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2019 Economic Forecast

Lies, Lies, More Lies and True Lies

Are we approaching a Constitutional Crisis?

Preamble: The 30th edition of this annual Forecast is designed to inform my readers of my assessments of the state of both the global and domestic economies and forecasting the outlook for 2019. My findings are predicated upon employing demographic theory and analysis as they relate to the economy and effect on the financial markets. But first, I will discuss our conflicted current administration.

As a Certified Public Accountant, I have always believed in the Republican Doctrines consisting of smaller government, lower taxation, free trade and fiscal prudence. Against the backdrop of a Republican controlled government, they passed a fiscally irresponsible tax cut that disproportionately favors the wealthy and corporate America and further exacerbates the escalating disparity between the rich and poor. This tax cut will add more than $2 trillion to our current unsustainable national debt of almost $22 trillion over the next 10 years. This was the first time in US history a massive stimulus package has ever been employed while our economy is operating above full employment. Sound monetary and fiscal policies are reserved to induce stimulation for periods of economic downturns. This was Trump's signature accomplishment and was passed without considering the near and long-term economic and social implications. The Republicans have apparently waned from their ideology, given the fact that they are spending more, taxing less and pursuing protectionism under the nationalistic premise of America first. **Government always runs better when no one party is in control.** On the upside, the Democrats have taken control of the House and with it, oversight and possibly fiscal discipline.

I have always maintained it will be the Republican Party to challenge the president. There comes a point in time where there is so much pervasive evidence of wrongdoings that it starts to appear that the Senate Republicans are co-conspirators. It is only then that they will act. You be the judge based upon the following:

- Is Trump profiting from his presidency placing himself in violation of the Emoluments Clause of our Constitution even though he promised to divest himself?
- Will the Democratic controlled House subpoena Trump’s tax returns or will Treasury Secretary Steven Mnuchin refuse to turn it over forcing a delay until the Supreme Court decides?

- During his campaign, he promised to pay off the National Debt within eight years. Does this even seem plausible when he will add almost $2 trillion to the debt within his first two years in office?
- Although the stock market initially benefited from the “Trump Bump”, can he be given credit for the economic expansion and job growth or was this merely a natural occurrence resulting from the prior administration's policies and domestic and global growth?
- Against the backdrop of inflammatory anti-immigration rhetoric, do you believe our southern border is unsecure even though we are more protected than ever before and are currently spending about $19 billion a year which is more money than all federal criminal law enforcement agencies combined receive?
- As Americans, is it appropriate to cage migrant children and separate them from their parents?
- How can Trump close the government and hold it hostage for political gain with the support of the Republican Senate knowing he never had the original votes for it from his own party? Notwithstanding it may possibly cost $30 billion to build, is the Wall really the answer when the majority of our undocumented immigrants arrived here legally and overstayed their visas? Isn’t it legal for migrants to seek amnesty at any of our borders?
- Did Trump fulfill his campaign promise to drain the swamp or did he merely add quicksand to it?
- Have we ever had a President who has refused to listen to his advisors and challenged the independence of the Pentagon, Justice Department, Federal Reserve and Free Press?
- Has the Supreme Court become politicized by the Republican Senate majority’s refusal to consider any of President Obama's nominees? Will this forever change the direction of the court and with it the loss of faith by the American public in our justice system?
- The Republican mantra has been to repeal and replace Obamacare since its inception? So why haven't we ever seen any replacement offered for the past nine years to cover the 36 million and 9 million people with pre-existing conditions who would lose coverage?
- How many more mass shootings must take place before we have constructive gun control?
- Is the Mueller investigation a witch hunt? Will we ever see his report?
- Is it possible Trump is beholding to Russia since they may have refinanced his real estate empire due to the lack of available US credit stemming from the 2008 crash?
- How can the President defy his military advisors and order the disengagement from Syria leaving our allies at bay and creating a vacuum that will be filled by Russia and Iran? Will our Kurdish allies be obliterated by Turkey and how will our other allies, especially Israel react?
- The New York attorney general has ordered the Trump Foundation to liquidate for fraud and multiple illegal acts including campaign violations. During his campaign, didn’t he ask that the Clinton Foundation be investigated for illegal activities?

No person is above the law. This is not the end but merely the beginning. We may very well be approaching a constitutional crisis. Will Trump’s legacy be the divider, a liar, creator of crises or the absolute worst, a Russian agent? Are these lies, lies, more lies and true lies? Enough said, you decide.

