Now comes the Donald!

Donald Trump will take office as president next week. We analyze what measures can be expected on day one. His further plans are expensive. The risk of a strong reaction in the bond markets is rising.

Bernd Weidensteiner [AC]
Dr. Christoph Balz [AC]

Inauguration next week...

On Monday, January 20, Donald Trump will be inaugurated as the 47th President of the United States. Unlike eight years ago, the handover of power has been much better prepared. This should give Donald Trump a flying start. During the election campaign, he had already announced a series of measures for the first day, even though there is – as usual with Trump – diverging and sometimes contradictory information.

... Plans for Day 1

Right at the start of his second term, President Trump is likely to reverse a whole series of executive orders issued by his predecessor Biden. Such orders are an instrument frequently used by US presidents when they have difficulty getting their policies passed into law by Congress or when, in their view, swift action is required. Such orders have similar effects in principle to federal laws, but – unlike laws – they can be easily withdrawn by a new president. At the beginning of his term in office, Biden also rescinded numerous orders from Trump's first term. A change of administration thus makes it possible to quickly change policy in many areas.

Trump sees the high level of illegal immigration as the most pressing problem and has therefore promised to take immediate action against it. One of the first orders of business is likely to be tightening border controls. In addition, he could divert funds from the defense budget to border security by declaring a state of emergency at the border.

Rapid decisions can also be expected in the energy sector. In doing so, Trump is likely to reverse Biden's moratorium on new natural gas export licenses. It is also likely that he will again award significantly more drilling licenses for oil and gas exploration on federally owned land (27% of the US land area is owned by the US federal government; in Alaska – where oil production plays an important economic role – the figure is as high as 60%). However, US oil production is already at a record level, so a significant expansion of production also depends on the development of oil demand. Finally, Trump will rescind Biden's moratorium on new drilling projects off much of the US coast. However, this would initially be more of a symbolic act, since fossil fuel drilling is not currently taking place in most of the closed areas anyway.

It is possible that restrictions will be placed on offshore wind turbines. However, the direct impact of a moratorium should not be overestimated here either. In the US, only a relatively small number of offshore wind farms are in the planning stage, and many projects have been stopped due to escalating costs. Furthermore, Trump could order the US to withdraw from the Paris Agreement on climate change.

... and for the first few months

Even if tariffs are seen as a panacea for Trump, it will likely take a while before they are imposed. This is because the Trade Act of 1930, which authorizes tariffs to be imposed on unfair trade practices by trading partners and tariffs on imports relevant to national security, requires prior investigations. It would be faster if Trump declared a national emergency under the International Emergency Economic Powers Act (IEEPA). However, this law has not yet been applied to tariffs, and legal experts see a risk that this approach could fail in court.

In the long term, however, Trump is likely to impose tariffs or raise existing tariffs and is unlikely to limit himself to selectively raising some tariffs in critical areas. He has not only raised the prospect of tariffs to reduce the US trade deficit, but also as leverage to curb immigration and stem the flow of drugs. Furthermore, the threat of high tariffs is intended to deter the BRICS countries from developing an alternative to the US dollar as the world's reserve currency. In addition, tariffs were lurking in the background as an instrument in his foreign policy fantasies of expansion towards Canada.

The views pf Stephen Miran, whom Trump wants to appoint as the head of his Council of Economic Experts, might indicate the direction of travel in the longer term. In his publications, Miran has discussed the advantages of a general 20% tariff rate for the US; currently, the average tariff rate is only 2.3%. Ultimately, the tariffs are likely to affect imports from China in particular, while for other countries the threat may also serve as leverage to persuade trading partners to make concessions.

Another of Trump's key concerns is the extension of the income tax cuts that were agreed during his first term in office and are due to expire at the end of 2025. However, a corresponding legislative package, which may also include a further reduction in corporate taxes, is not expected until spring.

Can Trump lift growth to a new level?

Donald Trump has inherited a strong US economy. Unlike the other G-7 countries, the US has quickly recovered from the economic downturn caused by the pandemic and returned to its old growth trend (Chart 1). Real gross domestic product in the US was recently 11.5% higher than in the fourth quarter of 2019, i.e. immediately before the economic downturn. This increase roughly corresponds to half of Germany's gross domestic product; by contrast, German economic output was only at the same level as at the end of 2019.

