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 15, 2015

2015 ECONOMIC FORECAST

The turmoil in the price of oil

Is the world on a path to disaster?

THE CASE FOR A LIVING WAGE

Capitalism by nature breeds wealth and income inequality. Based upon an article in Politico Magazine, its author Nick Hanauer advocates a living wage of $15 per hour. I have to agree with his findings. The problem at large is the fact that this disparity in wealth and income has reached historic proportions and that it may rise exponentially. In the U.S., the top 20% of income earners own 90% of privately held wealth. No society can sustain this kind of rising inequality against a background of a vanishing middle class and where more than 50% of the society continues to suffer a contraction in real wages. I have always asked my fellow advisors, where are all of the consumers? Henry Ford had it right and understood that raising his employees' wages would enable them to buy his cars and become consumers. However, the Republican's montra dictates that raising the minimum wage will force businesses to lay off workers. All I can say is their belief is totally unfounded. In this current economic cycle employers are operating with bare bones labor in order to maintain their bottom lines. If the minimum wage was increased it would force the employers to pass all the additional costs to their customers or otherwise absorb a portion themselves. When costs are passed on to consumers, basic economic principles call this cost-push-inflation. This is the key part to the argument that Nick Hanauer did not consider. The world is descending into a deflationary cycle. The best way to fight deflation is to create inflation. This will help the Fed reach its 2 1/2% inflation target. The Republicans also believe the government is too big. To reduce its size, they would cut government spending rather than reduce the need for government. Imagine for the moment a $15 per hour minimum wage. These workers would no longer need food stamps, health insurance subsidies or qualify for Medicaid. Federal and state governments would enrich themselves by collecting more payroll and sales taxes. Given their increase in disposable income, consumer consumption would rise and with it, both corporate profits and capital spending**. This is the way to create American prosperity rather than the alternative consisting of crisis, chaos and conflict and on a long-term perspective, revolution.** It appears quite remote that the Republican controlled Congress would ever increase the minimum wage to a living wage. Currently, there are 25 states considering raising their minimum wage, but probably not to the extent necessary. On the upside, both San Francisco and Seattle had complete success in raising their minimum wage to $15 per hour. **The time for change has come, so we need to contact our Federal and State legislative representatives.**

State of the U.S. Economy

The economy has surprised on the upside demonstrating in-trend growth after surviving the most severe recession in post-World War II history. When all is tallied, Gross Domestic Production (GDP) will average a bit less than 3%. The prerequisite for growth and prosperity lies in the expansion of both credit and consumption whether by governments, businesses or consumers. However, since the Great Recession there has been the simultaneous deleveraging and austerity measures instituted throughout the developed world causing a continued contraction and deterioration in aggregate demand. Despite these deflationary implications, the U.S. economy outperformed the rest of the world and maybe the only catalyst left to global prosperity. As such, let's discuss the economic factors affecting the U.S. economy for both 2014 and 2015 as follows:

- **The Federal Reserve's** monetary policies will remain extremely accommodative into 2015 even though inflation is well below their target of 2.5% and unemployment is below 6.5%. In October, the Fed terminated their quantitative easing/bond purchasing program that substantially increased both the money supply and the Fed's balance sheet without creating more core inflation.

- **The countries six largest banks** have been the greatest beneficiaries of the Great Recession and quantitative easing (QE). They have seen their stock values more than triple since the beginning of the Great Recession against the backdrop of their profits generated from the Fed's bailout and low interest rate loans. Although they remain well capitalized and flush with cash, access to credit is primarily available to the most credit worthy borrowers. On the upside, there is some improvement in credit availability . However, on the downside, tighter regulations on home mortgages have curtailed lending and subprime auto loans have become a new bank revenue source.

- **Corporate America** continues to demonstrate healthy earnings. For how long is the question? In a world of contracting aggregate demand, they had to rely on cost cutting rather than top line revenue growth. Their short-term strategy consists of repurchasing shares and increasing dividends to appease shareholders rather than the long-term commitment for hiring and capital spending to improve productivity. Although profits will benefit from lower energy costs, they will be severely impacted by the effect of the stronger dollar in an environment where world trade is contracting.