Since post-World War II, our alliances have been the cornerstone to protecting our Democratic values. Since the Trump administration, we have witnessed the disengagement of American global leadership. We used to be loved by the world. Now most countries hate us and it is getting worse not better. **The loss of global confidence in America could be the catalyst to the demise of the dollar remaining the dominant reserve currency in the world.** Already major countries are making bilateral agreements to move away from trading in the dollar. Once this occurs, all the cards will be off the table. American life as we have grown accustomed to will no longer exist. We will have a recession unlike any other with massive inflation, extremely high interest rates and our taxes will become unbearable since the world will no longer buy our debt. **No matter what one's party affiliation is, we need to unite and act together to avoid the loss of our democracy and along with it our living standards.**

Now let us stop discussing the most televised reality show in our history and turn to geopolitical risks.

Geopolitical Risks: A World of Turmoil and Uncertainty

The pursuit for peace and freedom will continue in a year of living more dangerously. We have observed the escalation of crisis and conflict such as the trade war, North Korea's "Rocket Man", Euroland's populism along with the possibility of the Brexit, the never ending Middle East fiasco, the Saudi assassination of a US journalist, the Mueller investigation, Russian interference in the US elections and cyber warfare in addition to many others. A US/China trade agreement appears elusive at best given it requires China's concessions on non-trade issues such as military restrictions and cyber hacking. This represents our most pressing geopolitical risk especially given the enormous global economic ramifications involved. These trade disputes should have included our allies forming a united front. **However, the world's greatest long term geopolitical risk lies in the disengagement of American global leadership.** Our State Department has been so decimated we still have vacancies for ambassadors and high level staff in global hot spots like South Korea. Even our allies, if we even have them, would consider turning to Russia for strategic partnerships. The long-term ramifications will be the loss of the US dollar as the dominant reserve currency in the world. These world disorders raise both the climate and environment for future crises, chaos and conflict. The cost of controlling these disorders depletes our global resources and impairs our living standards. **There is no prosperity without world peace.**

State of the Global Economy

The global economy has produced below trend growth of 2.9% against the backdrop of distressingly surmounting debt levels in the majority of countries. Other than the US, this is primarily the result of the reversal of their fiscal policies from austerity to pro-growth creating an upsurge in capital spending and overall aggregate demand. In this current environment of contracting global economic activity and accommodative monetary policies, this excessive debt appears to be manageable. However, this will not always be the case. This overpowering debt not only misappropriates future growth but also makes the world susceptible to any adverse economic obstacles. Since the demise of the Debt Super-cycle, monetary and fiscal policies may not be able to create enough aggregate demand during downturns in order to regenerate economic growth. In moving forward the world is facing potential trade wars and advancing protectionist actions along with rising inflationary fears, fiscal restraint and monetary policies that are destined to become more restrictive. **The key to renewed global expansion lies in China attaining an economic soft landing.**

Against the backdrop of an enormous contraction in economic activity, China's authorities remain committed in their transition from an export to a consumption-based economy. Their addiction to debt has created a never ending excess capacity to the extent that vacant buildings have reached historically elevated levels. Given the headwinds of US tariffs, their difficulty lies in stimulating the economy without adding more debt to an already untenable dilemma that has already breached 250% of GDP. Assuming a trade deal is attainable in the near term, China has the prerequisite arsenal of monetary and fiscal cards available to avert any financial crisis. **The odds favor China avoiding a hard landing by possibly mid-year and with it, a comeback in commodity prices and a turnabout in global economic activity.** For more than the past two decades, **Japan** remains trapped in their self-inflicted protracted deflationary stagnation due to their paralyzing demographics. They have the most rapidly aging population in the world along with a dwindling labor force. To alleviate this lingering trend, their authorities need to reverse their no immigration policies notwithstanding the possible risk of mitigating the sovereignty of their identity. Even though their interest rates have not surpassed negative territory, their Prime Minister's "Abenomics" monetary and fiscal policies implemented are showing minimal improvements consisting of anemic wage growth and finally, benign inflation expectations. Their negligible GDP may actually rise from .5% to 1% in 2019. The **European** Central Bank's quantitative easing programs have officially ended against the backdrop of subpar growth of 1.2%. With the expectations that interest rate hikes will be placed on hold in this environment of a continuing global contraction and complacent inflation, growth will advance producing below trend GDP of 1.8%. **Italy** is ready to be booted for their excessive spending. The **Brexit** political fiasco will probably result in either a new government election or a referendum. **At the end of the day, it is more probable than remote the UK may choose to remain in the EU rather than suffer the painful consequences in leaving it.**

