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2017 Economic Forecast

TRUMPMITIZED
Trick or Tweet?

Preamble: The 28th Edition of this annual Forecast is designed to inform my readers of my assessments of both the State of the Domestic and Global Economies by employing demographic theory and analysis as they relate to the economy and effect on the financial markets. But first I will discuss the US Presidency and the inherent geopolitical risks affecting the world.

Today America needs to welcome Donald Trump as our forty-fifth president. Even though Hillary Clinton secured 2.8 million votes more, his unprecedented and surrealistic victory rests with the FBI's baseless claim of her email re-investigation, a mere eleven days before the election and direct Russian cyber intervention including consistent blogs of bogus internet propaganda. Trump's ultimate success is the result of his mass appeal to the outrage of his disillusioned, economically deprived, working and middle class voters who believe the American Dream is unattainable. The Democrat's failure to address these voters was probably their most costly error in their campaign. While on the other hand, Hillary Clinton's September description of half of Trumps supporters as "a basket of deplorables" may have been the turning point leading to her demise. On a historic perspective, the government generally runs better when no one party is in control. However, the Republicans now control all of the branches of our government and with it, the conservative direction of the Supreme Court. We may witness a complete reversal of campaign financing restrictions creating the catalyst to monetary power grabs by wealthy Republican donors with enormous related repercussions that will affect us for years to come. **On the up side, Donald Trump is not your usual Republican President.**

President Trump's anti-establishment and non-factual campaign rhetoric blamed the loss of our jobs on illegal immigration, unfair trade deals, Obama Care and excessive corporate taxation. He pledged to alleviate this trend with the following campaign promises:

- Build the wall, reform immigration and deport eleven million illegal aliens
- Renegotiate our trade deals and impose tariffs on American goods produced abroad
- Appeal Obama Care
- Tax reform and offer US companies a one-time window to repatriate their foreign profits

President Trump presented these reasons as facts with both passion and conviction leaving no room for doubt. **Yes, his constituents were tricked and tweeted**.

There are two basic underlying forces that caused American job losses primarily in the manufacturing sector. The primary is the economic principle that production will always travel to the place where the product can be produced at the lowest cost per unit. However, this trend is slowly reversing as labor, shipping and other costs rise abroad along with enhanced technological advancements and lower energy costs domestically. Many American multinationals have and continue to bring back some of their foreign operations and are also investing in both new and expanding old facilities while the major foreign auto companies save a fortune in shipping costs by manufacturing throughout the US. The second is the reality of technological/automation advancement. The Boston Consulting Group estimates a 20% contraction in this sectors labor force due to robotics alone.

Most of President Trumps campaign promises appear elusive, at best. Although the empowered Republicans are more likely to tax less, their inclination to spend more will be limited given their intense concerns over the escalating national debt for the past eight years. Against a backdrop of the Republican controlled government, we may expect the following campaign outcomes:

- The wall will probably become a fence
- Immigration reform is clearly on the horizon. Nevertheless, the new administration in all likelihood won't beat Obama's all-time record of 2.7 million deportations.
- The tax reform proposals will probably be a substantially diluted version that will favor the wealthy. Based upon a Tax Policy Center study, his proposals would run up the national debt by more than $20 trillion by the year 2035.
- If US companies were granted a one-time repatriation tax on foreign profits, their benefits would be substantially impaired by a strong dollar.
- The fiscal stimulus proposals for both infrastructure and defense spending may be restrained.
- Obama care will be repealed but will require an alternative to protect the 30 million insured.
- The Iranian Nuclear Deal cannot be repudiated without Congressional consent.
- The NAFTA trade agreement pursuant to Article 2205 can be nullified with a six month written notice. To do so wouldn't be pretty given the enormous repercussions to US businesses.
- Presidents have the power to issue tariffs by executive order under Title 19. However, this authority is predicated upon protecting suffering US industries rather than a punitive measure against any US companies for moving operations abroad.
- Legalizing marijuana should be left up to the states, however all of his cabinet appointees will not sanction this.
- "Pathetic" Hillary will not be indicted.

