Three scenarios for Trump's second term

We expect Donald Trump to deliver important shifts in trade, fiscal, regulatory and immigration policy. But the precise scale and composition of these changes will shape the growth, inflation and interest rate outlooks in different ways.

Key Takeaways

- Our new 'Trump 2.0' base case envisages the incoming president following through on a pared-back version of his campaign pledges across fiscal, trade, immigration and regulatory policy.
- We expect some loosening in fiscal policy, large tariff increases on China but a case-by-case approach elsewhere, increased deportations and looser regulation.
- Our new forecasts therefore see inflation treading water at uncomfortably firm rates, while the Fed will cut rates more gradually and to a higher terminal rate in coming years.
- But we have also sketched out a 'Trump unleashed' scenario, which envisages more aggressive policy changes facilitated by a supportive Congress.
- Large tax cuts and higher defence spending in this scenario push the deficit much wider, despite larger and broader tariff increases. Deportations rise significantly, generating a sharp labour force shock.
- These policies would drive a reacceleration in inflation and make it hard for the Fed to cut at all, causing the president to threaten the central bank's independence.
- Finally, we've specified a 'Trump delivers for markets' scenario, in which the president focusses on the market friendly aspects of his agenda.
- This would involve a more measured tax bill, smaller tariff increases, less aggressive immigration policy, and a supply-side boost from deregulation. These policies would boost growth while still allowing inflation to normalise and interest rates to come down.

Trump has won, now what?

We consider three scenarios for assessing the direction of Donald Trump's second term.

Trump 2.0 (*60% probability)* is our new base case, in which Trump acts on his policy priorities but stops short of fully implementing campaign pledges.

Trump unleashed (*20% probability)* sees the president and Congress deliver more aggressive policy changes.

Trump delivers for markets (*20% probability)* involves the president focussing on the market-friendly aspects of his agenda.

How much fiscal loosening?

A major tax bill is all but guaranteed in 2025 due to the expiration of personal tax cuts in the Tax Cuts and Jobs Act (TCJA). But, while the current fiscal cliff will be avoided in all three scenarios, the extent and composition of stimulus could differ significantly.

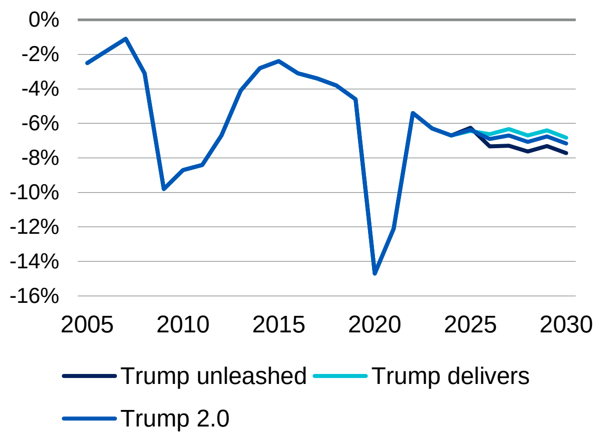
In our base case, we expect TCJA provisions to be fully renewed, alongside an enhanced Child Tax Credit of $2000 and full business investment and R&D expensing. We also expect a cut to the statutory rate of corporation tax to 20%, and a further cut to 15% for businesses manufacturing in the US.

On the spending side, defence budgets are likely to rise, while promises of deep cuts elsewhere are unlikely in practice. Meanwhile, tariff increases are likely to deliver only modest increases in revenue.

We think this policy mix will raise borrowing by $3.3tn over the next decade and widen the deficit to 7.1% of GDP by the end of Trump's term (see Figure 1).

The increase in borrowing would be much larger under our 'unleashed' scenario. A unified Republican Congress could introduce a 15% corporate tax rate across the board, abolish federal taxes on tips, lower income tax thresholds, pass an even more generous child tax credit, and remove the SALT cap. We also pencil in larger increases in defence spending in this scenario.

Figure 1: US deficit forecasts



Source: abrdn, CBO, Haver, November 2024

This would increase borrowing by a huge $7.5tn over the next decade. Some of this could be offset by higher tariff revenues, reducing the shortfall to $5tn. Still, the deficit would be 7.6% of GDP by 2028.

Finally, because the deficit is so large, especially in a full-employment economy, we think fiscal policy in our 'delivers for markets' scenario would involve reforming the tax code with growth friendly measures rather than big stimulus. This would avoid the fiscal cliff, while providing a small corporate tax cut alongside even more favourable treatment of investment and R&D. Smaller changes to discretionary defence and non-defence spending would occur in this more fiscally prudent scenario.