- **The consumer sector is** the primary beneficiary of our falling gasoline prices. This will bide well as an enhancement to their disposable income especially for the majority of consumers who are barely making ends meet. **We have an enormous income inequality that is at historic levels and getting worse with monumental geopolitical consequences.** The majority of consumers are actually making less than before the Great Recession on an inflation-adjusted basis. Even though there has been an improvement in both consumer confidence and spending, when the Christmas retail sales are tallied, 2014 will probably come up short compared to the prior year.

- **The unemployment rate** continues to unwind ending the year at approximately 5.6%, about one point less from last year. As per the Bureau of Labor Statistics, when you take into consideration people without jobs for more than six months and those who had to settle for part-time positions, the underemployment rate is more like 12%. Due to technological advancements that have replaced labor; I contend the unemployment rate should be 6.5% rather than the 5.4% the government considers for an economy at full employment. In 2015, it is even possible the rate may rise rather than fall.

- **The housing sector** homeownership rate collapsed against a backdrop of tighter mortgage lending regulations. The demand from first-time homebuyers, who are straddled with student loan debt, severely contracted due to both affordability and their inability to qualify for mortgages. It is no longer a seller's market. Values will continue to grow but don't expect double digit gains. On the upside, effective for 2015, Freddie Mac and Fannie Mae may start buying loans with 3% down payments.

In sum, your perspective of both the state of the U.S. economy for 2014 and forecast for 2015 will depend upon your financial position in life. If you are in the top 10% of earners you will say "life is good" against a backdrop of both enhanced earnings and wealth. If you are in the next 20% of earners, you probably will still be very happy. After all what could go wrong? The markets have climbed to all-time highs and the government implied the economy was in good order. Finally, the Republicans took control of Congress. However, if you are in the bottom 70%, you will feel like you're still in the Great Recession. If you're not one of the 9.1 million of unemployed and have a job, your net paycheck barely covers your basic living expenses. As such, on the domestic front, our growth trend cannot continue in a global environment that is clearly more deflationary rather than inflationary especially while economic activity is slowing throughout the entire world. Absent an implosion in Euroland and any geopolitical and/or natural disasters, our GDP at best may very well trend between 2 1/4 % to 2 3/4% in 2015. **On a long-term perspective we face the enormous financial costs associated with the following:**

- From the birth of our nation to Jimmy Carter's administration, our national debt was less than $1 trillion. Our unsustainable national debt trajectory has now breached $18 trillion.

- Our fiscal cliff looks more like Mount Everest when adding in our country's potential $100 trillion of unfunded liabilities consisting of the 21st Century Social Security and Medicare Panic and the related demographic issues associated with the retirement of 78 million baby boomers. It is apparent we have sadly become the **Great American Debt Society**.

- The **Debt Supercycle** has finally come to an end after decades of credit expansion. The government's monetary policies have failed to generate enough borrowing to create another credit cycle. Against the backdrop of restricted fiscal spending, the government has limited policy levers in their arsenal to stimulate the demand side of the economic equation.

Although the odds appear against us, the U.S. economy, the largest in the world, has been resilient on a historic basis tends to surprise on the upside.

State of the global economy

The global economy is on a down bound train with many developed countries approaching deflationary derailment. With exception of the U.S., global economic activity is contracting simultaneously throughout the entire world. The corporate sector remains reluctant to expand both their employment base and capital spending. While on the other hand, the majority of consumers have suffered a decline in real wages and are not willing to take on any more debt. In the developed economies, the governments have instituted severe austerity measures without considering any plans for economic growth. This creates a prescription for disaster and this trend will continue in the long-term. Economic principles dictate that when demand contracts and supply remains the same the price/value will fall. When this spirals out of control this represents the theory behind deflation.