On the upside, we should be assured of major deregulation in banking, food and drugs and the environment. To hell with climate warming, it doesn't exist! At the end of the day, the ultimate economic benefits to be derived from implementing their policies will be a 2018 story rather than 2017.

In sum: Donald Trump is not your usual Republican President. His miraculous election driven by his constituents who have lost their faith in the American Dream has left us a divided nation. Whether it is "lyin Ted, low energy Jeb or crooked Hillary", he has bought to American politics a reality showmanship that may very change the electorate process in the future. As a super salesman, his arguments have been quite persuasive even though the majority of his statements lacked any meaningful content. He tweets policy directives without consultation that are limited to a maximum of 140 characters. He ran as an anti-establishment, Wall Street and Washington candidate who wasn't beholding to anyone. Finally, he pulled off what the majority of the country believed was impossible, the presidency. Contrary to his anti-establishment stance, his Cabinet appointees have a combined wealth of $14 billion, the richest in our history and are further described as follows:

- Secretary of the Treasury: Steven Mnuchin was with Goldman Sachs for 17 years
- Secretary of State: Rex Tillerson was the former CEO of Exxon and a recipient of Russia's Order of Friendship Medal from Putin
- Secretary of Energy: Rick Perry was the former Governor of Texas, an oil man who declared he would eliminate the Department of Energy
- Secretary of Housing and Urban Development: Ben Carson who has no experience and claims "poverty is really more of a choice than anything else"
- Secretary of Transportation: Elaine Chao former Secretary of Labor and Senate Majority Leaders Mitch McConnell's wife
- Attorney General: Jeff Sessions the current Senator from Alabama has claims of racism and is considered anti-civil rights and immigration

These appointees all seem to be the personification of the establishment with deep ties to both Wall Street and Washington. Contrary to Republican doctrines that consist of free trade and laissez-faire capitalism, our President appears to be more of a protectionist and has directly intervened with private industry threatening tariffs on businesses that move abroad. President Trump may have an uphill battle in his Cabinet confirmation process. **However, his greatest obstacles relate to his conflict of interest issues, a pre-requisite to retaining his presidency.** Although it appears he has abandoned his working and middle class constituents, it is time to give our President the benefit of doubt. **America is expecting a lot from him, so let us all pray for a successful administration and pray some more. The time has come to unify our divided nation.**

GeoPolitical Risks: A World of Unrest and Uncertainty

The Obama administration has reduced America's influence in the world against the backdrop of China's enhanced power and continued Russian aggression. It appears President Trump may be taking the same path given his anti-NATO and Euro rhetoric. As in both the US elections and the Brexit, we have witnessed a political change based on anti-immigration and globalization. This phenomenon has infected Europe given the turmoil from the massive wave of Muslim immigration. This political instability is building in advance of the Euro elections in France, Germany, Netherlands and Italy this year. Notwithstanding the geopolitical implications, it is more probable the euro will remain intact, at least for now. With the world's ultimate success in the containment of ISIS, the Syrian and Iraqi conflict may transform into a Turkey struggle with the Kurds that may include both the Russians and Iranians. On the other hand, when the Islamic militants return home they may very well form terrorist cells creating a global disaster. President Trump's informal recognition of Taiwan along with his criticism of China's policies of both unfair trade and their rising influence in the South China Sea have placed US-China relations at an all-time low and with it, the potential for engagement. As usual, North Korea remains the wild card and the probability of a Palestinian/Israeli peace accord can be found in the Dead Sea. On the economic side, our greatest potential risk remains to be deflation, the most destructive force in any economy. The population of the industrial world is aging. This deflationary demographic trend will persist for many years to come and with it, a severe contraction in consumer demand. These world disorders raise both the climate and environment for future crisis, chaos and conflict. The costs of these disorders deplete our global economic resources and compromises our living standards. There is no prosperity without world peace. The quest for peace and freedom will continue in this year of living even more dangerously than in the past.

