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January 18, 2016

2016 ECONOMIC FORECAST

Is a U.S. Stock Market Crash Imminent?

Preamble: The annual Forecast is designed to inform my readers of my assessments of both the State of the Domestic and Global Economies and forecasting the Outlook for 2016. My findings are predicated upon employing demographic theory and analysis as they relate to the economy and financial markets. History dictates that demographic trends determine the rise and fall of civilizations. Given the severe global economic deterioration and the reversal of fortunes in the financial markets, this newsletter is a MUST READ. But first I will discuss other current issues and events consisting of; the Rise and Fall of the American Society, specifically our income and wealth disparity and our middle class, a Political Round Up concerning the U.S. elections and the inherent Geo-Political Risks affecting the world.

The Rise and Fall of the American Society

Once considered the majority of the nation and the economic backbone to the American Dream for at least half a century, the middle class has fallen to less than 50% of the population according to a Pew Research Center Report. Their common belief, if they worked hard they would most certainly get ahead, has become nothing more than a pipe dream in this economic cycle. The middle class consists of a family of three earning between $42,000 and $126,000 annually. Since 1970 their share of the American income pie has collapsed by 31% due to deteriorating wages caused by globalization, technological advancements and diminished union representation. The disparity in both income and wealth has reached historic proportions to the extent the top 20% of U.S. income earners own 90% of all privately held wealth. On the other side of the equation, the highest 5% of income earners paid almost 60% of the total income tax as compared to 3% for the bottom 50% of taxpayers in 2013 based upon IRS statistics. This trend is destined to intensify in the long run. Notwithstanding the fact that this is a by-product of capitalism, no society can sustain this kind of mounting inequality without extreme social and economic repercussions in the future. Yes, the middle class is dying. Economists Angus Deaton and Anne Case found white middle-class Americans over the past 15 years have the highest premature death rate in the industrial world. This represents a clear and present danger to our economic growth and capitalist ic democratic society. Politically speaking, the disparity of the income and wealth issue has two schools of thought. The Democrats are for shared prosperity and pro-income redistribution, while the Republicans are on the opposite end of the bell shaped curve. However, Donald Trump, with his trademark "Make America Great Again" and related promises, has gained support from the middle class. In sum, the American Dream is on the verge of extinction.

Political Round Up

Will Trump Triumph?

The first Republican debate featuring Donald Trump was the highest-rated primary debate in television history with 24 million viewers on the Fox network. On the other hand, the most viewed Democratic debate drew only 8.5 million people. Donald Trump has brought the entertainment factor to these debates giving the Republican Party enormous recognition against the backdrop of his anti-establishment, non-factual and reality showmanship rhetoric. He has mass appeal amongst his economically deprived middle class party members who are disenchanted with their dysfunctional controlled Congress that has failed to address our country's needs. On the downside, he managed to alienate the entire Latino vote that may prove to have been a prerequisite to attaining the presidency. Then there is the conspiracy theory that Trump is actually a part of the Clinton political machine given their long-standing and friendly relationship. It is probably too premature to project our presidential outcome but I'll give it my best shot. Whether Trump triumphs and gets the Republican nomination or even if he goes independent, absent any political scandals, the odds seem to favor Hillary Clinton for the presidency. On the other hand, one cannot rule out Bernie Sanders winning the Democratic nomination given his growing middle-class grass roots support. In the event he wins in both the Iowa and New Hampshire caucuses, it is also conceivable other Democrats may enter the race. Since the Great Depression the Republicans have the largest congressional majority consisting of 247/435 seats in the House and 54/100 seats in the Senate. This November, elections will also be held to elect all 435 Districts in the House of Representatives and 34 seats in the Senate of which 10 seats are Democratic and 24 are Republican. Notwithstanding Congress' discreditable approval rating of 16%, the Democrats have a 50/50 chance of retaking the Senate and the Republicans will retain control of the House. On a historic standpoint, the government generally runs better when no one party is in control.

