February Economic Outlook

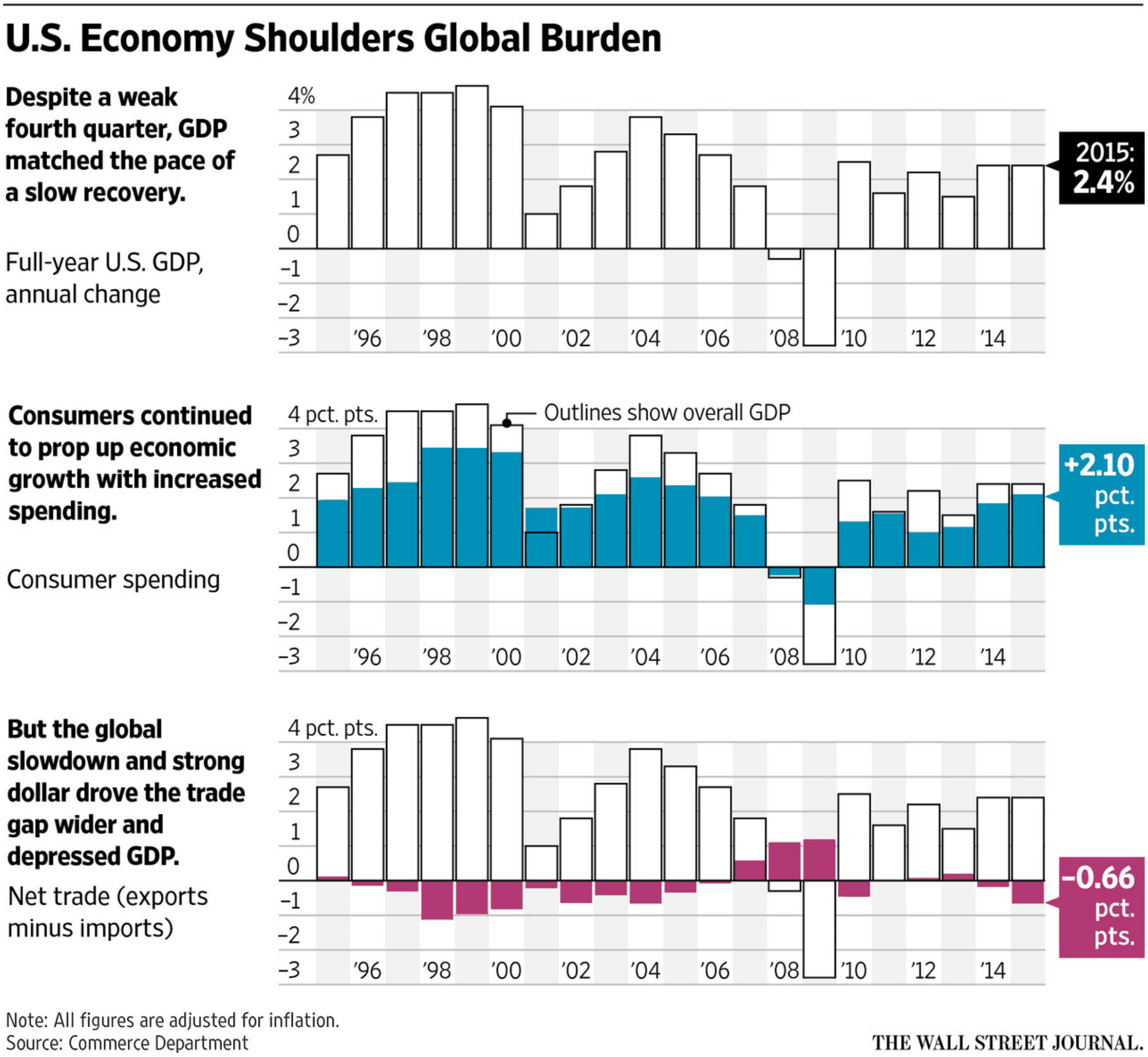
Summary

- U.S. economy and consumer are doing fine
- Last GDP and employment reports were disappointing
- This economic cycle is different than most
- External risks are rising: China's slowing, Chinese trading partners especially resource countries are contracting, Middle East remains dangerous, European banks and refugee problems.
- There are growing concerns about the elections.
- The markets are focusing on oil price trends for signs of a global slowdown/recession

Economy

Our economy grew 2.1% in 2015, but the 2015 4th quarter growth was only .7%. Also, the latest employment report was disappointing.

Below are some charts from the WSJ with the important trends from 2015:



As the chart above shows, growth was 2.4% for 2015. Consumer spending growth was 2.1%, but exports had negative growth due to the strong dollar.

The slowing global economy is impacting our exports, and the earnings of our international companies.

Abnormal Cycle

I took an investment class in graduate school many year ago. The professor taught us about the many cycles that investors, businesses and economies face (market, interest rate, political, economic, product….)