- **Euroland is destined for a threepeat recession.** Against the backdrop of their enormous debt burdens, severity of the austerity measures instituted, protracted unemployment and continued retrenchment in both consumer and capital spending, Euroland will become infected by deflation. The European Central Bank (ECB), the lender of last resort," will do whatever it takes" and will expand their QE program to include the purchase of sovereign bonds. Further on the downside, there will be national elections in both Greece and Spain where it is expected the anti-austerity parties will win given the discontent in both countries where unemployment is currently at almost 25%. If the EU members fail to legislate growth solutions to their structural fiscal imbalances associated with the enormous disparity in their economies of scale, it is possible that members may leave the Union and/or the Euro could collapse. On the upside, the Bank Credit Analyst has indicated that the IMF is considering reversing their position and will promote fiscal spending on infrastructure rather than requiring the implementation of severe austerity measures. This is the only way to prevent the deterioration of aggregate demand and economic stagnation throughout the developed world.

- **Japan has the worst demographics on the planet consisting of the oldest population and with it the most fragile fiscal position in the world**. It has been in a severe recession for decades and remains trapped in a period of protracted deflationary stagnation. Their Prime Minister instituted the first round of "Abenomics" consisting of a $29 billion fiscal stimulus package, aggressive monetary easing and structural reforms in order to promote trade. The Yen fell, GDP went negative and the consumption tax hike was postponed to October 2015. The probability of success for the second round of "Abenomics" remains remote. Given these policies and a continuing weakening Yen, Japanese GDP would be lucky to enter positive territory for the first time in more than 20 years.

- **China continues to make progress in unwinding their real estate sector excesses in the hopes of avoiding an economic hard landing.** Although they remain threatened by the enormous debts created during the period of speculation and easy credit, the belief that they may suffer a financial meltdown is unfounded. Their banks are primarily government owned and they have all the monetary and fiscal cards necessary in which to avoid any financial crisis. The country remains committed in its transition from an export to a consumption-based economy. Their exports will continue to contract in this deflationary global environment. The odds still favor a soft landing. Their double digit growth is something of the past. Although they should attain a commendable 7% GDP, on a long-term perspective, their demographic issues associated with their aging population will become a drag on future growth.

- **Commodity based economies will severely contract against the backdrop of the collapse in oil**

prices and the otherwise bear market remaining intact. Russia, already under sanctions from the west, resulting from their Ukrainian affair, has witnessed their currency meltdown losing 41% of its value versus the U.S. dollar. Russia will suffer a painful recession. Brazil, with the weakest president in history, a stagnant economy and corruption scandals will follow suit. Venezuela, already in a recession, without a functioning private sector, has the highest inflation rate in the world at 64% and will probably default on its debt obligations. Literally, the commodity based economie s are running on empty.

In sum and notwithstanding the benefits derived from the lower cost of oil, global GDP will disappoint on the downside. When you consider the slowdown in China, Russia destined to a severe recession, Euroland entering a triple-dip recession and Japan remaining in protracted deflationary stagnation, you should expect global GDP to come in below trend, say 3% at best. Given the developed economies deleveraging, fiscal restraint and monetary policies that were unable to promote borrowing, their governments will have limited economic cards to play. This economic environment could even trigger a liquidity trap. In substance, the Debt Supercycle has come to an end, and with it, the potential for disastrous financial implications. **Global growth appears to be solely dependent upon the uncertainty of the U.S. economic expansion.**

The turmoil in the price of oil

Both the deflationary and geopolitical implications of the collapse in oil prices are extremely profound. The United States is undergoing its energy industrial revolution as the result of fracking. This technology is so far-reaching that the U.S. has become a net energy exporter. The crash in prices is primarily due to the oversupply created by the U.S. producing more, the Saudis refusing to produce less and the retrenchment in global demand. I can only speculate the Saudis want to disable the U.S. production. The Saudis recognize that U.S. fracking is no longer profitable when oil is priced at $50 per barrel. Notwithstanding the negative global deflationary implications, lower oil prices are good for consumers/importers and bad for producers/exporters. Oil producing countries will stop production when it is no longer profitable creating additional unemployment and potential corporate bankruptcies. The price of oil in the near-term has a far greater downside, say $35/barrel. Morgan Stanley claims oversupply should peak sometime by mid-2015 and the price will trend upward to close the year at $82 a barrel. The curtailment of production will ultimately lead to a supply shortage and higher prices down the road. Either way, the price of oil will primarily be controlled by the Saudis. In the event my belief is incorrect and the collapse in price is solely due to oversupply , then the price will rise in the near-term as the excess inventory is absorbed in the marketplace. In my last year forecast, I indicated the price of oil would trend lower due to the supply side of the equation. I never suspected a complete collapse. **The geopolitical implications represent a clear and present danger to the world.** This will place many oil exporting countries on the brink of financial disaster with the potential of creating chaos and conflict in a world that is already in disorder. You never know what countries like Russia and Iran will do when their economies are held hostage against the backdrop of a self-inflicted Saudi oil crisis along with the continued economic sanctions. Venezuela's regional influence is evaporating along with their oil dependent economy. They have failed to reinvest in oil refineries and their mismanaged production is retrenching. Why do you think Cuba is seeking relations with the U.S.? Probably because they know they cannot rely on any form of assistance from Venezuela. **Either way, the world has become a more dangerous place.**