Geo-Political Risks: A World of Uncertainty and Despair

Geo-political risks are measured by their potential affect in the financial markets. The conflicts in the Middle East have not only intensified but have become even more convoluted with the Russian and Iranian military intervention. Although the defeat of ISIS is in the cards, it will not resolve the centuries old conflict between the Saudi Sunnis and the Iranian Shiites. It is becoming more difficult to draw a distinction between who are our allies or enemies. I contend Saudi Arabia, with its extremist Islamic ideologies, can no longer be considered an ally. The 911 terrorists were Saudi. The country is winning the war waged against the U.S. oil industry creating recessionary repercussions and political unrest in the oil producing emerging nations. Against the backdrop of their recent beheadings and execution of Shia Cleric Sheikh Nimr Al-Nimr, both Saudi and Iran severed diplomatic relations adding more fuel to the Middle Eastern fire. Although Iran's nuclear aspirations have been resolved diplomatically, they set off two ballistic missiles in violation of the UN resolutions. At the end of the day, the fate of Syria, the Kurds and the massive migration in Europe remains unpredictable. The demographic trends in this region dictate continued political instability, tribal feuding, and terrorism. Tensions continue to escalate with Japan as China seeks to control the South China Sea islands. While in the same region, and after North Korea alleged a 4th nuclear test, they threatened war against the South Korea after they were bombarded by constant propaganda broadcasts. Our greatest Geo-political risk is deflation. This is the most destructive force in any economy. To further complicate matters, the population in the industrial world is aging. This demographic trend will persist and dictate a severe contraction in consumer demand. Actually, the world is infected with inadequate aggregate demand given the ineffective government policies consisting of severe austerity measures and debt reduction. These world disorders raise both the climate and environment for future crisis, chaos and conflict. The cost of controlling these disorders depletes our global economic resources and impairs our living standards. There is no prosperity without world peace.

State of the U.S. economy

The U.S. economy has demonstrated sustainable below trend growth in a year in which the rest of the world's economies are contracting. When all is tallied, GDP will average between 2% and 2.5% in a domestic environment consisting of benign inflation and easy money. The primary obstacle to growth has been the simultaneous deleveraging and austerity policies instituted throughout the developed world. This has precipitated a continuing deficiency and deterioration in aggregate demand. Our demographic trends associated with the retirement of 108 million baby boomers will assure us that subpar growth will persist until 2020. Notwithstanding the deflationary ramifications that may last until 2023, the U.S. economy surpassed the rest of the world. As such, let us discuss the economic fundamentals affecting our domestic economy as follows:

- The Federal Reserve's first rate hike was premature at best. It appears they are not even following their own policy. They have reached their 5% unemployment objective but failed to consider that these were primarily low paying jobs. Their inflation prerequisite of 2% to 2.5% may never be reached for years in this deflationary environment given the current rate of 0.5%. Their actions have the effect of strengthening the dollar that places further pressure on our exports and with it corporate profits. If rates continue to rise we might wind up with a Fed induced recession. I have to ask, how can rates rise when the rest of the world is suffering?
- Corporate America's profit margins remain under mounting pressures given the contraction of global demand, rising labor costs and a strong dollar. The earnings reported for the 3rd quarter fell to their lowest level since the Great Recession. Our manufacturing sector is now showing signs of weakness. Our once promising energy sector has been decimated by Saudi Arabia. Although a collapse in earnings is not in the cards, these trends may persist in the long run.
- Consumer spending has retrenched notwithstanding the benefits derived from falling gas prices. The issue is the persistent and rising income inequality. Their disposable income is waning with little expectation to the upside and their anemic wage growth remains subdued.
- The unemployment rate improved closing the year at 5% adding 2.7 million jobs. The majority of which fall in the low paying category. This rate is clearly distorted. It does not include people who are unemployed for more than two years. After considering this, plus the under

employed part-timers, the rate breaches 20%. Against the background of subpar economic growth, the unemployment rate is more likely to rise rather than fall.

- The housing sector will continue to expand even with a small uptick in mortgage rates. New construction is well below what the demographic progressions require. On the upside, 14% of banks have loosened their lending standards. However on the downside, BankUnited got out of the retail residential mortgage business all together and the government backed mortgages, such as FHA, VA and USDA, tightened their standards. The sector probably has a one to two year window of growth before any reversal of fortune occurs.

