor costs are lower. This may have as much to do with low selling prices as the availability of shirts on Amazon. Consumer electronics have been falling in price (adjusted for features and quality) because of advances in chip speeds and capability.

Expenditures that cannot easily be delivered online or at scale, like many services, are still in a pattern of inflation. In many markets, services make up more than half of the consumer price index. (In the United States, this fraction is 63%; in the United Kingdom, it is 58%.) Unless online portals make more significant inroads into service industries, their impact on overall inflation may remain limited.

Amazon seems ready to test the boundaries. Recently, the company announced a partnership with J.P. Morgan Chase and Berkshire Hathaway to improve the healthcare they offer to their U.S. employees. The stated goals of the partnership are lofty and, thus far, light on detail: "simplified, high-quality and transparent healthcare at a reasonable cost." However, the announcement itself caused a market reaction among healthcare providers. Amazon has shown its skill at reducing prices in consumer-focused categories, and this is a market that presents many opportunities to improve efficiencies and create a better user experience.

Healthcare presents a *prime* opportunity to be Amazon's next major disruption.



Sources: Eurostat, ONS, Statistics Bureau Japan, Invesp; *non-seasonally adjusted

The big online portals do have their detractors. They have gotten so big that competition may not be as keen, which may provide them some pricing power. By locking consumers into services like Amazon Prime, and by suggesting additional purchases during online sessions, e-commerce titans may actually be getting us to trade convenience for cost.

It is difficult to quantify the exact effect that e-commerce has on inflation. A European Central Bank paper voiced these concerns. A study by Cavallo showed that price levels are about 72% identical between physical and online channels. Goldman Sachs has estimated that e-commerce has reduced core inflation by .1% per year.

In sum, e-commerce has likely dampened inflation slightly in the near term and could become more influential over the long-term. Lower inflation is a net benefit to most consumers — and in this case, our lower costs are delivered to us neatly packaged with unlimited two-day shipping.

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