

January 20, 2018

## 2018 Economic Forecast

### The Disengagement of American Global Leadership

#### Governance by Crisis and Chaos

**Preamble:** The 29th 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 associated analysis as they relate to the economy and effect on the financial markets. But first, I will discuss the reality of the New Tax Reform.

**The GOP passed their historic Tax Cuts and Jobs Act (TCJA) representing the most significant tax reform since 1986.** In a political gamble, the GOP tax reform is being sold to a skeptical American public that permanent corporate tax cuts will help the middle-class, that is, what's left of them. The majority of Americans justly believe their taxes will rise rather than fall and our national debt will explode within ten years. This is especially true in Democratic states that have both high income and real estate taxes. Even for the needier taxpayers, any potential tax savings is more likely to be eaten up by the Republicans self-induced rising health insurance costs. The TCJA expects Corporate America to invest their tax savings and repatriated foreign accumulated profits that are subject to a one-time tax, back into the American economy, creating more jobs and raising our gross domestic production (GDP) to an unattainable rate of 3%. It is more probable than remote Corporate America is more likely to pay down debt, continue stock buybacks but at a slower pace, intensify mergers and acquisitions and increase both shareholder dividends and executive compensation. A Wharton School of Business study has determined GDP may rise .5% at best. At the end of the day, this fiscal stimulus package is nothing more than an enormous giveaway to both the wealthy and corporations. This will be at the cost to all other taxpayers. On the horizon, and only while the GOP retains control of the government, we can expect substantial cutbacks in entitlements, including but not limited to Social Security, Medicare, and Medicaid. The TCJA further widens the skyrocketing gap between the rich and poor that has reached historic proportions annually since 1980. Our middle class, once considered the economic backbone to the American Dream, is disappearing. At one time they were the majority of our population only to drop below more than 50% today. 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. On the other hand, and domestically, 1% of households own 37% of all privately held wealth. This is not only a US dilemma. According to a Credit Suisse Report, 1% of the world's richest own half of the world's wealth. This trend is destined to intensify in the long-run. **Notwithstanding the fact that this is a bi-product of capitalism, no society can sustain this kind of mounting inequality without extreme social and economic repercussions in the future.**

**This is the first time in US history a massive stimulus package has ever been employed while our economy is operating above full employment.** This type of stimulus is ordinarily reserved for periods of economic contraction such as recessions. President Trump's belief that a 4% GDP is obtainable has no merit. Economic cycles are directly associated with demographic trends. Prosperity has always been fueled by population growth. Domestically, this principle has turned to the downside given the 108 million baby boomers entering their retirement years. These trends are so profound that in addition to our \$21.6 trillion national debt, our government needs to address the estimated \$120 trillion of unfunded liabilities associated with the 21st Century Social Security & Medicare Panic and government pensions. We will also suffer the consequences of the demographically induced subpar economic growth (GDP) over the long-run. All of our Representatives are aware of this imminent debt disaster, yet the TCJA may very well add more than \$1.5 trillion to our national debt. So, I need to ask, what happened to our fiscally responsible Republicans, such as the Freedom Party? Was this win so important to hastily passing such legislation, not even recognizing the near and long-term economic and social implications? We probably can expect our economy to start heating up. Our labor markets will become even tighter, causing wages to rise along with inflation. The Federal Reserve (Fed) will raise interest rates, possibly three to four times and the dollar will ascend having a negative impact on our export sector. The Fed's monetary policies historically overshoot the economy. **As such, a Fed induced recession may be in the cards in the near-term.** The TCJA is the epitome of supply-side economics (Reaganomics) where lowering the tax on the wealthy produces greater economic benefits than giving tax cuts to lower-income earners. It didn't work for Reagan. On the other hand, Clinton raised taxes, the economy expanded and the deficit reversed to a surplus. The question becomes, what will we do at the next economic downturn? **Against the backdrop of limited monetary and fiscal policy tools, we will have no choice but to borrow even more leaving our heirs to deal with our self-inflicted debt catastrophe.**