In sum, **notwithstanding the outlook is entrenched with escalating risks and uncertainties, the world is in the midst of a sustainable above trend economic growth of say 3.5%.** Although monetary policy has been biased towards an extremely accommodative stance, the global economic contraction will make it difficult to reduce their excessive debt dilemma. The ultimate direction of the global economy depends upon China achieving a soft landing and the continued success in the US. Assuming a free trade deal is negotiated shortly, it becomes more likely the global economy will turn around by midyear. **Given the existing economic fundamentals, it appears a global recession is not in the cards. However, 2020 may be a different story.**

State of the US Economy

The economy has surprised on the upside demonstrating unsustainable above trend growth in the second longest expansion in our history. Our economy is driving full speed ahead on all of its cylinders against the backdrop of benign inflation, complacent monetary policy, tax reform fiscal stimulus, elevated corporate profits, full employment and abundant liquidity. Our domestic GDP of 2.8% is untenable at best given the expansion is approaching the top of the economic cycle and is further compromised by the strengthening dollar and the China tariff war. The prerequisite for growth lies in the expansion of credit and consumption. As evident in the current cycle, the breadth of aggregate demand has been in both the public and private sectors. On the downside, capital spending is dwindling, consumer confidence is destined to erode along with a curtailment in consumption and any additional fiscal stimulus remains remote. So, let us discuss the economic fundamentals affecting our domestic economy as follows:

- **The Government Sector:** Fiscal irresponsibility has become the standard operating procedure during the Republican controlled Trump administration. Notwithstanding his campaign promise to eliminate the national debt within eight years, it is estimated their budgets would add more than $8 trillion in four years. During periods of economic expansion and full employment, our government is supposed to run surpluses. However, since Trump's election, his deficits have continued to grow greater than the previous administration. His 2019 deficit is projected to surpass an unsettling $1 trillion. This uncontrollable debt represents our greatest threat to our future growth as well as the deterioration of our living standards. Perhaps there will now be some oversight with the Democratic controlled House. Government generally works better when no one party controls. Either way, it will be incredibly painful to reverse this trend. So there is no misunderstanding, in the long term taxes are guaranteed to rise.
- **The Federal Reserve:** Monetary policy became less accommodative to the extent of 100 basis points in 2018, not to mention the prospect of more rate hikes this year. Given the global neutral rate position and economic slowdown plus benign domestic inflationary expectations, the Fed remains less likely to overshoot and thus avoid a Fed induced recession. They will probably raise their rates by no more than 25 basis points perhaps twice this year.
- **Corporate Sector:** The 2018 astonishing profits will not be repeated. Profit margins historically come under pressure during the late stages of an economic expansion. While top-line revenue may continue to advance, their profit margins will be subject to a prolonged compression by virtue of the tight labor market, related health insurance costs and the negative impact of tariffs. On the downside, capital spending surged in the first quarter due to the tax reform, however, corporate America opted to use their tax savings for buybacks and dividends rather than investing in productivity. At the end of the day, profit growth may reach 6%. On the upside, Christmas retail sales increased 5.1% representing the strongest season in six years while online sales is expected to increase 15% from the prior year. Despite bankruptcies have fallen to a two year low, this trend is more likely to reverse as brick and mortar retailers fall victim to their internet competitors.

