Brian Lynn, C.P.A., P.A.

Certified Public Accountant

Two South University Drive, Suite 215
Plantation, Florida 33324
Broward: (954) 474-1111
Dade: (305) 940-1878

E-Mail: Brian@BrowardCPA.com
Website: www.BrowardCPA.com
Fax Transmission: (954) 474-5373

January 20, 2014

2014 ECONOMIC FORECAST

The Long-Term Demographic Implications On The Global Economy

The Midterm Elections

A government shutdown has been averted with the passage of the Bipartisan Budget Act. This is the first budget agreement since 2009 and postpones the budget/fiscal debates until 2015. The Act provides a cap of approximately $1 trillion of discretionary spending for the current fiscal year and $63 billion in sequester relief over two years, financed by other budgetary savings and revenues. Against the backdrop of the November midterm elections, our dysfunctional Congress is unlikely to address our country's economic pro-growth and other needs. Although the Act is silent on the debt ceiling, the government is expected to run out of money by January 31st. A repeat of a possible U.S. debt default crisis remains unlikely. Raising the debt ceiling is merely a procedure allowing the government to pay for the accrued expenses previously approved by Congress. So there is no misunderstanding, no political party has ever held the government hostage, using the debt ceiling as leverage until the fiscally irresponsible Tea Party members and the remaining majority of the Republican conservative base employed this tactic.

The President is at his lowest approval rating of 41% during his five years in office given his Obama Care incompetency. On the other hand, Congress, with its 9% rating is approaching the lowest point in our history. Notwithstanding these numbers, the Democrats actually are ahead in the polls after the Republican induced government shutdown. On a historic standpoint, midterm elections favor the opposing party of a sitting president, especially when it is his second term. The entire House of Representatives, 35 seats in the Senate and 36 Governorships are up for election this fall. A six seat swing in the Democratic controlled Senate would give the Republicans control of both houses and with it a lame duck presidency. Democrats will control both Houses and the White House if they win an additional seventeen seats in the Republican controlled House. What makes this midterm election different from all others is the fact both parties have an uphill battle from their own primaries rather than the midterm elections itself. However, the Republicans have the benefit from redistricting and low voter turn out. At this early stage, the odds favor a Republican House and a Democratic Senate. Generally, the government runs better when no party is in control.

However, if a status quo is elected, then we can expect little to be accomplished over the next two years. As such, it would take a miracle for Congress to act on the following:

- Extend unemployment insurance for the 1.3 million unemployed
- Raise the minimum wage for income equality
- Pass the Transportation & Infrastructure Bill for pro-growth and job creation
- Readjust the Affordable Care Act
- Tax reform for pro-growth and job creation
- Immigration reform

Republican advertisements are blaming the President for our subpar growth. Contrary to their belief, as I stated in my prior Economic Forecast, 2013 would be the year of the turning point in our recovery, and it was. **In sum, if the economic conditions continue to improve, the Democrats could possibly take control of the House.**

The rise and fall of civilizations and economic cycles are directly associated with demographic trends. Economic prosperity has always been fueled by population growth. Domestically, the tides have turned to the downside given the 78 million baby boomers entering their retirement years. These trends are so profound that we not only have to address the estimated $120 trillion of unfunded liabilities associated with Social Security, Medicare, federal pensions and health care costs, but suffer the consequences of the demographic induced subpar economic growth (GDP) over the long-run.

The negative impact of these demographic trends will be a major drag on GDP and will affect the world at different times over the coming decades. Japan, the world's third largest economy, has the oldest population on the planet. Their economy has remained in protracted deflationary stagnation for decades. The advanced economies consisting of the U.S. and Euroland are approaching their early stages. While the mature developing countries such as China, Russia, Brazil and India will succumb to these trends over 20 years. On the other hand, the emerging economies are experiencing uncontrollable population growth that continues to place enormous stress on their limited resources. It is expected that the Islamic population will become the majority in France by 2020 and be equal to that of the industrialized world by 2050. The CIA believes these trends to be a clear and future danger to both the United States and world stability. These trends support the proposition that societies that are more educated and encompass a higher per capita GDP produce less children.