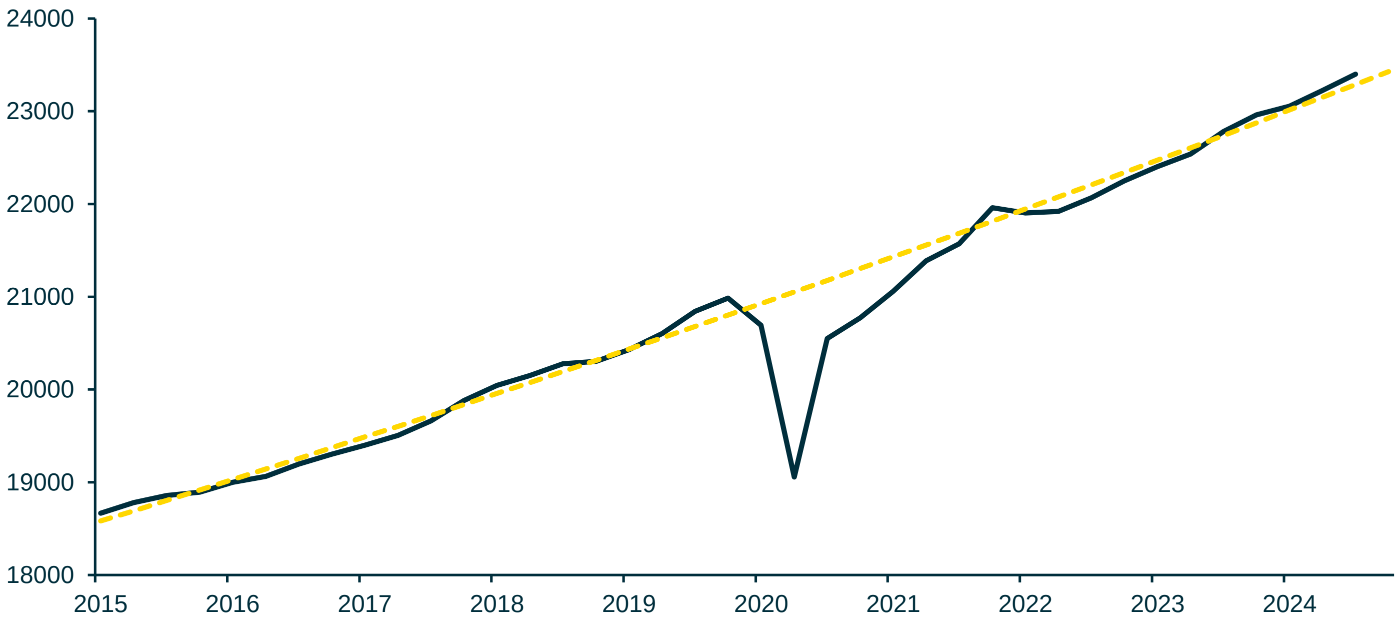
However, economic capacities in the US are likely to be largely exhausted, meaning that in the medium term, growth will only be possible in line with productivity and labor growth. At present, potential growth is estimated at 2% at best, which means that the rather strong growth of presumably 2.8% in 2024 is unlikely to continue. This applies all the more since some of the high growth rates of recent years are attributable to high immigration, which is already declining noticeably.

However, the Trump team wants to boost potential growth through supply-side policies. For example, Scott Bessent, the nominee for Treasury Secretary, promises an average growth rate of 3% for the coming years. Tax breaks, particularly in the corporate sector, are to boost investment, while comprehensive deregulation measures are to remove obstacles to growth. A special commission (the Department of Government Efficiency, DOGE) headed by Elon Musk and Vivek Ramaswamy is to be set up for this purpose.

However, experience shows that deregulation measures take time to have an impact on growth. Moreover, some of Trump's policies, especially his increased protectionism, are more likely to slow growth. We therefore consider an additional growth spurt to be unlikely. Ultimately, the positive and negative effects of the Trump administration's economic policy are likely to balance each other out in the short to medium term, although this still means that the US economy will expand faster than most developed countries, as in previous years.