### **Geopolitical Risks: The Disengagement of American Global Leadership**

**The quest for peace and freedom will continue in a year of living more dangerously than in the past.** During this past year, we have witnessed the escalation of crisis and conflict, including but not limited to, North Korea's "Rocket Man", Russia's influencing our democratic elections and their Ukrainian aggression, atrocities in Syria, Iran's terrorism meddling in the Middle East, the Saudi Sunnis regional Yemenite proxy war with their centuries old enemy the Iranian Shiites, China's rising global influence and of course cyberspace espionage and crimes. Although the defeat of ISIS was in the cards, the consequences of their fighters dispersing throughout the world may become even more problematic. **However, the world's greatest geopolitical risk lies in the disengagement of American global leadership.** This started with George W. Bush's misadventures in the Iraqi and Afghanistan wars. Obama botched the follow up. Then came along President Trump who campaigned "Let's make America great again and America first". Contrary to every other Presidential commitment, Trump has reneged on the Paris Climate Agreement, a **HUGE** job creator. America is the only country in the world that did not sign. He is in the process of renegotiating NAFTA even though we are the primary beneficiary with Canada, our largest export trading partner. Next will be the Iranian Nuclear Agreement and with it, the possibility of greater turmoil in the region. He has alienated our allies. Europe already recognizes they cannot rely on America and are now on their own. America's disengagement has left a European vacuum that will be filled by Germany and France.

No one can trust us. Actually, with the preponderance of fake news and attacks on our media, we can't even trust each other. **This administration's foreign policy can be summed up in one word, unpredictable.** Our State Department is in shambles. Under Secretary of State Rex Tillerson's management, he has cut the budget by almost one third and instituted a hiring freeze. In 2017, one hundred senior Foreign Service Officers left the department, many without any explanations and eliminated most of the minorities and women's jobs. Notwithstanding the North Korean crisis, Syrian War and possible Iranian/Saudi Arabian conflict, we do not even have assistant secretaries for East Asia or the Near Eastern Affairs and no ambassadors for South Korea, Saudi Arabia, Turkey, Jordan, Egypt or Qatar. Per a New York Times article, Senator John McCain sent a letter to Mr. Tillerson stating "America's diplomatic power is being weakened internally as complex global crises are growing externally." **In sum, this is a disaster waiting to happen. Mr. President, America has always been great. Although you have attempted to make us first, you have succeeded in making us second on the world stage.**

### **Governance by Crisis and Chaos**

**Our political fiasco can be summed up as the great divide where "bipartisan" has become a dirty word.** One would suspect that depriving the Democrats from participating in the TCJA legislative proceedings would have major repercussions such as a further divide between the parties and loss of trust and mutual respect in the American democratic process. Contrary to the public's general belief, Republicans were not excluded from the Obamacare enactment. This was probably the most negotiated bipartisan process in two decades. There were 160 Republican amendments from the Joint Committee included in the law. The Republicans participated in the entire formation but at the end of the day not one Republican voted for it. However, they shut down the government in an attempt to defund Obamacare. Every politician wanted tax reform. Perhaps if the Democrats participated we may have wound up with a fiscally responsible and non-discriminatory piece of legislation. No one, no Democrat no Republican or Independent should ever shut down the government or use the budget as a political tool. However, The Democrats recognize that their only opportunity for any of their agenda, specifically the Dreamers, rests in holding up the budget process given the Republican control of the government and their related abuse of power. So there is no misunderstanding, we are a country built on immigration. Our demographic issues advocates elevating legal skilled immigration to support our retirees and social security system. The President and Republicans knew the Democrat's DACA position back in September when all parties agreed to a 2 month extension. Now we are looking at either a third short term extension or a shut down. Perhaps it's time to reverse this long-term trend and return to bipartisanship and start supporting all the American people rather than each party's base. **Our present political fiasco is what I call governance by crisis with the Democrats and chaos with the Republicans. At the end of the day, the Republicans cannot govern against the back drop of a splintered party and a lack of presidential direction.**

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## State of the US Economy

The US economy continues to establish sustainable below trend growth against the back drop of a domestic environment consisting of benign inflation, accommodative monetary policy, a weaker dollar, enhanced corporate profits, full employment and abundant liquidity while the rest of the world's economies are growing at an above trend rate. When all is tallied, GDP will come in about 2.2% while inflation fell short of the Fed's target, closing the year at 2.1%. The prerequisite for growth lies in the expansion of both credit and consumption. In this current cycle, the expansion of aggregate demand has been businesses and to a lesser extent consumers. On the downside, our deflationary demographic progressions associated with the retirement of 108 million baby boomers will guarantee us that this subpar trend will persist for the long-term. So, let's discuss the economic fundamentals affecting our domestic economy as follows:

- **The Federal Reserve's** monetary policies will tighten during our economic expansion triggering say, three to four rate hikes totaling 75 to 100 basis points. Labor markets will toughen placing upward pressure on wages along with inflationary expectations. The Republican tax cuts are inflationary by nature and will tend to overheat the economic expansion. When global interest rates remain neutral the dollar will strengthen which will have a negative impact on our exporting sector. In this environment the Fed is most likely to overshoot and induce a recession.
- **Corporate America's** incredulous profits are peaking and may continue to by midyear, at best. Although Wall Street believes earnings will surpass 2017, this trend cannot continue while the economy is operating at full-employment and our labor market continues to contract. Their profit margins will be squeezed against the back drop of escalating labor and health insurance costs and a strengthening dollar. Despite the corporate tax rate cut from 35% to 21%, the average S&P 500 rate is only 24.8%. The after tax benefit maybe completely offset by the TCJA provisions allowing the immediate expensing of capital expenditures. Their balance sheets remain healthy, are plush with cash and maybe further enhanced with repatriated dividends from abroad. Despite thousands of retail store closings this year, their holiday sales rose 4.9%. This was the best since 2011 while e-commerce rose by a stunning 18.1%. Both high-end and discount retailers prospered. On the other hand, stores that relied on the dying middle class such as Macy's, Sears and JC Penny were amongst the many that closed stores. The change in buying habits to on-line and the continued decimation of our middle class has forced many retailers to seek bankruptcy protection. Some examples are; Toys R Us became No Toys 4 U, Perfumania evaporated, Vanity got a face lift and Payless Shoes became Pay No More. At the end of the day when all is tallied, Amazon may very well account for 50% of all e-commerce sales for 2017. At this rate, we can only expect more bankruptcies which will ultimately have severe adverse economic implications to the shopping mall industry in the long-run.
- **The Banking sector** remains well capitalized and access to credit continues to improve. The banks will be the primary beneficiaries of falling taxes and rising interest rates. The industry's expectation of major deregulation is probably missed placed. The headwinds facing these institutions are cyber security and the migration to mobile and digital technology in order to remain competitive. Although fintechs are the leading innovators in this industry, it is more probable that major banks will partner with the likes of

Facebook, Amazon, Google and others. This sector expects to physically see only half of their onsite customers in 2018 and beyond.

- **Consumer's confidence** has demonstrated an incredible revival against the backdrop of rising incomes, pent-up demand, low interest and unemployment rates and a forever climbing stock market. On the down side, it may not take very much to reverse this trend. Despite the fact that disposal income will get a boost from tax cuts, this benefit may be offset by rising health insurance and medical costs. Their incomes are still rising but at a much lower rate. In addition, the gains associated with the tightening labor market will not be broad based. It is unreasonable to believe consumers will expand their spending at a greater rate than their incomes are rising.
- **The unemployment rate** has fallen to 4.1% from its 4.6% rate in the prior year. This represents an economy operating at full employment. However, the preponderance of jobs added were low paying ones primarily in the retail and food service arenas. The Fed prefers to use the real unemployment rate which is about 8% and also includes part-timers and discouraged workers. However, the best measurement that is not publicly disclosed is the underemployment rate which was 12.5% at July 31, 2017 and will be updated by January 29, 2018. This includes workers whose skills are not fully utilized and those earning less than the poverty level which is \$10.50 per hour. On the bright side, this is almost an impressive 9% improvement over the previous year. Given the TCJA, we can expect the unemployment rate to drop temporarily to 3.9% in 2018 but expect it to ultimately rise to 4.2% in 2019. Contrary to the general belief, job losses are primarily associated with technological advancements rather than US operations being moved abroad. On a long-term perspective, millions of jobs will be replaced by robotics. Given our demographics, the unemployment rate is more likely to rise rather than fall in an environment of subpar economic growth.
- **The Housing Sector's** new construction has been a major contributor to our economic expansion in 2017. This trend should continue given new homes still remain well below our demographic needs. We may very well see a 10% increase over the prior year in housing starts, which would account for 1.33 million new homes. Realtors are projecting a 3.7% increase in existing home sales and also expect the national median value to rise 5.5%. On the downside, the industry is facing a low supply of existing homes, causing prices to rise and making homes less affordable in several parts of the nation. In addition, mortgage rates are expected to rise and there will be some negative implications associated with the Tax Cuts provisions effecting the limitations of both real estate taxes and mortgage interest deductions.