Geopolitical Issues

The quest for peace and freedom will continue in a year of living more dangerously than in the past.

Most recently, we have witnessed Paris under siege by Islamic terrorists over an offensive cartoon. Demographic trends indicate Muslims are the fastest growing population on the planet. **France** has the largest Muslim population in Western Europe. Conflicts in the Middle East have not only intensified but become even more complicated after the U.S. withdrawal from Iraq leaving a vacuum that was filled by extremists. The rise and successful invasions by the **ISIS** in Iraq and Syria took us by surprise. On the upside, the coalition will ultimately destroy the ISIS terrorists. On the downside, corrupt **Iraq** will eventually be divided between the Shiites, Sunnis and Kurds. There appears to be no diplomatic solution to the Civil War in **Syria**. However, there is one certainty; Turkey, Lebanon and Jordan do not have the resources to support the massive continuing migration of Syrian refugees. The chance for a renewed peace process in the **Promised Land** lies with the results of **Israel's** early elections and the hope for a pro-peace administration . **As such, I need to ask, is radical Islam at war with the world?**

Given the sanctions and crash in oil prices, **Iran's** nuclear aspirations should be resolved diplomatically. **Russia's** annexation of Crimea and support of the Ukrainian conflict triggered economic sanctions. With the country already in financial ruin, it is difficult to predict what Putin might do to unify his financially strapped and faultfinding citizens. **North Korea** always remains a wild card. Then the dispute between **China** and **Japan** over some islands in the East China Sea still remains unresolved.

Although **Africa** is not consider one of our priorities, the continent is engulfed with civil wars in South Sudan, Dafur, and the Central African Republic, Boko Haram insurgents in Nigeria and pirates in the Gulf of Guinea. Finally, the **Ebola** contagion still is not contained. Actually, some ISIS insurgents in Mosul, Iraq have been infected. To add insult to injury, Glaxo SmithKline claims the vaccine is too late for the current epidemic. In any case, the cost of controlling these world disorders depletes our global diminishing resources and impairs our living standards. **There is no prosperity without world peace.**

These world disorders raise both the climate and environment for future crisis, chaos and conflict. Now let's consider the interplay of the macroeconomic factors as follows:

- The Pew Research Center reports that the U.S. has the largest inequality between the wealthy and the poor over the past 30 years. It is expected this disparity will continue at a greater rate. The wealthy are getting richer, the middle class is disappearing and the lower-income families are actually making less. The bad news is that this problem is global.

- The world is increasingly more deflationary rather than inflationary. The best examples are the collapse in oil prices and the Internet.

- Not only are the developed economies, other than the U.S., in or entering recessions, but they will be joined by many oil producing/commodity countries.

- These countries will be facing protests and rioting against the backdrop of their economic debacle, severe austerity measures and enormous unemployment.