State of the US Economy

The US economy has produced sustainable below trend growth against the back drop of a domestic environment consisting of accommodative monetary policy and benign inflation. When all is tallied, GDP fell well below expectations reaching no more than 1.6% and inflation closed the year at 1.53% never even approaching the Fed's targeted rate of 2%. The head winds to growth have been a rising US dollar, contraction in international trade and the deleveraging and austerity policies set in motion throughout the developed economies. These anti-growth measures have been the catalyst to debilitating global aggregate demand. On the downside, our deflationary demographic trends associated with the retirement of 108 million baby boomers will reassure us that the subpar growth trend will persist for the remainder of the decade. On the upside, the US economy surpassed the rest of the world. As such, let us discuss the economic fundamentals affecting our domestic economy as follows:

- **The Government Sector:** The Fed's intent to ultimately bring its monetary policy to a neutral stance of a 2% rate seems elusive at best. It is more probable we may see only one to two rate hikes of no more than 50 basis points this year. It appears their inflation expectations are overstated. Either way, President Trump's expansionary fiscal stimulus proposals will ease the burden on monetary policy. When the Fed policy tightens and the developed economies remain neutral, the dollar rises. This creates undo pressure in our exporting and manufacturing sectors. The implementation of both the fiscal policies and tax reduction will have the greatest impact in 2018 rather than 2017. With our Republican control government and our President who built his empire with debt, the fact that our national debt is already at an unsustainable level may be merely a non-issue.
- **The Corporate Sector's** ability to cut costs to improve their profits has been limited at this point in the maturing economic cycle. Their profit margins continue to be compressed against the retrenchment in global aggregate demand, escalating labor and health insurance costs and a stronger dollar. The promise of fiscal stimulus, tax reduction and diminished regulations will bode well for their 2018 bottom lines but probably will not materially boost their capital spending. Their

balance sheets remain healthy and are flush with cash. At the end of the day, it appears earnings expectations are exaggerated at best, especially for 2017. When all is tallied, retail sales will probably show a 4% year-to-year increase along with the rise in consumer spending. However, in this economy there are winners and losers. Amazon had their best season in history and expects to add 100,000 jobs. On-line sales jumped 11% to the detriment of brick and mortar stores. Macy's sales dropped 2%. They're closing 100 stores and giving 10,000 employees pink slips and discount cards. Kohl's is in trouble. Suffering Sears had to sell off their Craftsman tools, their signature line since 1927, in order to stay afloat. The Big Apple Circus got eaten by their creditors and filed for Chapter 11. After 146 years, Ringling Bros. and Barnum & Bailey Circus stopped clowning around and closed after being inflicted with elephantiasis. The Greatest Show on Earth is no more. Caesars Palace, who crapped out two years ago is betting their way out of Chapter 11. I find this hard to believe when the house always wins. On the down side, many retailers will seek court protection this year. While on the upside and absent the energy sector, corporate bankruptcies have actually trended lower in 2016.

- **The Banking Sector** remains well capitalized and access to credit has shown improvement. This sector may be the greatest beneficiary of rising interest rates and prospective deregulation.
- **The Consumer Sector** is showing signs of rebirth. They are in the late phase of deleveraging but still will be reluctant to take on any further debt. Their balance sheets have substantially improved given the advances in both real estate and equity markets. Enhanced consumer spending and confidence resulted from gains in employment, wage growth and lower gas costs. However, the disparity in both income and wealth continues to reach historic proportions. In a world infected with contracting aggregate demand, it will probably be the American consumer to reverse this trend.
- **The unemployment rate** has fallen to 4.6% which is considered an economy operating at full employment. There were 2.4 million jobs added in 2017. The majority of which were low paying. However, the underemployment rate is 13.7%. This is defined as those unemployed for two or more years and those who had to settle for part-time positions. Given the new Republican administration's agenda to reduce the size of our government, they will probably be the largest employer with the greatest number of layoffs over the next four years. Contrary to the general belief, job losses are primarily associated with technological advancement rather than operations being moved abroad. On a long-term perspective, millions of jobs throughout the world will be replaced by robotics. As such, the unemployment rate is more likely to rise rather than fall in an environment of subpar economic growth.
- **The housing sector** has demonstrated a 25% rise since it dipped in 2011 and remains approximately 7% below its pre-recessionary highs in 2007. However, the sector is facing the headwinds of housing affordability at these current levels. The dismal wage gains are insufficient to support these valuations, especially in an environment of rising mortgage rates. Finally, foreign investment is drying up against the appreciation of the dollar. On a positive note, new construction is well below our demographic needs. Housing may rise 4% this year at best and go negative in 2018.