This would see borrowing increase by 'just' $1.7tn over the next decade, with the deficit broadly moving sideways at admittedly still concerning levels (6.6% of GDP in 2028).

A global trade war or isolated spats?

In our base case, we think tariff increases will be lower than Trump's campaign pledges. This is because of practical hurdles, negative economic and market fallout, the political unpopularity of higher inflation, and Trump's history of using tariffs threats in negotiations.

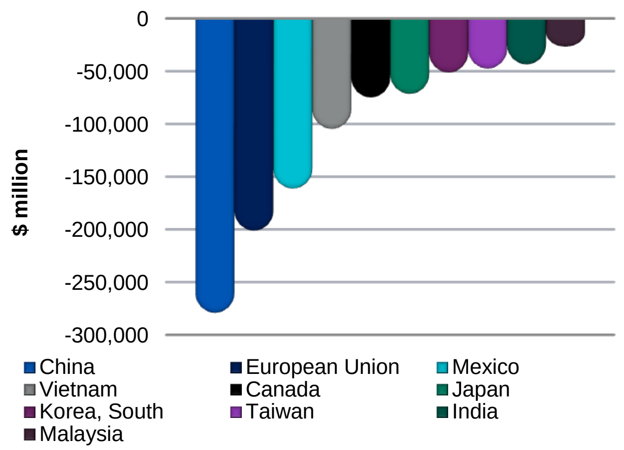
Admittedly, we think tariffs on China will increase to 60% for many of those goods targeted in the previous trade war. This would imply the effective tariff rate on all Chinese imports rising from 16% now to around 35-40%. Tariffs will likely increase incrementally over Trump's term.

But we expect isolated spats with other trade partners and on specific products, rather than the 10-20% baseline tariff across all imports threatened by Trump.

The EU and Vietnam, which have large surpluses with the US (see Figure 2), are most at risk, and the autos, steel and aeronautical sectors could be targeted. However, some of these conflicts could be temporary, and reversed upon the agreement of a deal.

All told, this would constitute a 3%-5% increase in US effective tariff rates (see Figure 3).

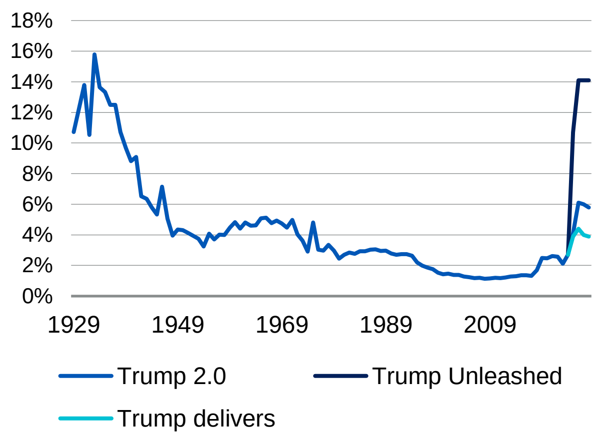
Figure 2: Those with the highest trade surplus are most vulnerable to tariffs



Source: abrdn, US Department of Commerce, September 2024

Our 'delivers' scenario would involve smaller tariff increases. We still think China would be in the firing line, but with a smaller rise in effective tariff rates closer to 25-30%. Elsewhere, aside from some product centric measures, there would be no major tariff announcements, while the USMCA is renewed.

Figure 3: Effective US tariff rate forecasts



Source: abrdn, Haver, Yale University, November 2024

However, in our 'unleashed' scenario, the US would pursue faster economic decoupling from China, with an effective tariff rate of 50-60% and legislation that further limits trade, technology and financial flows.

The president might also target countries rerouting trade from China or hosting Chinese corporates.

This scenario would also involve a 10% baseline tariff on all imports. This could be part of a reconciliation bill to partially finance large tax cuts. There could even be additional tariffs on top on individual trade partners or products.