On the upside, and in the distant future, say thirty-five years, Generation Y will be our demographic redemption in the developed world. This competitive and highly educated generation was born in early 1980 through 1991 and represents approximately 80 million people. This generation will produce the greatest baby boom in our history. This will occur in Euroland and ultimately to a lesser extent in Japan. Against the backdrop of almost 80 million babies being born through 2025, global aggregate demand will rise dramatically and with it, assets of all classes should benefit. On or about 2050, governmental deficits should become surpluses and their fiscal and monetary imbalances should start to unwind. On the downside, the United Nations report projects a 33% increase in world population growth by 2050 primarily in the developing economies, especially Africa. A projected 9.6 billion people will place massive pressure on commodities and water may become as valuable as oil. **Either way, the long-term demographic implications on the global economy should turn positive in the 80 year economic cycle of life.**

State of the U.S. Economy

2013 represented the turning point of our recovery after surviving the most severe recession in post World War II history. The economy has demonstrated subpar growth in an environment staid with domestic political uncertainty and global risks. When all is tallied, GDP should exceed 2.5%. This still remains less than the prerequisite 3% necessary for healthy job creation. On the other hand, if you eliminated the negative impact of the Republican induced government shutdown, GDP may have actually reached 3%. The essentials for growth and prosperity are based on the expansion of consumption whether by governments, businesses or consumers. However, since the great recession, there have been the simultaneous deleveraging and austerity measures instituted throughout the developed world causing a contraction in the demand side of the equation. Notwithstanding this tenacious economic environment the U.S. economy performed reasonably well. It appears the underlining economic fundamentals for continued growth are falling in line as follows:

- With the **inflation rate** below their 2% target and excess capacity still a drag in the economy, the Fed's monetary policy will remain extremely accommodative for at least two years or possibly three.

- **The banking sector** is the epitome of health. Their reserves expanded as the direct result of the Fed's bond purchasing program. The top six banks net income rose 21% even after enormous litigation costs. However, the access to credit has grown more difficult. As President Truman once said "the banks won't loan you money unless you can prove to them you don't need it."

- **Corporate America** has demonstrated solid earnings in an otherwise precarious economic environment. This was accomplished by enhancing their margins from cost cutting rather than top line revenue growth. However, in 2013 their margins had peaked and they will need to rely upon gross revenues going forward. Against the backdrop of uncertainty, they were reluctant to expand both their employment base and capital spending. As the global economy recovers, this trend should reverse. Corporate America's balance sheets are so flush with cash that Goldman Sachs is estimating stock buybacks to the tune of $450 billion.

- **The consumer sector** continues to make progress in deleveraging whether it is voluntary or involuntary. Their debt service burdens are at record lows. Given the bull market and improvement in the housing sector, their household wealth has surpassed their pre-recession values. Their wage growth, even though anemic exceeded the rate of inflation. In addition, 98% of consumers will not be affected by the Taxpayer Relief Act. Consumer spending is more likely to accelerate given their pent-up demand and gains in disposable incomes. Retailers will be the ultimate beneficiaries.

- The persistent **unemployment rate** ended the year at 6.7%. Approximately one percentage point less than the last year. However, this rate is clearly distorted. Once it is revised, the rate will probably be 7.1%. There still remains about two million fewer jobs since the recession started. On the upside, and what may be a reasonable indication of the future, both November plus December produced 274,000 jobs. 2014 may generate an unemployment rate of 6.75%. On a theoretical standpoint, economists believe that the 5.4% unemployment base rate represents our economy at full employment. I contest this belief. In our modern economy due to technological productivity gains, there will be many in our work force that will be unemployable. As such, I believe this rate should be 6.5%.

- The **housing sector** has demonstrated gains in both existing and new home sales and building startups. Against the headwinds of higher mortgage rates, gains will continue but at a more moderate rate.

We welcome Janet Yellen, our newly appointed and first chairwoman of the Federal Reserve. Her policies, called "Yellenomics" consists of easy money in an environment where inflation is well below the Fed's target and persistent high unemployment is primarily attributable to weak demand rather than a structural contraction in labor supply. The Fed will do whatever it takes to reflate demand. With Yellenomics, the Fed's fund rate will probably remain at close to zero even after the economy reaches the threshold unemployment rate of 6.5%. Given her bias to monetary ease, we shouldn't expect any increase in the Fed rate for the next 2 to 3 years. The Fed's tapering and ultimate reversal of their quantitative easing program should not imply a future change to their interest rate policy but should rather be interpreted as improved economic conditions. The reversal of quantitative easing may have little impact on inflation and the overall economy since the liquidity wound up in bank reserves. As such, it is possible the equity markets will rise rather than the general consensus that they will fall.