In sum, our easy monetary policies fell short of our expectations and only partially revived the expansion of private credit, the prerequisite to boost consumption on the demand side of the equation and with it, economic growth. The problem occurs when both governments and consumers simultaneously deleverage causing a massive contraction in aggregate demand. This has occurred globally but is slowly reversing domestically. On the upside, consumers are in their late stages of this process and with it their spending is accelerating. Given the Republican mandate, our fiscal stance is proposed to transform from neutral to expansionary. These fundamentals are all positive to growth. On the downside, inflation, interest rates, the US dollar and labor costs are all rising while corporate profits and global trade are contracting at the same time. On a long-term perspective our unsustainable national debt is approaching $20 trillion excluding an estimated $120 trillion of unfunded liabilities. On the other hand, the probability of a recession remains remote. These economic fundamentals suggest subpar growth for many years to come. Absent any Geopolitical and/or natural disasters, our GDP will yield 2% or less. **The odds favor sustainable but improving below trend growth with our economy continuing to surprise on the upside against the backdrop of advancing global economic fundamentals.**

State of the Global Economy

The world has produced post-crisis anemic growth of 2.3% against the headwinds of diminishing global trade, elevated policy uncertainty, ungovernable debt and adverse demographics in the advanced economies that have enormous deflationary ramifications now and in the near future.

The European Central Bank's (ECB) quantitative easing that has been extended to 2017 has failed to stimulate demand. It may take another financial crisis before the EU recognizes that fiscal stimulus rather than monetary incentives is the primary pro-growth policies to enhance aggregate demand and turn around their economies. Either way, the EU members need to find and enact solutions to their structural fiscal imbalances associated with the vast disparity in their economies of scale. Otherwise, other members will follow the Brexit course of action and the euro may collapse. **Japan** has remained trapped in a protracted deflationary stagnation for more than two decades given their crippling demographics consisting of a shrinking labor force and a rapidly aging population. Their interest rate had entered negative territory demonstrating their monetary policy failures. Their government is implementing a massive $45 billion fiscal package that may very well finally turn their GDP into positive territory. On the upside, **China** has avoided a hard landing notwithstanding their structural fiscal imbalances. Their successful economic acceleration and related GDP growth of 6% was self-attained by their policy induced expansion of untenable debt that is already 250% of GDP. Although this may be the greatest threat to their economy, their banks are primarily government owned and they have all of the monetary and fiscal cards necessary in which to avoid any financial crisis. Their economic recovery has triggered a rise in commodity prices directly benefiting emerging countries especially Brazil who may be in the final stages of their recession.

