1. Editorial

Theoretically, hard and soft economic indicators should converge in due course. All things equal, a rise in consumer confidence or business expectation (soft indicator) should also lead to a rise in consumption or investment (hard indicators). However, following the election, survey expectations began to climb at a fast pace while consumption slowed and investment remained flat. This gap widened despite limited progress on tax reform, healthcare, infrastructure, immigration and trade policy. This begs the questions as to what forces will narrow this divergence? And how long will it take?

Looking at some soft indicators reveals that consumer expectations stand at their highest level in 17 years while optimism in the small business sector reached its highest level in 12 years. Financial market indicators exhibit a similar behavior. The S&P 500 is 20% higher than a year earlier, its price to earnings ratio adjusted for economic cycles stands at its highest since 2002, and volatility indexes, a proxy for financial risk, are 40% lower than the historical average.

If these trends are auspicious signs of future performance, the economy is bound to experience higher growth. However, hard indicators are providing little evidence that an economic boom is about to occur. Year-over-year GDP growth has remained below 2% for the past five quarters, one percentage point lower than 1994-2007. Auto sales have declined. Nondefense durable goods orders excluding aircraft have remained flat since early 2017. Finally, private sector nonfarm payroll experienced the slowest year-over-year gain since 2011 in March.

One potential explanation behind the divergence is that some businesses and individuals attached a high probability to tax cuts and deregulation. If these factors have a large influence on their outlook, the indexes would tend to increase as the data has shown. In addition, if markets anticipated a friendlier environment for corporate businesses — for similar reasons— it would be reasonable to see stock prices edging higher. An alternative explanation is that the swing in expectations relates more to political preferences, which have become more polarized.

Neither the lukewarm hard indicators nor potentially surreptitious signs from soft indicators invalidate an assumption of high economic growth. Nevertheless high levels of optimism and asset prices could produce a positive feedback loop if growth and profits align with a glass-half-full policy outlook. This could produce conditions that help bring the economy out of its perceived doldrums. However, expectations alone will not support long-run growth. Altering the course of long-run growth will require structural reforms, hard choices and compromises in a growingly partisan environment.

Moreover, it is unlikely that all the promises made during the campaign trail will fully materialize. The Trump administration faces opposition from Democrats in Congress, divisions within the Republican Party, as well as lack experience and manpower to design, negotiate and promote these reforms. Therefore, a more likely outcome is one of watered down changes with lower effects on growth. Nonetheless, even without meaningful policy changes, similar to previous administrations, we could have an extended period of misalignment between expectations and asset prices with economic growth, at least until players have to show their hands.

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