In sum, although it remains an uncertainty, I find it difficult to argue that the Republican controlled House of Representatives will create another debt ceiling crisis given the upcoming midterm elections. The government has addressed our unsustainable debt trajectory in a manner acceptable to the credit rating agencies but not to certified public accountants. From the birth of our nation to Jimmy Carter, our national debt was actually less than $1 trillion. Our current national debt is $17.3 trillion excluding $120 trillion of unfunded liabilities. We became the **Great American Debt Society** primarily from the fiscally irresponsible Republican administrations spending habits. On the upside, our congressional obstructionists managed to set aside their differences and pass the Bipartisan Budget Act of 2013. The sequester relief provision will have the positive effects of reducing the fiscal drag on the economy and enhancing GDP. For the last fiscal year, the U.S. deficit fell dramatically to $680 billion as compared to the $1.1 trillion in the year before. The majority of this enormous improvement was sourced from higher receipts that surpassed all expectations. Once the uncertainty associated with debt ceiling is resolved, both business and consumer confidence will surge and with that consumer spending. Corporate America will follow suit and our persistent unemployment will benefit. Absent an implosion in Euroland and any geo-political and/or natural disasters, GDP may very well trend to 3% or more. On the downside, once the demographic consequences associated with the retirement of the 78 million baby boomers takes hold, GDP will trend between 2% to 2 1/2% until Generation Y redeems us in thirty-five years. 2013 was in fact the turning point of our recovery. **The odds favor the U.S. economy continuing to surprise on the upside against the backdrop of improving global economic fundamentals.**

State of the Global Economy

The world is in the midst of a sustainable below trend economic expansion that has the potential to surprise on the upside.

Euroland, with the exception of Italy, has survived their double-dip recession. The European Central Bank (ECB) became the lender of last resort and prevented bank failures and reversed the sovereign debt crisis. Euroland is destined to anemic GDP growth given its enormous debt burdens, economic imbalances between the members of the north vs. the south and the demographics associated with an aging population in the long-term. Either way, the EU members need to find and legislate solutions to their structural fiscal imbalances associated with the enormous disparity in their economies of scale. Otherwise, the euro may be destined to fall apart. The severe austerity measures forced on their southern members will continue to undermine growth and further exacerbate their unemployment crisis and with it, fears of deflation. At best, their GDP will be 1½%. **Euroland is so fragile that a triple-dip recession cannot be ruled out.**

Japan has been trapped in a protracted deflationary stagnation for 20 years. They have the worst demographics on the planet consisting of the oldest population in the world. Their Prime Minister Shinzo Abe instituted massive fiscal stimulus, aggressive monetary easing and structural reforms to boost trade. These measures were appropriately named “Abenomics". The results were encouraging with the Nikkei rising 57% and the yen falling 20%. Although, Abenomics missed their inflation target of 2%, their central bank will do whatever it takes to achieve that target. In my 2013 Economic Forecast I had recommended Japanese equities as a contrarian play. **Given these policies and a weakening yen, Japan GDP could enter positive territory for the first time in 20 years producing growth of 1½%.**

China's double digit economic growth is no longer attainable in this global environment. Against the backdrop of slower global demand, China's export sector severely contracted. Its currency has risen to fair value making their exports even more expensive. Their cost of labor continues to rise eroding their global competitiveness. Their housing sector remains in a bubble fueled by speculation and easy credit. The government continues to struggle with its transformation from an export to a consumption-based economy. The belief that China would suffer a financial meltdown is unfounded. The government holds all the monetary and fiscal cards necessary to deal with any financial crisis. The odds clearly favor a soft landing. China should produce GDP between 7 1/2% to 8 1/2%. On a long-term perspective, China's GDP will trend lower given the demographic issues associated with their one child per family policy.

In sum: Notwithstanding the forecast remains encumbered with risks and uncertainties, global growth will trend a bit higher producing 3 3/4%. This global expansion will be driven by the developed economies and primarily by the U.S. On the upside, monetary policy will continue to be extremely accommodative and even to some extent aggressive in this environment that appears to be more deflationary rather than inflationary. The price of oil will trend lower given the technological advancement on the supply side associated with U.S. based shale production. Infrastructure fiscal policies in some countries should offset the austerity measures in others. The pace of consumer sector deleveraging is slowing. Although remote and on the downside, if Euroland suffers a triple-dip recession, the euro could collapse, international trade would plummet and all bets would be off the table. **Absent any geo-political and/or natural disasters, the global economy will accelerate and probably surprise on the upside.**