In sum, despite the Outlook is tainted with extensive risks and uncertainties, the world is in the midst of a sustainable below trend economic expansion, say GDP of 2.7%. The ultimate direction of the global economy depends upon the continued success in both the US and China. It is possible that the global economy may very well bottomed out in late 2017, especially if their governments recognize their monetary policy failures and ultimately shift from austerity to pro-growth fiscal measures. **At the end of the day, the odds of a global recession appear to be abating.**

2017 Economic Forecast

The equity markets have climbed a surrealistic wave of optimism fueled by investor's exaggeration of both earnings expectations and economic growth since the election. The Dow nearly breached the 20,000 milestone mark closing the year at 19,763 producing a surprising return of 13.1% in a year of domestic political uncertainty and mounting global risks. The S&P 500 attained its all-time high of 2239 and an impressive 9.5% annual yield in an otherwise low-return global environment. On the other hand, the NASDAQ has currently toppled its historic highs multiple times since closing the year at 5383 demonstrating an admirable 7.5% return. All of the US market indexes closed the year surpassing their historic highs. However, when you remove the effect of investor's post-election irrational exuberance, these indexes still produced an impressive 4% over all annual return. On a technical perspective, the prerequisite for a bull market lies in equity valuations, earnings expectations, abundant liquidity, benign inflation and accommodative monetary policy. Although liquidity should remain positive, all the other economic fundamentals will be biased to the downside. I suspect the Fed's monetary policy will marginally tighten along with the labor markets even though core inflation will fall short of their 2% target. The perceived economic benefits associated with the new administration's tax reduction and fiscal stimulus may wind up being partially imaginary, and even if it all becomes reality, we will not feel the rewards until 2018. The earning expectations are acutely distorted in a climate where corporate margins are being compressed due to the rising US dollar, labor and health care costs. Adding insult to injury, global trade is weakening and remains under the threat of possible new tariffs and potential trade wars. The market equity valuations are approaching elevated extremes given their inflation adjusted P/E ratio is 26 times earnings as compared to their historic norms of 16 times earnings. **It is more probable than remote to expect a major sell-off of equities within the first quarter. This should be viewed as a buying opportunity along with rebalancing a portion of your portfolios from fixed income to equities. So there's no misunderstanding, the US equity markets, post correction can surprise on the upside and ultimately rise in an environment where corporate profit margins are being squeezed.**

In sum, in this global economic environment, central banks will remain biased towards an extremely accommodative monetary posture. It will probably take a financial crisis to prove these policies are ineffective. At this time, they will convert to pro-growth fiscal expansion and with it, enhanced global aggregate demand. In this low return world, these easy money policies encourage investors into reflation trade strategies, ones that favor equities over bonds. Against the backdrop of a pending correction, equities will still outperform all other asset classes. After the correction, the US markets should outperform the rest of the world. Although the emerging markets will most likely under perform in this setting, investors should consider both China and India subject to the related currency risks. In terms of sectors considered moderate positions in financials, investment banking, industrials and technology. On the other hand, avoid consumer staples, energy, telecom and utilities. The wildcard would be healthcare given the expected repeal of Obama care. Although the rising dollar and contracting global trade will have a negative impact on US large caps, their size alone enables them to ride out any storm. Then again, US small caps will be the direct beneficiary of proposed tax reduction and fiscal expansion. At the end of the day, investor's philosophy should favor capital preservation rather than asset appreciation. The world continues to remain more deflationary rather than inflationary and this reality will persist in the long-run. As such, the primary objective of investors should be cash flow is everything. **In this world of low returns, investing has become so convoluted that I recommend considering professionally managed accounts.**

Absent any geopolitical and/or natural disasters, the forecast assumes improved global economic fundamentals, normalization in the EU's growth and continued expansion in both China and the US. The US equity market, whose post-election valuations climbed to elevated extremes is destined to an imminent correction of no more than 20%. It is more probable that this will occur within the first quarter of the year and represent a buying opportunity. Thereafter, the equity markets may produce double digit returns from their post correction lows. The Dow will trade between a range of 15,800 and 18,500 closing the year at 18,000. The S&P 500 and NASDAQ may close the year at 2100 and 5,000 respectively. On the acute downside, world renowned demographic economic forecasters Harry S Dent Jr. and James Dale Davidson have made extremely compelling arguments predicting both a stock market and real estate crashes of 80% and 40% respectively by 2018. Either way, uncertainty breeds volatility, as such, this trading year may be one of eminent turbulence.