**In sum, the US economy's performance has surpassed all reasonable expectations.** All the economic fundamentals have turned to the upside primarily consisting of surging domestic and global aggregate demand. However, we are at the top of the economic expansion cycle that has lasted nine years. Regrettably, all good things generally come to an end. On a positive note, a bull market tends to do well as the cycle matures. We are facing the headwinds of inflation associated with a labor market operating at full employment along with rising interest rates. Our economy should continue to surprise on the up side until at minimum the end of the third quarter of 2018. **The odds favor a recession towards the end of 2018 or the beginning of 2019 that may very well be initially propagated by the Fed rather than a contraction in growth. Either way, a US recession will**

**spread like a contagion to the rest of the world.** On a long-term perspective, we will encounter so many issues that are so pervasive they will challenge the face of American Society. We will be forced to address the demographic negative impact of our aging population, national debt of \$142 trillion inclusive of unfunded liabilities, deteriorating infrastructure, climate change, wage stagnation and the enormously escalating inequality between rich and poor which will eventually lead to civil unrest. **The prerequisite for prosperity lies in productivity rather than debt accumulation.** The TCJA is nothing more than deficit financed tax cuts for both corporations and wealthy individuals and will add \$1.5 trillion ultimately to our national debt. This is the first time in our history that a stimulus package has been created while our economy is operating at full employment. Injecting stimulus at this point in the cycle will heat up the economy triggering inflation. So there's no misunderstanding, the stimulus benefits will be short-lived and the long term impact will be clearly detrimental to our nation. Absent any geopolitical and/or natural disasters, our GDP may rise to 3% during the year only to close at 2.5% and possibly 2% in 2019. **Although the US economy, the star performer in the world, has always been resilient on a historic basis, it is more probable to disappoint on the downside.**

#### State of the Global Economy

**The global recovery has developed into an impressive above trend GDP growth of 3.7%.** This expansion is the direct result of an environment consisting of extremely low inflation, accommodative monetary policies and advancing aggregate demand. **While in the major advanced economies their fiscal policies reversed from austerity to pro-growth creating an upsurge in capital spending.** Given the momentum of this expansion, 2018 growth may very well be as good as it gets and may continue until a US recession. **Euroland** with the exception of the UK was the stellar performer against the backdrop of fiscal spending and enhanced lending from their recapitalized banking sector. Actually, all of Europe contributed towards their growth despite their structural and fiscal imbalances associated with the disparity in their economies of scale. **Japan** continues to remain trapped in their protracted deflationary stagnation given their demoralizing demographics consisting of the oldest population on the planet and their shrinking labor force. **China** is the global wild card given their structural fiscal imbalances. They need to revamp their industries, recapitalized their banks and fight corruption. Their society suffers from both massive poverty and inequality between the rich and poor that may lead to civil unrest in this communist country. On the bright side, they have all of the monetary and fiscal tools necessary in which to avoid any financial crisis and enable a soft economic landing. **In sum, notwithstanding the outlook remains entrenched with risks and uncertainties, the world is in the midst of an unsustainable above trend economic growth and its direction is contingent upon the degree of a US recession in late 2018 or early in 2019.**

## 2018 Economic Forecast

**The equity market's performance can be summed up in one word, surrealistic.** This phenomenal upsurge has been fueled by spectacular corporate profits, a synchronized global economic expansion and continued investor optimism since President Trump's election. All the positive economic fundamentals remain in-line to support this trend in the near-term. Bull markets tend to do very well when the economic cycle starts to peak. It is even possible for the Dow to hit 30,000 by midyear. However, the underlying factors cannot persist and will start reversing probably in the second half of the year. Corporate profits will be squeezed due to rising wages inherent in tightened labor markets. In addition, the inexcusable tax cut stimulus will overheat the economy and wage/price inflation will advance forcing the Fed to raise interest rates. It is more probable the Fed, under Jerome Powell's new leadership will overshoot monetary policy. **The odds favor a Fed induced recession by the end of 2018 or early 2019. This may very well mark the end of this nine year bull market or it will be merely a postponement depending upon the magnitude of our next correction.**

The Dow surpassed the 25,000 milestone mark on January 4, 2018 closing the year at 24,719 producing an unprecedented return of 25% in a year of geopolitical crisis and chaos. The S&P 500 attained its all-time highs of 2,674 demonstrating a superb yield of 19%. While on the other hand, the NASDAQ was the top performer closing the year at 6,903, generating a monumental return of 28%. All of the US market indexes surpassed their historic highs multiple times in a year without trading volatility. On a technical perspective, equity market valuations since 2016 has reached elevated extremes where by their inflation adjusted price to earnings (P/E) ratio is 26 times earnings as compare to their historic norms of 16 times earnings. In 2018, we will witness an enormous amount of mergers and acquisitions (M&A) activity, especially in healthcare and technology. On the other hand, there will be a substantial reduction in stock buy-backs due to their extreme valuations. **It is more probable than remote to expect a major sell-off of equities when the goldilocks economic fundamentals start reversing, perhaps after midyear. This may represent a buying opportunity since US equity markets can surprise on the upside, and ultimately rise in an environment where corporate profit margins or being squeezed.** After the corrections, equities will still outperform all other asset classes but Euroland, and Japan should outperform the US markets. In terms of sectors consider technology, healthcare, energy, industrials, investment banking and financials. On the other hand, avoid consumer staples, telecom and utilities. The primary objective of investors should be cash flow is everything. As such, consider large caps that will be able to ride out any storm and ones that consistently pay increasing dividends. **At the end of the day, investor's philosophy should favor capital preservation rather than asset appreciation.**