These combined world disorders and macroeconomic forces create an environment for even greater conflict. **If the world does not address these issues it will clearly be on a path to disaster.**

2015 Economic Forecast

The equity markets amazingly performed in-line with my 2014 forecast. The Dow and S&P 500 once again attained new historic highs in an otherwise difficult economic environment. The Dow closed the year at 17,823 producing a commendable 7.5% rate of return in an otherwise low return world. The S&P 500 closed at 2,059 generating an impressive annual rate term of 11.4% while the NASDAQ closed at 4,736 demonstrating an inspiring rate of 13.4**%. Last year, my predictions were right on the money with the Dow, S&P 500 and NASDAQ closing the year at 18,000, 2,125 and 4,900 respectively.** The Dow actually reached its all-time high of 18,103. On a technical perspective, the prerequisite for the bull market to continue lies in equity valuations, earnings expectations, abundant liquidity and accommodative monetary policy. I expect liquidity will remain positive. Contrary to the general consensus, it is more probable the Fed will not raise rates in 2015 given the global deflationary risks. As such, their monetary policy will remain accommodative . It is in the Feds interest to err on the side of ease in order to attain their inflationary target. The market equity valuations appear quite elevated but not to extremes. The problem lies in earnings expectations. Corporate profits will be challenged by the headwinds consisting of both contracting global trade and aggregate demand and a strengthening dollar. However, Corporate America has tendency to surprise on the upside. With our domestic economic fundamentals improving, a bear market is not in the cards. **The odds favor a 10% to 15% correction in the first half of the year in a market that will unlikely produce double digit returns.**

In sum, in this world of low returns, the central bank's monetary policies throughout the developed world keep encouraging investors into reflation trade strategies, ones that favor equities over bonds. Notwithstanding an imminent correction, equities growing 5% plus will still outperform all other asset classes. Either way, investors should be biased towards capital preservation rather than asset appreciation. In terms of markets, Euroland's lower valuations are indicative of their economic dilemmas and offer a far greater upside as compared to the U.S... Japan may prove to be a profitable contrarian play so long as their currency is sold short. The emerging markets will continue to suffer earnings disappointments and capital outflows. Stay away from corrupt and bankrupt Russia along with other commodity based countries and more specifically Brazil. In a world that is clearly more deflationary rather than inflationary, cash is king. Your primary objective should be cash flow. As such, the U.S. is the safest place in this otherwise delicate global economy. You should consider high-yield dividend equities in companies with a consistent track record with less of an exposure in Euroland. In terms of sectors, consider overweight positions in consumer discretionary (especially China), IT, investment banking and energy; second, neutral positions in financials and healthcare: and finally, underweight positions in consumer staples, industrials, materials and utilities given their 2014 run-up. **The investment world has become extremely complex, as such; you should consider professionally managed accounts.**

> **Absent any geopolitical and/or natural disasters, the forecast assumes Euroland, Russia and Brazil fall victim to recession, Japan remains in protracted stagnation and the global economic contraction starts to unwind. Against this backdrop, the Dow may trade between a range of 16,000 and 19,500, closing the year at 19,000. The S&P 500 and NASDAQ may close the year at 2,150 and 5,000 respectively. This trading year will be one of elevated to extreme turbulence . It is more probable than remote the market will be temporality impaired by a global crisis induced correction of between 10% and 15% within the first half of the year. This will represent a buying opportunity rather than a bear market. However, given the debt supercycle has come to an end, if the world suffers a liquidity trap, all bets will be off the table and the markets will react violently.**

- **Deflation/Inflation:** The world appears more deflationary against the backdrop of deterioration in aggregate demand and contracting global trade. Deflation is the most destructive underlying force in any economy. However, domestically, core inflation ended the year at 1.7%, a little bit less than 2013. The Fed abolished their QE program that was also designed to reach their 2.5% inflation target. As such, QE only created asset inflation and had a negative impact on core inflation. CPI will probably fall rather than rise closing the year at 1.5% given the persistent deflationary forces in the world.