In sum: The rise and fall of civilizations have always been determined by demographics. These trends guarantee subpar growth for at least the next five years. Deflation is the cancer of any economy and this global cycle will persist to 2020 and beyond. On a long term perspective, we will encounter many headwinds that are so pervasive they will challenge the face of American Society. When you add our unfunded liabilities to our unsustainable $19 trillion national debt, you arrive at $211 trillion or $658,000 for every man, woman and child. Almost all of this debt was created after the Jimmy Carter administration and was the result of fiscally irresponsible bipartisan policies. The prerequisite for prosperity is productivity rather than debt. There is more than $1 trillion in student loans debt. This bubble is ready to burst given 27% of the loans are already in default. To add insult to injury, our middle class, the backbone to our nation is disappearing against the backdrop of the perpetual disparity in both wealth and income. Absent a hard landing in China, an implosion in Euro Land and any geo-political and/or natural disasters, our GDP may very well trend 2% or below. In this economic environment of both low growth and inflation, easy money and stable unemployment the probability of a recession appears to be escalating. Although the U.S. economy, the star performer in a low growth world, has always been resilient on a historic basis, it is more probable to disappoint on the downside.

The State of the Global Economy

The global economy has produced substandard growth in an environment consisting of unmanageable debt, eroding international trade and detrimental demographics in the advanced economies that will have immense deflationary consequences for many years to come.

Euroland is predestined to continued slow growth given their central bank's failure to take more aggressive monetary action to stimulate demand. Their anti-prosperity policies will probably lead to a three-peat recession placing even greater pressure on keeping the union together. If the EU members fail to enact pro-growth solutions to their structural fiscal imbalances associated with the disparity in their economies of scale, it is more probable members may leave the union and/or the Euro could collapse. The UK’s membership is currently up for vote. It appears they will elect to remain in the Union. On the other hand, without debt relief Greece may have to exit. Germany, France and Italy are the only members to generate dismal growth of 1.3%. The massive migration is over powering Europe and will place further downward pressure on their GDP probably producing less than 1.5% at best.

Japan continues to remain trapped in their protracted deflationary stagnation with no end in sight. Their economic stimulus package has failed to promote trade even as the yen continued to fall along with real wages. Their monetary cards have been played and they will have to rely on fiscal stimulus. On the upside, Japan's GDP will enter positive territory for the first time in 20 years but not by much.

China remains the wildcard in the global economic game. The question becomes whether they will have a soft or hard landing. Their days of double digit GDP have come to an end based upon the following:

- Their manufacturing is in recession causing unemployment
- Their industries will remain in deflation until the excess capacity is absorbed in their economy
- Their real estate is in a bubble ready to burst
- Their pollution is horrific causing social unrest
- Their stock market crashed mid-year losing about one third of its value while the government botched their intervention and with it, investor confidence

Their authorities remain committed in its transition from an export to a consumption-based economy. Their difficulty lies in alleviating their credit excesses in order to avoid a slowdown. Most economists believe they have an entire arsenal of monetary and fiscal cards available to forestall any financial crisis. I personally find it difficult to believe anything from a manipulated economy. It is more probable China should attain a 5% GDP at best. On a long term perspective, their new policy of allowing two children per family will help to offset their demographic repercussions associated with their aging population.

Commodity-based economies continue to suffer severe deterioration in economic activity given the collapse in the prices of oil and other commodities and trade. Specifically, Russia and Brazil linger in a protracted recession. The Venezuelan economy has been decimated and they are suffering from hyperinflation and the scarcity of basic goods. Corruption prevails and is their common denominator.

In sum, notwithstanding the forecast remains entrenched with risks and uncertainties, the global growth looks quite gloomy. Despite the lower cost of oil, global GDP will disappoint on the downside producing 3% at most. The global despair and anxiety associated with below trend growth and mounting deflationary pressures will persist for many years to come. Although monetary policy has been biased to an extremely accommodative stance, the contracting GDP growth has made reducing the massive excessive debt dilemma unattainable. When the world recognizes their policies failed, they will have no choice but to shift from austerity to pro-growth fiscal policy. Although this is currently politically incorrect, it may take a deepening crisis to convince the authorities to the contrary. The ultimate direction of the global economy depends on how the China Wild Card plays out. The Chinese yuan has been granted reserved currency status by the IMF. Given this elite status, the odds are 50/50 China may aggressively devalue their currency flooding the global markets with inexpensive goods. This would place intense pressure on competing nations resulting in recession and with it, deeper deflation.