- **The Unemployment Rate:** The rate actually rose to 3.9% from a low during the year in November of 3.7% but still is less than the 4.1% last year. Given the economic expansion has matured, expect the unemployment rate to rise rather than fall to say 4.25%. Contrary to fake news, job loss has less to do with US operations moving abroad and more to do with technological advancement. Imagine for the moment the amount of people that will be ultimately displaced by the future of robotics.
- **The Consumer Sector:** Consumer confidence retreated 6% in December after the stock market's worst performance since the Great Depression. After filing their income tax returns, the majority of consumers will find the new tax reform really did not benefit them especially after considering their increase in health insurance costs. Their wage growth was negligible at best. The inequality of wealth between the rich and poor continues to grow unabated. The tax reform benefits preeminently went to the wealthiest Americans that added $1.5 trillion to our national debt that our grandchildren will have to pay back. Throw in the political anxiety and you have consumer confidence doomed for collapse triggering retrenchment in spending, a prerequisite to our economic expansion.
- **Banking Sector:** The banks are well capitalized and remain the epitome of health surpassing all of their global counterparts. It has been ten years since the financial crisis and the banks have to thank the aggressive regulatory actions for their wellbeing along with the beneficial economic fundamentals and digital technologies that made them extremely profitable.
- **The Housing Sector:** To sum up 2018 in one word would be disappointing. There has been a contraction in home values, sales activity and developer expectations against the backdrop of rising mortgage rates and buyer discontentment. The government even wants out of their Fannie Mae and Freddie Mac programs. To add injury to insult, the tax reform act placed limitations on real estate tax expenses and mortgage interest. On the upside the housing affordability has improved while on the downside new construction still remains well below our demographic needs.

In sum, the US economy's performance has beaten all reasonable predictions. All the economic fundamentals were in line. As we start 2019, our domestic economy faces many headwinds that may become a drag on growth such as a retrenchment in consumer spending, mounting inflation, overly restrictive monetary policies, an unsettling China trade war, lack of a global turnaround and political turmoil. Notwithstanding we are approaching the top of the economic cycle and absent any geopolitical or negative shocks, the expansion can continue at a somewhat lower rate of growth. There is no economic data that suggests an oncoming recession. **Given the extended term of this economic expansion, it appears more probable to anticipate a recession in mid-2020. On the other hand, it could be much sooner if the Fed's monetary policies become too restrictive and self-inflict a recession.** Demographics have always determined the rise and fall of empires. On a long-term perspective, we will encounter so many crises that are so pervasive they will challenge the face of American society. We will ultimately have to come to terms with the adverse demographic impact of our aging population and the 75 million future retirees. Our insurmountable national debt is $22 trillion and does not include $210 trillion of unfunded liabilities. **Yes, we are addicted to debt and so is the rest of the world.** Our eroding infrastructure, climate change, wage stagnation and the mounting inequality between the rich and poor that will be the catalyst to civil unrest all need to be added to this equation. So there is no misunderstanding, you can't borrow your way to prosperity. Absent any geopolitical and/or natural disasters, our GDP will de-escalate to 2.5%. **The US economy, the global giant, has always remained resilient on a historic basis and is more likely to forge ahead and surprise on the upside into 2020.**

2019 ECONOMIC FORECAST

Are the Bears eating the Bulls? This was a December you did not want to remember. We have witnessed the entire 2018 market gains getting wiped out in this month. The confluence of factors provoking high anxiety on Wall Street consists of Trumps trade war with China, global economic contraction, threat of Fed tightening and domestic political chaos. **Yes, fear is in the air.** The Dow and S&P 500 closed the year 23,327 and 2,507 producing distressing negative returns of 5.6% and 6.2% respectively. The NASDAQ closed at 6,635 suffering 3.9%. This entire catastrophe occurred in December. The prerequisite for a continuing bull market rests in earnings expectations, equity valuations and abundant liquidity. The current economic fundamentals support a continued Bull Run but in a lower investment return environment. Equity markets tend to do very well when the economic cycle starts to peak. At this stage, corporate profits will weaken but trend in positive territory. Restrictive monetary policy expectations appear to be overblown, especially since the inflation outlook is more likely to fall below the Fed target of 2%. China will settle their trade disputes and avoid a hard landing. This will bode well for the global slowdown enabling it to turnaround by midyear and fend off a recession. Given this market correction, equity valuations have become more attractive. However, there remains one wild card I call **"Trumpmatized Uncertainty"**. This is where Trump's political uncertainties and equity markets collide. **It is more probable the equity markets will get worse before getting better especially given the government shutdown. The Bears should remain in hibernation until say mid-2020. This year of trading will be intensely challenging marked by extreme volatility and turbulence. Given the late stage of the economic cycle, investors may very well be rewarded by remaining in the market.**

In this world of low returns, the central banks will remain biased to an accommodative monetary stance. This encourages investors into reflation trade strategies, ones that favor equities over bonds and therefore, taking on substantial risk in this world of unpredictability. Equities will still outperform all other asset classes. While diversification is a key to a well balanced portfolio, there are no particular regions that stand out other than the US. On the other hand, Japan appears to be a good contrarian play given their low valuations and potential currency gains. China equities lost 25% in value and should be considered after they achieve their soft landing. When China comes around so will emerging markets who had severely suffered from both the rising US dollar and interest rates. In terms of sectors, consider financials, energy, healthcare and technology that got particularly hard hit in this correction. On the other side of the coin, stay away from consumer staples, materials and telecom. In this investment climate of risk and anxiety, investor's primary objective should be cash flow is everything. Therefore, consider large caps that will be able to ride out any storm and companies that consistently pay increasing dividends. **At**

the end of the day, investors should favor capital preservation rather than asset appreciation. If you are willing to take on greater risk then consider value in place of growth.