Geo-Political Risks

Geo-political risks are measured by their potential affect in the financial markets. Conflicts in the Middle East have intensified given both the civil war in Syria and the military coup in Egypt. The Syrian conflict has infected Turkey, Lebanon and Jordan. Iraq will not be immune. On the positive sides, first, there is no U.S military intervention and a negotiated chemical weapons disposal agreement is being enforced. Second, Israel won't have to bomb Iran so long as their nuclear aspirations are resolved diplomatically. And third, there is a renewed peace process in the Promised Land being driven by Senator Kerry. Demographic trends in this region have dictated continuing political instability, tribal feuding, chaos and terrorism. With all this turmoil in the Middle East, there was virtually no interruption in the supply of oil. However, the greater risks may very well lie in Asia. Tensions continued to mount between China and Japan over the disputed ownership of some islands in the East China Sea. The issues relate to air defense ID zones and fishing rights. This has caused a contraction in trade between the two countries costing billions. China even attempted to create an international incident with their near miss collision of navy vessels in the China Sea. North Korea remains a wild card since we never know what to expect. In addition, both southern Euroland and many emerging economies will face protests and rioting against the backdrop of disappointing economic performances and severe austerity measures. These world disorders raise both the climate and environment for future crisis, chaos and conflict. The cost of controlling these disorders depletes our global limited economic resources and impairs our living standards. **There is no prosperity without world peace.**

THE 2014 ECONOMIC FORECAST FOLLOWS:

So there is no misunderstanding all financial investment analysis and specific investment recommendations must be discussed with your financial advisors.

2014 Economic Forecast

The equities performance can be summed up in one word, surrealistic. The Dow and S&P 500 attained new historic highs while many investors sat on the sidelines and missed this opportunity. The market appears to have agreed with my belief that 2013 would be the turning point in our recovery. The Dow closed the year at 16577 producing a phenomenal 27% rate of return in a year of domestic political uncertainty and global risks. The S&P 500 closed at 1848 generating a spectacular 30% annual return while the NASDAQ closed at 4177 procreating a mind-boggling return of 38%. Last year, I predicted both the Dow and S&P 500 could possibly surpass their 2007 all-time highs. They not only did but dramatically exceeded my own expectations. On a technical perspective, the prerequisite for a bull market rests in equity valuations, earnings expectations and abundant liquidity. There are many that believe the market is extremely overvalued and even in a bubble. Goldman Sachs predicts a 67% chance of a 10% correction sometime during the year. One can not argue that both earnings and margins are at advanced levels at this stage in the cycle. However, equities have done well after their margins have peaked. Corporate America has a tendency to surprise on the upside and its top-line revenue will accelerate along with the global economic expansion. Notwithstanding the Fed's planned tapering of quantitative easing, in a low-yield world investors will continue searching for higher returns favoring risk assets. In this environment of easy money, benign inflation and sustainability of strong corporate earnings, equities are more likely to rise rather then fall and will probably surpass our expectations. **On the downside, a correction is probably imminent.**

In sum, the central bank's monetary policies throughout the developed world are encouraging investors into reflation trade strategies, ones that favor stocks over bonds. Against the backdrop of a pending correction, equities will still outperform all other asset classes. With respect to markets, in the developed economies it is more likely Euroland will surmount the U.S. given their upside prospects. Although the economic fundamentals in Japan are showing signs of improvement, their superior equity gains occurred in the early part of last year and were partially offset by currency losses for the remainder of the year. Even though the yen will continue to fall, Japan may prove to be a profitable contrarian play. Since the commodity bull market has ended, Canada and Australia should be avoided until China's economy becomes red. Stay away from corrupt Russia. With respect to the emerging economies, it is more likely 2014 will be a repeat of last year. They will continue to suffer from earnings disappointments and capital outflows. Brazil is on a precipice to a recession. On the other hand, there are a few bright spots consisting of Mexico and China, more specifically Chinese consumer discretionary. In an environment that is more deflationary rather than inflationary cash flow is king. As such, your primary objective should be investing in high-yield dividend equities in companies with a consistent track record. Investors should first consider overweight positions in IT, consumer discretionary and industrials; second, neutral positions in financials, health care and materials; and finally underweight positions in defense, consumer staples, utilities and telecom services. In the energy sector consider U.S. refineries and manufacturers of fracking equipment.

Absent any geo-political and/or natural disasters, the forecast assumes continued improvement in Euroland's economic growth. Against this backdrop, the Dow will trade between ranges of 15,000 and 18,600 closing the year at 18,000. The S&P 500 and NASDAQ may close the year at 2,125 and 4,900 respectively. The trading year will be one of a bit more pronounced volatility. There is a 50/50 chance the market will be temporarily impaired by a 10% correction that could occur anytime during the year. This will represent a buying opportunity rather than a bear market.