2016 Economic Forecast

The equity markets are in the midst of a correction. My prior-year optimism had succumbed to far greater economic deterioration than expected. The Dow and S&P 500 closed the year 17,425 and 2,044 which is pretty close to where they began. They produced disappointing negative returns of 2.2% and less than 1% respectively. On the other hand, NASDAQ closed at 5,007 generating a modest 5.7% yield in an otherwise low-return world. The markets started the year in the midst of a correction entirely wiping out the 2015 NASDAQ gains and falling almost 10% while both the Dow and S&P 500 are off approximately 8%. The prerequisite for a bull market rests in earnings expectations, equity valuations and abundant liquidity. However, it appears the BEARS DEVOURED THE BULLS. With the exception of benign inflation all the other economic fundamentals are to the downside. This is a sign of what is in store for the future. The economists, Harry S. Dent Jr. and James Dale Davidson make a compelling case for both a crash and bear market predicated upon the following:

- Earnings expectations: Corporate profits are under escalating pressures given the contraction in global aggregate demand and trade, rising labor costs and a strengthening dollar. These trends may persist in the long run.
- Valuations: The U.S. equity market valuations are extremely elevated. The inflation adjusted P/E ratio at 27 times earnings is well above its historical average of 16 times.
- Margin debt: The current debt has surpassed the levels that preceded the 2008 crash.
- Market participation: After removing stock buy-backs from the equation, market participation has retrenched while valuations have been lofty.
- Velocity of money: This measurement of aggregate demand for goods has literally fallen off the charts.

In sum, all of these factors are not only bearish but generally are a precursor to a recession. In this world of low returns the central banks will remain biased towards an extremely accommodative monetary stance. This encourages investors into reflation trade strategies, ones that favor equities over bonds and therefore taking on substantial risk. All of these unfavorable fundamentals warrant an acute underweight position in U.S. equities. Investors should discuss with their financial advisors/brokers selling the U.S. market short and going long in Europe and possibly Japan. These markets offer a far greater upside subject to currency risks. Otherwise, stay clear of corrupt and bankrupt Russia and Brazil, commodity countries and emerging markets. Only consider China after their hard or soft landing. In terms of sectors consider moderate positions in financials, investment banking, healthcare and defense. Ultimately consider IT and energy only after a rebound. On the other hand avoid consumer staples, industrials and materials. At the end of the day, investor's ideology should lean towards capital preservation rather than asset appreciation. The headwinds of deflation have fallen upon the world and will persist in the long-run. In this economic climate, the primary objective of investors should be cash flow. Cash is king and the U.S. dollar bull market will remain intact at least over the next couple of years. As such, bonds will outperform equities. Consideration should be made for high-yield dividend equities in foreign companies with a consistent track record. After a U.S. stock market crash, the demographic economist Harry S. Dent, Jr. recommends Proctor & Gamble, Caterpillar, Philip Morris, Johnson &

Johnson, Coca Cola and Teva Pharmaceuticals . Other than the pharmaceutical company, these American iconic giants are safe havens and will outperform. The investment world has become so convoluted that I recommend considering professionally managed accounts.

Against the backdrop of both the domestic and global demographic and deflationary economic realities, the U.S. Equity Market, whose valuations are already at elevated extremes is destined to crash between 2016 and 2017. Despite the fact we are in the midst of a correction we may witness the DOW, S&P 500 and NASDAQ collapse by approximately 40% to 10,000, 1,250 and 3,000 respectively. While on the extreme side, both Harry S. Dent Jr. and James Dale Davidson, two leading economic forecasters are predicting a staggering 80% Stock Market and 40% Real Estate crash. Either way, the trading year will be one of immense turmoil and volatility where the market will rise on good news and fall on bad provoking a series of multiple corrections.