- **Gross Domestic Production (GDP):** Our domestic economy should produce sustainable below trend growth of 2% or less, while the rest of the world should demonstrate anemic growth producing GDP of 2.7% at most. Our domestic demographic deflationary headwinds imply this subpar growth trend will persist for the next decade.

- **Deflation/Inflation:** Deflationary forces still linger in our domestic economy even though the Fed has fears of inflation. This contagion is prevalent throughout the world and will not abate until the retrenchment in global aggregate demand unwinds. Once again, the US core inflation will fall short of the 2% Fed target.

- **Interest Rates:** The Fed's December rate hike appears to have been a bit premature with inflation at 1.54%. Both their inflation and growth expectations seem to be Trumpmitized or in other words, blown out of proportion. Either way, interest rates are destined to rise given the Feds intent to reach monetary equilibrium with the rate at 2% along with an economy that's picking up steam. We should expect two rate hikes of say 50 basis points in total. The 30-year and 10-year treasuries closed the year at 3.07% and 2.43% respectively while the 30-year mortgage closed at 3.92%. All of these rates are likely to rise between 25 and 50 basis points unless the Fed reverses their policy.

- **Bonds:** It is more probable their yields will fall in the near-term only to trend higher along with the Feds rate movements. Given the interest rate destiny, the bond bull market may be in its final stages and may not resume until the next downturn. Investors should consider rebalancing a portion of their fixed income portfolios to the benefit of equities after the market correction. In addition, they should consider investment-grade and high-year corporate bonds with a neutral term. On a cash flow basis **AAA Municipal Bond** fundamentals remain a safe investment with a low risk of loss so long as investors can hold the bonds to maturity.

- **Currencies:** The US dollar bull market remains intact. Since our elections**,** the dollar surged 5%, a 14-year high only to partially deflate by year-end. This trend will persist for many years placing continuing pressure on our export sectors profit expectations. We should expect at least a 5% rise against the other major global currencies. This dilemma will be further aggravated by the rise in the Fed rate causing an influx of foreign investment that will further exacerbate the problem. The unintended consequences of a strengthening dollar consists of falling oil prices since this commodity is traded in US dollars, discouraging of energy production/investment and encouraging corporate America to move their operations overseas.

- **Turmoil in Oil:** This crisis primarily relates to the supply-side of the equation. As such, both OPEC and non-OPEC countries have agreed to cut production in their attempt to boost prices. Their success is probably somewhat limited. The collapse in oil prices decimated the energy sector. Notwithstanding the positive support in prices, a recovery is not in the cards in the near-term. The price of oil closed the year at $54 per barrel. It is reasonable to believe oil will trade within a range of $45-$65 and retreat to $55 per barrel by the end of the year. The bear market has further to run on until global demand accelerates.

- **Gold/Silver:** Although these precious metals shined last year it is plausible to believe they will lose their luster in 2017. Gold closed the year at $1150 per ounce while silver closed the year at almost $16 an ounce producing superb returns of 8.5% and 6% respectively. By virtue of the rising US dollar, expect these precious metals to trend lower. From a contrarian perspective, a 5% to 10% position makes sense in a diversified portfolio given heighten geopolitical risks.

- **Real Estate:** New residential construction is well below the level required for our demographic needs while commercial construction has demonstrated strong growth. Sales of new and existing home will continue to advance but at a more sluggish rate as compared to the prior year. Real estate values are predestined to retreat since their prices cannot accelerate faster than wage incomes and inflation. As such, real estate is facing the headwinds of housing affordability in this environment. More Americans are priced out of the market since their anemic wage gains cannot support these valuations along with rising mortgage rates. Expect housing to rise 4% this year and turn negative in 2018.

As a result of our election, investors have been Trumpmitized, tricked and of course, tweeted. In this world where risk and uncertainty has become more elevated, I remain less optimistic about the outlook.

Disclaimer

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