Chart 1 - The outlier among G7 economies: The US returned to the pre-Covid growth trend

GDP, in 2012 dollars, quarterly data. Dashed line: 2015-19 trend



Source: BEA, S&P Global, Commerzbank Research

... or just inflation?

Trump's policies are likely to have a greater impact on inflation. In our view, it is realistic to assume that new tariffs will come into force from around mid-2025, which could increase the price level by around 1 percentage point over a twelve-month horizon.

On top of that, progress on disinflation has anyway stalled. Because inflation was stronger than expected in recent months, we are raising our forecast for 2025 from 2.5% to 2.8%. For 2026, we are confirming our forecast of 3.2%, which is well above the consensus.

A brief window for rate cuts in 2025

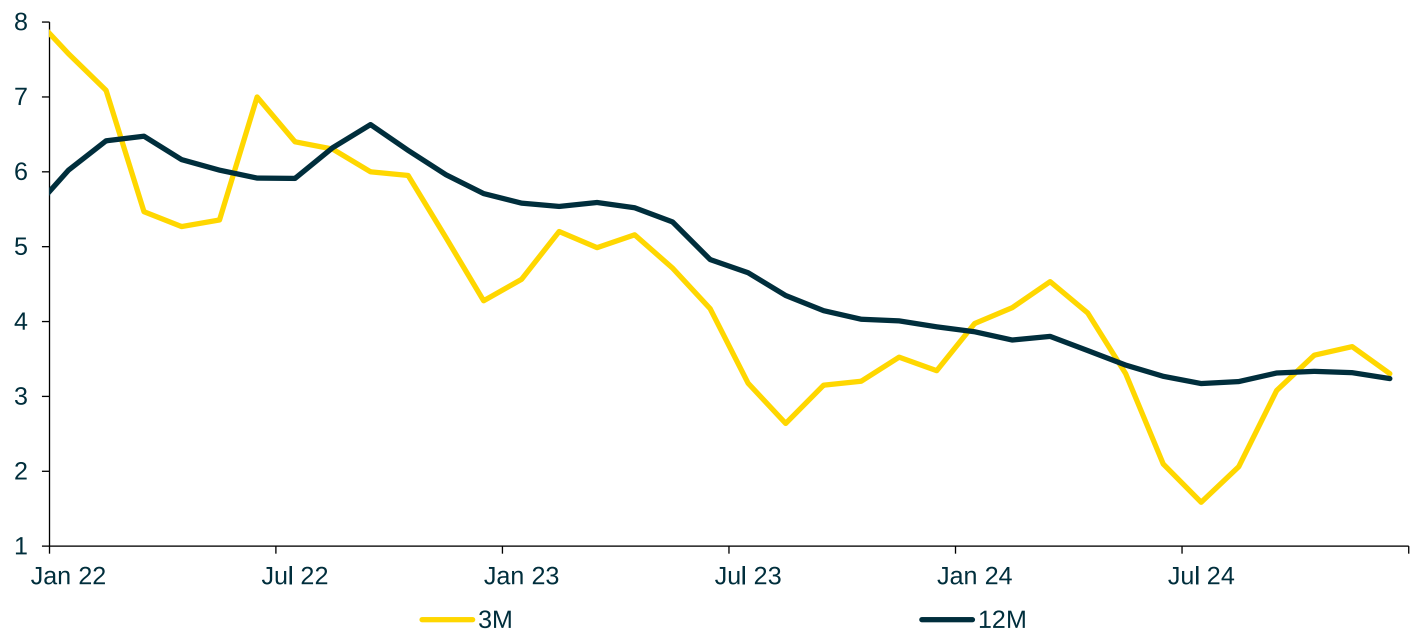
At present, the Fed obviously favors a pause in interest rate cuts as the economy continues to grow robustly and the decline in inflation is stalling. In addition, the Fed, like everyone else, is waiting for the first concrete measures from the future administration to assess their impact on inflation and growth. In light of this, we have adjusted our Fed forecast slightly. We still expect two rate cuts of 25 basis points each, but only in March and June (previously: January and March).