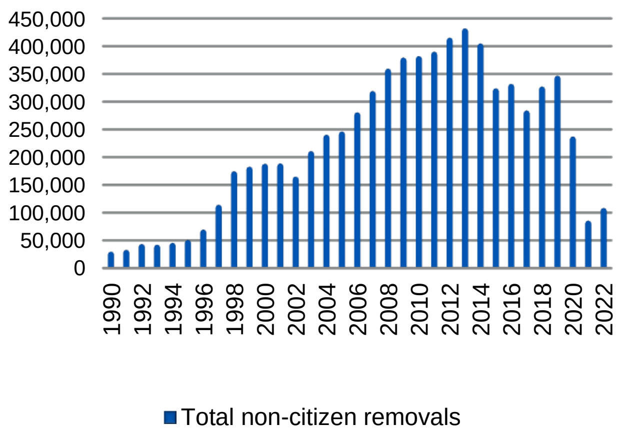
How large will the crack down on immigration be?

Early Trump nominees suggest the new administration will attempt to follow through on campaign pledges to significantly tighten immigration policy.

In our base case, we expect legislation based on H.R.2, the Secure the Border Act, early in Trump's term. The Congressional Budget Office estimates the bill would decrease the US population by 600,000 over a ten-year period relative to baseline assumptions. Efforts to lower legal migration and a deterrence effect will add to this drag.

We also think deportation of unauthorised migrants will rise sharply to between 2-4mn over the next four years (we have assumed 3mn in our forecasts). This would be significantly higher than in Trump's first term but below campaign promises (see Figure 4).

Figure 4: Historically, deportations have been well below Trump's proposals

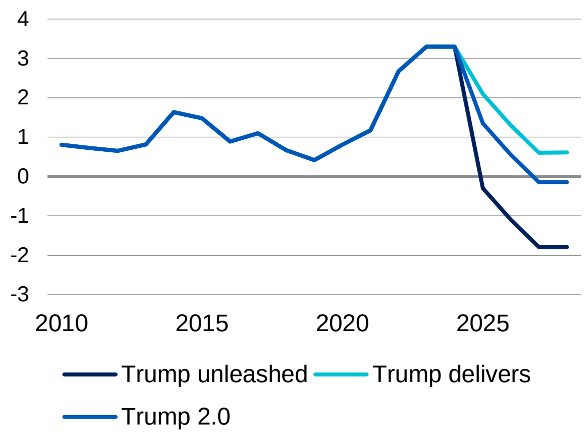


Source: abrdn, Office of Homeland Security Statistics, November 2024

All told, this implies a stall in net migration flows which will be a step change from the 3mn per year surge seen over recent years (see Figure 5).

In our 'unleashed' scenario, we envisage a total of 8mn deportations over the next four years, which equates to 3% of the US population. Alongside measures to slow immigration, this would see net migration fall deeply negative during his term. While this is below Trump's claims that he could deport between 10-20 million people, more than the unauthorised population (see Figure 6), it would still be an enormous increase that would require a massive logistical operation.

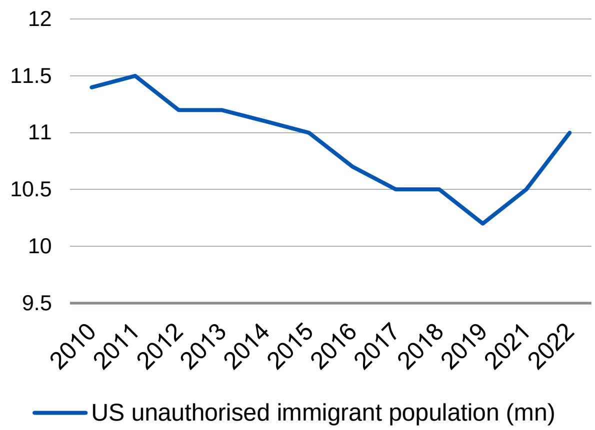
Figure 5: Net immigration forecasts (mn)



Source: abrdn, CBO, November 2024

Finally, in our 'delivers' scenario, the impact on the labour force would be much smaller. A pared back version H.R.2 would still be passed, and net migration would be lower than our pre-election assumptions, but the hit to the labour force would be far smaller than in the other scenarios.

Figure 6: Estimates of the unauthorised migrant population fall well below Trump's campaign claims



Source: abrdn, Pew Research Centre, November 2024

Deregulation across the board

We envisage a degree of deregulation in all three scenarios.

In the base case, we think anti-trust regulation will be relaxed, with appointees to the Federal Trade Commission (FTC) effectively reversing the Lina Khan-era policy. Financial services regulation will also be relaxed, including around bank capital requirements, although this might have to wait until Trump can appoint a new Vice Chair for Supervision at the Fed in 2026. In the energy sector, Trump is likely to use executive orders to increase oil and gas permitting, raising domestic production.