Absent any geopolitical and/or natural disasters, the forecast assumes investor complacency and irrational exuberance while all the positive economic fundamentals remain in-line, at least in the near-term. We are approaching the top of our economic cycle which will probably start reversing after midyear. This may very well mark the end of the nine year spectacular bull market. On the upside, bull markets tend to perform quite well as the economic cycle reaches maturity. On the downside, a market collapse usually implies recession in 3 to 6 months. Although the DOW may breach 30,000 by midyear, it will ultimately succumb to multiple corrections. The first may be 5% to 10%, giving way to a total collapse of 33% by year end that may otherwise partially run into early next year. The S&P 500 will trade between a range of 2,700 and 3,100 closing the year at 2,100. The top performer, NASDAQ will trade between a range of 7,000 and 8,400 to close at 5,500. The equities after the corrections will approach their historic valuations representing a buying opportunity.

- **Gross Domestic Production (GDP):** Our domestic GDP may rise to 3% during the year and then fall to produce sustainable below trend growth of 2.5% by the end of the year and further contract to 2% in 2019. Given our demographic concerns subpar growth will persist for the next decade. On the global front, the rest of the world should demonstrate above trend growth of 3.5%.
- **Deflation/Inflation:** The world is fundamentally deflationary since technological innovations and the internet will continue to drive prices down. Our maturing cycle is creating an inflationary injection that will reverse in our next economic down turn. The prior year core inflation was 2.1% and will rise to 2.5% in the current year.
- **Interest Rates:** Against the background of rising inflationary expectations associated with our tightening labor markets and unwarranted tax stimulus the Fed will raise rates between three and maybe four times for a total of 75 to 100 basis points. The 30-year and 10-year treasuries closed the year at 2.74% and 2.5% respectively and the 30 year fixed mortgage closed at 4%. All of these rates are likely to rise by at least 75 basis points. It is more probable the fed will overshoot their inflation and unemployment forecasts provoking a recession in late 2018 or early 2019.
- **Bonds:** Their yields will trend higher along with the Fed's rate movements. The bond bull market is over given their interest rate destiny. Investors should maintain a short to neutral positions. On a long-term perspective, we may be facing stagflation by 2020 where interest rates tend to climb.
- **Currencies:** The US dollar declined about 10% against the other major global currencies in 2017. As the Fed raises rates and the rest of the worlds monetary policies remain accommodative, the dollar will trend higher. We should expect this trend to continue in 2018 until the next economic downturn.



- **Oil:** The bear market has come to an end against the backdrop of strengthening demand associated with the global synchronized economic expansion. The price of oil closed at \$60 per barrel. It is feasible to believe oil will trade within a range of \$60-\$75 per barrel so long as OPEC and Russia comply with production restraints. On the upside, the US is the world's largest producer of natural gas and is on the verge to overtake both Russia and Saudi Arabia as the number one oil producer. This enables the US to add stability to the oil markets.
- **Gold/Silver:** These precious metals tend to do well in an inflationary environment. Gold closed the year at \$1306 per ounce, while silver closed the year at \$17 per ounce demonstrating solid returns of almost 14% and 6% respectively. Rising interest rates does not bode well for gold. On the other hand, inflation, dollar depreciation and geopolitical uncertainties may bring gold and silver to close the year at \$1500 and \$18 per ounce respectively. Even from a contrarian perspective, a 5% to 10% position makes sense in a diversified portfolio given intensifying geopolitical risks.
- **Real Estate:** New home construction will continue to thrive on both strong demand and the lack of supply to meet our demographic needs. We should expect a 10% increase in housing starts and a 3.7% increase in existing home sales. However, the industry is facing rising mortgage rates and a low supply of existing homes that causes prices to rise, making home sales less affordable. On our next economic downturn values will contract.

**The odds support a recession in late 2018 or early 2019 procreating even greater risk and uncertainty in our global markets against a backdrop of rising geopolitical concerns. As such, I remain less optimistic about the outlook.**

**The general consensus, regardless of party affiliation is that we are happy 2017 is over and we pray 2018 will be better.**

#### **Disclaimer**

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