The Fed should resume interest rate cuts as inflation figures are likely to improve somewhat soon. Measured by the core rate, which excludes energy and food, price pressure has not fallen steadily since 2022. Rather, there were repeated phases in which short-term price pressure increased, i.e. the annualized three-month change rose (Chart 2). So far, inflation has always subsided again after a few months, and the decline in the inflation rate has continued.

This could be the case this time as well. A first indication was the weaker core rate in December, which was reported this week and slightly lowered both the short-term momentum and the year-on-year rate. Since the Atlanta Fed's measure of wage growth, perhaps the most important inflation driver, continues to ease, this downward trend in the year-on-year rate should continue and the short-term momentum should continue to decrease. This results in a limited window of opportunity for the Fed to lower rates before inflation is likely to pick up again in the second half of the year. Since the central bank does not want to risk an open conflict with the new administration, which is certainly pushing for interest rate cuts, it will probably use this leeway and lower the key rate by 25 basis points in March and June.

Chart 2 - Core inflation resumes downtrend

consumer price index excluding food and energy, 3- and 12-month changes, annual rate in %



Source: S&P Global, Commerzbank Research

Is the bond market going to accept rising deficits?

In recent decades, no one in Washington has been concerned about the ever-increasing national deficits. “Deficits don't matter” continues to be the fiscal policy guideline [1]. The increasing polarization of US politics likely plays an important role in this. This leads each administration to max out the fiscal space so that when the administration changes, the other camp has as few funds as possible for their plans.

Over the last 20 years, the US federal government's deficit has averaged 5.6% of gross domestic product. In the fiscal year 2024, it was as high as 6.7%, despite a fully employed economy. As a result, the share of interest payments in the US budget continues to rise,

Research contacts (E-Mail: firstname.surname@commerzbank.com)

Chief Economist
Dr Jörg Krämer
+49 69 136 23650

Economic Research

Dr Jörg Krämer (Head)
+49 69 136 23650

Dr Ralph Solveen (Deputy Head; Germany)
+49 69 9353 45622

Dr Christoph Balz (USA. Fed)
+49 69 9353 45592

Dr Vincent Stamer (Euro area, World trade)
+49 69 9353 45800

Dr Marco Wagner (ECB, Germany, Italy)
+49 69 9353 45623

Bernd Weidensteiner (USA, Fed)
+49 69 9353 45625

Tung On Tommy Wu (China)
+65 6311 0166

Interest Rate & Credit Research

Christoph Rieger (Head)
+49 69 9353 45600

Michael Leister (Head Rates)
+49 69 9353 45610

Rainer Guntermann
+49 69 9353 45629

Hauke Siemßen
+49 69 9353 45619

Ted Packmohr
(Head Covered Bonds and Financials)
+49 69 9353 45635

Marco Stoeckle
(Head Corporate Credit)
+49 69 9353 45620

FX & Commodities Research

Ulrich Leuchtmann (Head)
+49 69 9353 45700

Antje Praefcke (FX)
+49 69 9353 45615

Tatha Ghose (FX)
+44 20 7475 8399

Charlie Lay (FX)
+65 63 110111

Michael Pfister (FX)
+49 69 9353 45614

Volkmar Baur (FX)
+49 69 9353 26854

Thu-Lan Nguyen (FX, Commodities)
+49 69 9353 45617

Carsten Fritsch (Commodities)
+49 69 9353 45647

Barbara Lambrecht (Commodities)
+49 69 9353 45611

Tung On Tommy Wu (China)
+65 6311 0166

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Analysts

Dr. Jörg Krämer AC
Chief Economist
+49 69 136 23650
joerg.kraemer@commerzbank.com

Bernd Weidensteiner AC
Senior Economist
+49 69 9353 45625
bernd.weidensteiner@commerzbank.com

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Frankfurt	**London**	**New York**	**Singapore**
Commerzbank AG	Commerzbank AG	Commerz Markets LLC	Commerzbank AG
DLZ - Gebäude 2, Händlerhaus	PO BOX 52715	225 Liberty Street, 32nd floor,	128 Beach Road
Mainzer Landstraße 153	30 Gresham Street	New York,	#17-01 Guoco Midtown
60327 Frankfurt	London, EC2P 2XY	NY 10281-1050	Singapore 189773
Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000