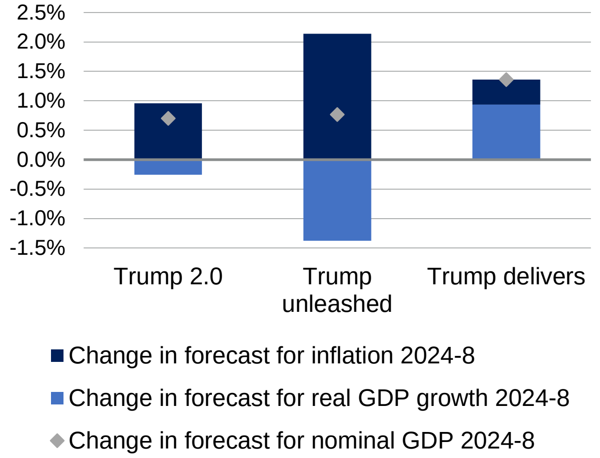
The 'delivers' scenario could see a more meaningful supply-side boost from deregulation, which supports growth while helping cool inflation.

Meanwhile, in the 'unleashed' scenario, the administration could test its legal powers over the Fed by attempting to remove Michael Barr before his term ends. Such a move would bring the prospect of earlier and more sweeping bank deregulation, but also lay the groundwork for further political control over the Fed.

Big differences in the growth/inflation mix

We now forecast nominal GDP growth to be higher across all our scenarios than our pre-election assumptions. However, the mix of real growth and inflation will differ across scenarios (see Figure 7).

Figure 7: Changes to our pre-election baseline show stronger nominal GDP, but big differences in the contributions from growth and inflation



Source: abrdn, Haver, November 2024

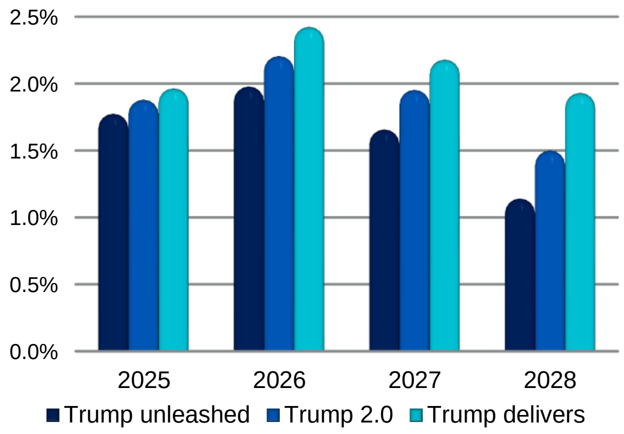
It takes time for these differences to emerge, with changes in tax policy likely to come after a lengthy reconciliation process in the latter stages of 2025 and other shifts in immigration and regulatory policy to take time to materialise. Tariffs on China can come into force in early 2025, but broader measures will need to move through lengthy USTR investigations or be slotted into the tax reconciliation bill.

However, we think from 2026 we will see the economy start to be more materially influenced by policy shifts. In our base case, fiscal loosening and deregulation help to raise real GDP growth that year, more than offsetting the drag from tariffs.

However, we think this boost will fade from 2027, with immigration policy weighing on potential growth. Accordingly, we forecast a deceleration in GDP growth through 2027 all the way down to a soft looking 1.5% in 2028 (see Figure 8).

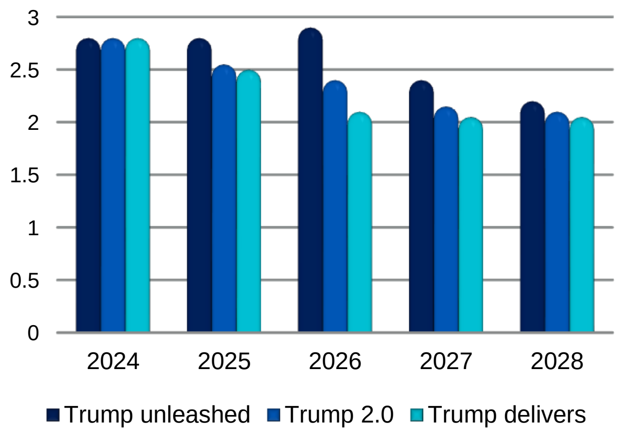
Our base case inflation forecasts are also now higher. Higher tariffs shock the price level higher in 2025 and into 2026, although we think this effect will be modest at around 0.1-0.2 percentage points. Adding to this is stronger short-term demand and lower labour supply. We think these effects leave core inflation running around 2.5% in 2025 and 2026 (see Figure 9).