- Deflation/Inflation: The world is being infected by the contagious disease called deflation. In this environment inflation is unlikely to rise. The inflation rate closed the year at .5% and may move to 1% by year end at best. It is not only limited to commodities but is spreading to other sectors in the economy. Given the escalating deterioration in aggregate global demand and trade, these deflationary forces will persist for perhaps another seven years.
- Interest rates: In this climate monetary policy should always remain extremely accommodative. However, the Fed erred in raising rates and probably will stay that course. On the other hand, a Fed induced recession is not in the cards. The 30- year and 10-year treasuries closed the year at 3.02% and 2.27% respectively and the 30-year mortgage closed at 4%. All of these rates are likely to rise between 25 and 35 basis points unless the Fed eases and then they would remain flat. U.S. interest rates are destined to trend at historic lows for many years to come.
- Municipal Bonds: On a cash flow basis AAA bond fundamentals will always remain a safe investment so long as investors can hold these bonds to maturity. If the Fed reverses their monetary stance from gradual restraint to accommodative, interest rates will fall and bond values will rise. These bonds closed the year at 2.71% and may advance no more than 25 basis points. Investors should consider Muni's with a neutral duration given rates will climb inevitably in an inflationary environment and on a long term perspective.
- Currencies: The U.S. dollar bull market remains intact. This progression continues to have a negative impact on our exports placing further pressure on our profit expectations. No country wants a strong currency during a period of global contraction and as such, this trend will persist for many years. The dollar will rise against the yen and to a lesser extent, the euro. The wildcard is the Chinese yuan. The yuan has now become a reserve currency. If the Chinese authorities aggressively devalue their currency, the U.S. should liquidate our debt obligations lump sum with them. It would be like settling the debt at $.50 on the dollar and further create the inflation injection to combat our deflation.
- Gross Domestic Production (GDP): The prerequisite for growth and prosperity is based on the expansion of consumption whether by governments, businesses or consumers. This is all absent in our current cycle. Against the backdrop of a global contraction in aggregate demand and internatio nal trade, the U.S. GDP will be less than an anemic 2% while the rest of the world will

produce 3% at best. Our domestic demographic trends will guarantee us that subpar growth will linger until 2020.

- Turmoil in Oil: The deflationary and geopolitical implications associated with the collapse in oil prices are a clear and present danger to the world. Notwithstanding the retrenchment in global demand, this crisis is primarily on the supply-side, implemented by the Saudis in a war waged against the U.S. production industry. This has placed the oil exporting countries on the threshold of recession creating chaos and conflict in a world that is already in disorder. On the other hand, consumers/importers have become the beneficiaries with improved disposable income. Once the Iranian sanctions are lifted, they will be back in production adding to the existing glut. The price of crude oil closed the year at $37/barrel. It is more probable oil will trend lower, possibly to $25/barrel before gradually rising to close the year at $50/barrel. The bear market has much further to run.
- Gold/Silver: The golden bear market remains intact. It closed the year at $1,060/ounce and unbarred 10% in value. This precious metal generally rises with inflation and in times of war. Given our global deflationary environment, expect gold to continue its downward trend for many years to come. Although an uptick is possible given our world disorders, gold may close the year at $900/ounce. While Hi-Ho Silver is trotting down the Lone Ranger's trail of diminishing returns, it closed the year at $14/ounce unhitching 10% in value and may end the year at $12.
- Real Estate: Although new residential construction is up 17%, it remains well below the level required given our demographic trends. The sales of new and existing homes will advance but at a more sluggish rate in relation to 2015. Real estate values are destined to ultimately retreat as more and more Americans are priced out of the market. Both economists, Harry S. Dent and James Dale Davidson are predicting a 40% crash. Although their reasoning is extremely compelling, I tend to believe real estate may have a one to two year window of growth before their valuations cave in to the deteriorating economic cycle, falling 20% at best.

All the economic fundamentals appear to the downside procreating even greater risk and uncertainty in our global financial markets. Yes, I have become discouraged about the outlook.

ACKNOWLEDGEMENTS

I would like to give credit for the research materials in this article to: The Bank Credit Analysist, demographic economists Harry S. Dent Jr. and economist James Dale Davidson.