Interest rates: Yellenomics dictates the Fed rate will remain close to zero while inflation stays below their 2% target even if our persistent unemployment falls below 6.5%. We may not see a Fed rate hike until 2016. It is more probable long-term rates will rise along with an improving global economy and domestic housing activity. The 30-year and 10-year treasury yields closed the year at 3.94% and 3.03% respectively. Both rates may rise by 75 basis points at best. While the 30-year mortgage rate closed the year at 4.45%, it may very well rise between 5% and 5 1/2%. Although this rate is still low on a historical standpoint, it will have a negative impact on our housing sector. **The bond bull market has ended in this environment of rising yields.** Investors should consider investment-grade and high-yield corporate bonds of a shorter duration. On a long-term basis, global government bonds continue to be less captivating especially if the dollar trends higher. In addition, U.S. Treasurys also appear less compelling with the exception as a safe haven investment.

Municipal bonds: Last year these bonds suffered their worst performance since 2008 in this environment of rising yields. This downward trend will continue as rates continue to rise. We have witnessed the Motor City's demise. This was the largest municipal bankruptcy in U.S. history, goodbye Detroit. Although the yields on high-quality bonds are lower than a year ago, their fundamentals clearly remain solid. On the upside, state governments are required to balance their budgets, there has been great success in deleveraging and their coffers are being replenished with an expanding tax base. On a cash flow basis, high-quality municipal bonds will always remain a safe investment so long as investors can hold these bonds to maturity.

The U.S. Dollar: The rise in the U.S. dollar was associated with global weakness. No country wants a strong currency during a recovery. The dollar should rise against the Japanese yen, and fall against the Euro, the Chinese renminbi and the Indian rupee. This will benefit our export sector. Either way, as our economy expands so will our demand for imports and with it, our current account deficit. Although the U.S. dollar bear market remains intact with many years to run, the dollar will remain the global currency of choice.

Gross Domestic Product (GDP): When all is tallied, our domestic 2013 subpar growth should come in about 2.5%. Given the improving domestic and global fundamentals, our GDP should trend above 3% and possibly more while global GDP should approach 3.5%.

Inflation/Deflation: The world appears less deflationary than one year ago. Deflation is the most destructive underlying force in any economy. The fed has been extremely successful in battling deflation with its limited powers consisting of aggressive monetary policy and their inflationary injection known as quantitative easing (QE). At this stage in the cycle, core inflation remained at 1.8%. So long as this rate remains below 2% and both unemployment and excess capacity shows signs of unwinding, the Fed will start tapering off their QE bond purchasing program possibly by the end of the first quarter.

Gold/Silver: The golden bear market is upon us and could last a decade. Gold closed the year at $1202 per ounce and silver closed at $19 per ounce making these precious metals the worst performers in 2013. They lost a despicable 28% and 37% in value respectively. In my last year's forecast, I was clearly too optimistic. At best, gold may possibly close 2014 at $1000 per ounce and silver at $16 per ounce. The reasons for this tragedy are as follows:

- An environment of low inflationary expectations
- Abating global uncertainties
- Massive exodus of funds from precious metal ETFs moving into equities
- Slowdown in China
- India’s regulated importation restrictions

Other Commodities: The commodities bear market remains intact. Both hard and soft commodity prices continue to be victims of over supply and technological advancement, such as fracking in the U.S. and its effect on natural gas prices. Only a substantial expansion in global activity, especially in China, can reverse this trend.

Oil and Gas: The demand for oil has retrenched against the background of ample supplies. The price per barrel closed the year at $98 and probably will trend higher to $105 as the global economy picks up momentum. The U.S. is on the road to energy independence and will probably overtake Russia to become the world's number one net-exporter of petroleum products. This will have profound political ramifications in the Arab world. The turmoil in oil still rests with Iran. A diplomatic solution with Iran would eliminate the risk premium paid per barrel and substantially improve the supply side of the equation. And with this, the price of oil will fall. The gas bear market remains smelly given excess supply. The price per million BTU closed the year at $4.45 and probably will trend between $4.75 and $5.25 in 2014. Since crude oil is traded in U.S. dollars, the long-term perspective for this commodity remains bullish.

Real Estate: New construction and sales of both new and existing homes will continue to rise but at perhaps a significantly slower rate as compared to 2013. On the upside, new construction is not enough to keep up with a growing population. Demographic issues combined with pent-up demand should both act as a catalyst for new home construction. On the downside, the appreciation of home values will moderate, but they were enough to eliminate both foreigners and speculators from the market place. Furthermore, rates are rising and mortgages are only available to those with larger down payments and good credit scores.

Either Way, I remain optimistic about the outlook.