Figure 8: GDP growth forecasts



Source: abrdn, Haver, November 2024

Figure 9: Core PCE inflation forecasts



Source: abrdn, Haver, November 2024

The growth and inflation mix in the 'unleashed' scenario is more negative. Large fiscal loosening and deregulation should support demand in 2026, even if this is dampened by crowding out effects in an economy near full employment. However, large negative supply shocks via higher tariffs and aggressive deportations dominate, especially into 2027 and beyond. This growth hit could be particularly pronounced in sectors reliant on immigration, such as agriculture and construction.

The scenario would also involve a bigger increase in inflation. We think tariffs would add around 1 percentage point to the level of core inflation between 2025 and 2027, with wage and other cost pressures exacerbating this impulse. Core inflation would reaccelerate to around 3%.

In 'delivers', the forecast profile looks healthier. The drag from tariffs and deportations is almost negligible, and growth benefits from tax reform and deregulation. Moreover, this combination is much less inflationary.

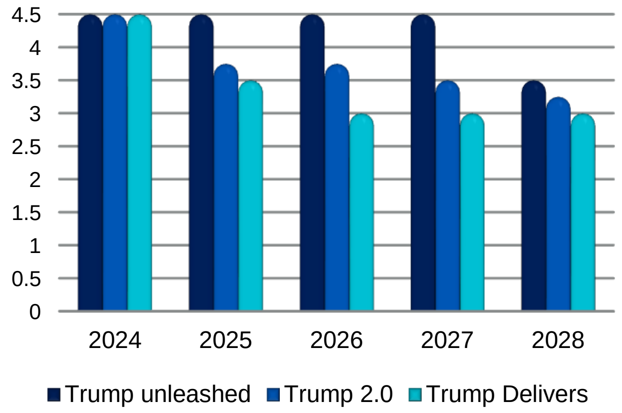
The outlook would be broadly similar to the soft-landing environment that markets had anticipated ahead of the election.

A difficult balancing act for the Fed

In the near term, elevated policy uncertainty means the Fed will probably be a little more cautious around policy easing. While Chair Jay Powell argued that the Fed should not speculate on possible government policy changes when setting rates, Fed policymakers will surely judge that the risks around inflation have increased.

In our base case, we now forecast the Fed to deliver fewer rate cuts than we had previously expected. We expect three cuts next year, before the fed funds rate settles around 3.5% through 2026. There may be scope for further modest loosening in 2027 as the effect of tariff increases falls out of inflation rates and the boost from fiscal stimulus fades. This could see rates land at around 3% in the longer run.

Figure 10: Fed funds rate forecasts



Source: abrdn, Haver, November 2024

President Trump might criticise this caution, putting pressure on the Fed to cut more. However, in our base case we don't think this will mean an attempt to fire the chair before his term expires in 2026. Thereafter we think the new chair will be broadly credible.

However, our 'unleashed' scenario represents a more difficult environment for the Fed.

First, it will need to balance the large and competing effects of stronger short-term demand and negative supply shocks. This environment would leave little room for cuts and could even see the market speculate about the need for hikes (see Figure 10).

Second, the push-back from Trump on this policy approach would be more aggressive, particularly if the dollar appreciates more markedly.

So, the president may attempt to fire Powell, triggering a legal standoff and institutional uncertainty. Alternatively, Trump could announce a shadow chair who signals a much more dovish reaction function and is lined up as the new Fed chair in 2026.

This could prompt significant market volatility and higher inflation expectations and term premia.

The 'delivers' scenario would be less bumpy. The Fed would have more room to ease, mitigating the strength of the dollar, and quieting Trump's criticism. Moreover, in this scenario Powell's replacement would presumably be a highly credible individual.

What to watch?

Ahead of inauguration and in the early stages of Trump's term, we will be watching a few waymarks to see which scenario is materialising.

First, Trump's nominations will give a sense of his policy priorities, with more "anti-establishment" candidates raising the risk of a more disruptive presidency.

Second, the willingness of the Senate to confirm these appointments will demonstrate how malleable it is to Trump's demands. Pushback would lower the risk of the 'unleashed' scenario.

Third, Trump's policy priorities in his first 100 days will indicate how aggressively he is following through on campaign promises. Faster action around trade and immigration policy, in which he has executive power, might indicate a desire to deliver more fully on campaign commitments.

Authors

Lizzy Galbraith and James McCann

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