- **Interest rates:** In an environment where global deflationary pressures continue to persist, U.S. unemployment is less than 6.5% and inflation remains benign, the Fed rate will stay near zero and probably remain there for the entire year. In the event the Fed does raise the rate, it will be in 25 basis point intervals. If the Fed does this in the first half of the year, the markets would suffer a short-term correction. On the other hand, if this occurred in the second half of the year, investors would probably remain bullish believing economic fundamentals are improving and the markets could rally. The 30-year and 10-year treasury yields closed the year at 2.75% and 2.18% respectively. Both rates may rise by 25 basis points at best. The treasuries closed this year almost 100 basis points less than 2013. As such, the bond market rallied. While the 30 year mortgage closed the year at 3.75%, it may rise between 25 or 35 basis points but still was less than the 4.45% in 2013. On the investment side, investors should consider investment-grade and high-yield corporate bonds with a neutral term. Given the global risks, both sovereign debt and emerging market bonds should be avoided. Even U.S. treasuries appear less compelling against the backdrop of rising rates.

- **Municipal Bonds:** These bonds rallied in 2014 given the drop in treasury yields. AAA bond fundamentals remain solid with an extremely low risk of loss. When the Fed reverses their monetary policy from accommodative to restraint, interest rates will rise and bond values will fall. Rates closed the year between AAA at 2.7% and AA at 3.3%, much less than 2013. In an environment where rates will rise rather than fall, expect rates between 3% and 3.5% by year end. In this low return world, investors should still consider Munis only with a neutral duration. So long as investors can hold these bonds to maturity, they will always retain their value.

- **Currencies:** The U.S. dollar is in a bull market. This is unusual given the Fed's previous QE. Either way, the rise in the dollar is associated with severe global weakness and this will probably continue. After all, no country wants a strong currency during recessions and/or recoveries. To the detriment of our export sector, the dollar will rise against the Yen and to a lesser extent, the Euro. Investors should not consider commodity based currencies given their risks. Many economists believe the dollar will lose its world dominance. Their belief is unfounded. The dollar will remain a safe haven and the global currency of choice.

- **Gross Domestic Production (GDP):** Given the improvement in our economic fundamentals, when all is tallied our GDP will average about 3%. In 2015, our GDP will trend lower between 2 ¼ % to 2 ¾ % against the background of global economic distress and a stronger dollar. On the global front and in recognition of their potential deflationary derailment, they would be lucky to squeeze out something less than 3%.

- **Oil & Gas:** The price of crude oil crashed closing the year at $53/barrel in what appears to be primarily a Saudi self-induced crisis combined with weak global demand. It is more probable the price will trend lower, possible to $35/barrel before rising and closing the year at $82/barrel. If my belief is incorrect and the crisis was attributable to oversupply and diminished demand, then the price will trend closer to historical norms as the excess inventory gets absorbed in the marketplace. The profound deflationary and geopolitical implications are discussed under the section titled **"The turmoil in oil"**. Natural gas closed the year $2.92 and will probably trend between $3.25 and $3.75 given the contraction in the demand side of the equation.

- **Gold/Silver:** Gold has lost its luster in this otherwise deflationary world. It closed the year at $1,184 per ounce, not much different from last year. Gold is a currency that cannot be debased and rises during inflationary periods and times of war, chaos and conflict. Absent any geopolitical disasters, don't expect much of a turnaround in 2015. However, given our world disorders, a 5% + position in your portfolio is a reasonable hedge. While Hi-Ho Silver is riding down the Lone Ranger's trail of diminishing returns, it closed the year at $15.57 losing 18% in value.

- **Other Hard & Soft Commodities:** The commodities bear market remains intact and has many years to run. Prices continue to be the casualty of constrained global demand and adequate supply. Most prices that were pushed up from excessive global demand during the 10 year bull market have now retreated to their historic norms.

- **Real Estate:** U.S. housing needs to climb an additional 20% in order to reach the pre-recessionary levels on an inflation adjusted basis. Lenders have tightened their standards causing the home ownership rate to deteriorate. This is especially true for the first-time home buyers’ market where student loan debt has become an obstacle. However, Fannie Mae and Freddie Mac may come to the rescue by buying mortgages with only 3% down stokes. Either way this would only apply to the most credit worthy buyers. Existing home sales slowed substantially given the decline in distressed sales and investor demand dried up. New home and commercial construction is expected to rise about 10%. This is extremely low on historical standards and not enough to keep up with a growing population. Valuation will be moderate at best. The years of double digit returns are behind us. It is now a buyers’ market.

In this world full of risk and uncertainty, I remain less optimistic about the outlook.

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