Absent any geopolitical and/or natural disasters, the forecast assumes China will settle the Trump trade war in the near-term and achieve a soft landing, the global economy will turn around by mid-year and our monetary policies will remain accommodative. The markets will be more challenging during the first half of the year as compared to the remainder. It is possible that we may see double digit rates of returns this year. The Dow will trade between a range of 22,000 and 27,000 closing the year at 26,000. While the S&P 500 and NASDAQ may close the year at 2,750 and 7,500 respectively. At the end of the day, this trading year will be one of extreme turbulence and volatility where the market will rise on good news and fall on bad possibly triggering a series of mini corrections.

On the downside, China's inability to resolve its trade disputes would create an enormous drag on the global economy and/or we have a US constitutional crisis then all bets are off the table. The Bull Market would come to an end, markets would crash and we would be on the precipice of a recession.

- **Growth Domestic Production (GDP):** Our GDP will recede to sustainable below trend growth of 2.5%. The detrimental demographic impact of our aging population and our paralyzing national debt assures subpar growth for decades to come.
- **Deflation/Inflation:** The world continues to become more deflationary due to technology and the Internet. When approaching the top of our domestic economic cycle and running at full employment one would foresee an inflationary injection, yet 2018 came in at 2.21%. The expectation for this year should be less than 2% at best which is below the Fed target.
- **Interest Rates:** Notwithstanding the fact the Fed raised rates by 100 basis points during 2018, their 3% rate remains in accommodative territory on a historic basis. The belief that the Fed intends on multiple increases is without merit. It is more probable they may raise the rate 25 basis points once or possibly twice this year. The 30-year and 10-year treasuries closed the year at 3.015% and 2.685% respectively while the 30-year fixed mortgages closed at 4%. All of these rates may rise by at least 25 basis points.
- **Bonds:** With interest rate destiny to the downside over the next five years, investment grade fixed income and high yield will perform well in this environment.
- **Currencies:** The US dollar bull market has further to run. By midyear, the Fed rate increases should have come to an end. Ultimately, the global rates should start to normalize alleviating the differentials between the currencies allowing the dollar to fall. This will benefit our export sector and corporate profits.
- **Turmoil in Oil:** The recent turbulence in the price of oil has more to do with the supply side of the equation rather than the demand side. This was a Trump induced phenomena and is not the beginning of a bear market. The Trump administration granted waivers to Iran's major importers after levying sanctions causing the collapse in the price. Oil closed the year at $45 per barrel after

the price climbed from $60 to $74 preceding the crash. Given the demand side of the equation, the price should trade in a range of $70 to $75 per barrel.

- **Gold/Silver:** These precious metals did not do well in this climate of rising interest rates and benign inflation. Gold lost about 2% and silver about 9% closing the year at $1,283 and $15.43 respectively. There does not seem much upside to warrant any major investment. However, on a contrarian standpoint, a 5% position seems justified in a diversified portfolio given the escalating geopolitical risks. Gold and silver may close the year at pretty much the same place they started it.
- **Real Estate:** The residential market disappointed on the downside against the backdrop of dwindling valuations and sales activity further compounded by rising mortgage rates and income tax limitations. While on the commercial side they are facing the headwinds of oversupply especially in the retail arena. Investors need to view real estate on a cash flow perspective rather than enhanced valuations.

The odds support our economic expansion to continue well into 2020 but at a subpar below trend growth rate. Again, this is predicated upon China's ability to resolve their trade disputes in the near-term and effectuate a soft landing. China's transition would be the stimulant to a global recovery. On the downside, the Trump administration's uncertainties tend to be on a consistent collision course with our financial markets. These are challenging times full of risks that can make it extremely difficult to navigate turbulent markets. As such, investors should consider managed accounts.

Disclaimer

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