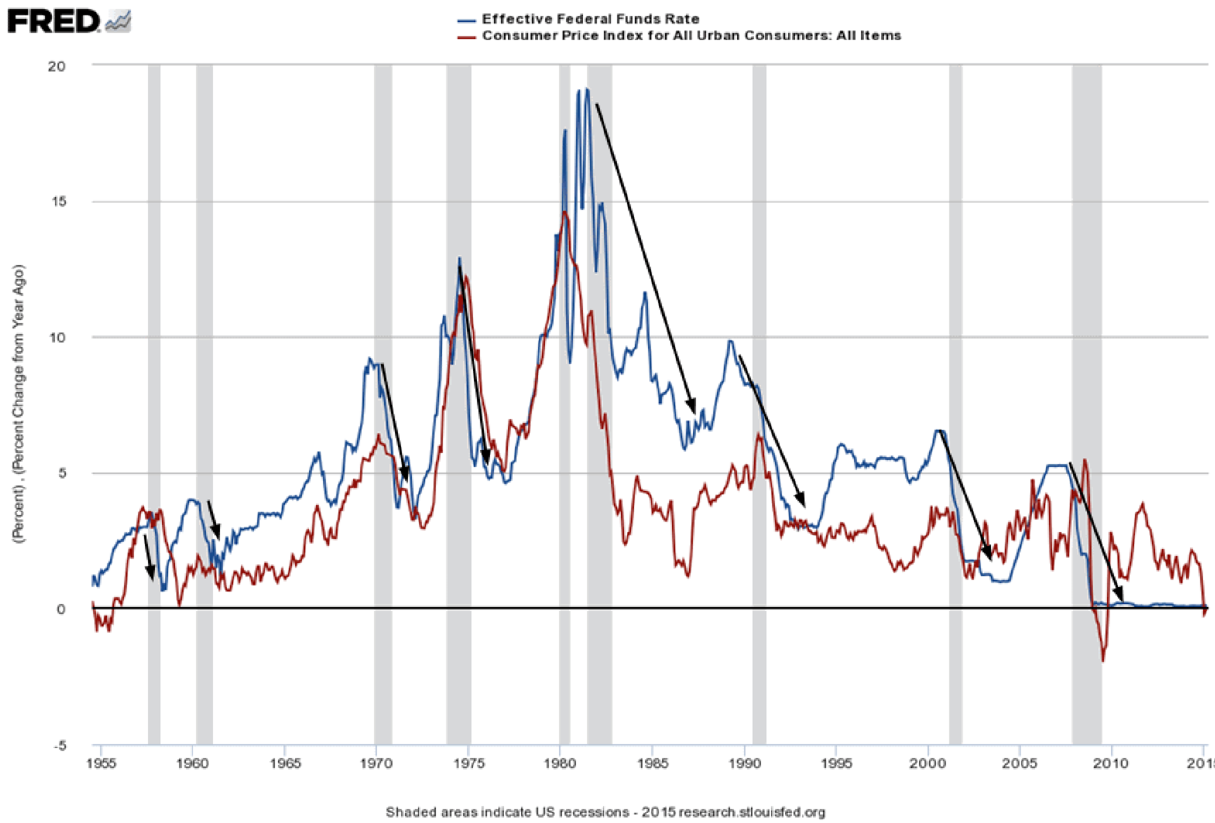
This economic cycle is very different than most, and future cycles may look and act different than past economic cycles, we have probably entered a new ear for our economy and markets. Below are some of the differences:

- Much more severe contration in the economy than most economic cycles
- Interest rates fell to historic lows. Interest rates normally reflect inflation, investors want to protect their purchasing power of their investment/savings dollar. Inflation has averaged about 1.8%, but the Fed Fund's rate is only .5%, way below inflation. Many savers, and lenders of money are not being paid for inflation or the risks they are assuming if their investing in non guaranteed income producing investments.
- Normally the Fed is raising rates to slow an overheating economy that is causing inflationary pressures (demand-pull inflation). The Fed is raising rates, but their trying to normalize rates not raising rates to slow the economy and inflation.
- In past cycles part of the inflationary pressures come from oil and natural gas prices rising. This cycle oil prices have collapsed (more on this in the section *Oil and the Markets*)
- This economc expansion is lasting more than most. Most economic expansions last about 5.25 years. This expansion is about seven years old.
- Our economic concerns are creating a very different political election cycle. More on this in the section below, *Elections*.
- Our economy is much bigger, about $18 trillion, so its harder to grow faster and produce more high paying jobs.
- In the past, when the U.S. caught a cold, the rest of the world caught pneumonia. This cycle, the world is catching a cold, the U.S. is comparatively healthy. The question many investors, including myself, are asking – can the U.S. remain healthy?

If the rest of the world goes into recession, will it drag the U.S. with it. If we do go into a recession because of a global recession, it will be the first time in modern economic history that we did not cause a global recession.

Global Recession and the U.S. Federal Reserve?

In past recessions, the U.S. Federal Reserve lowered rates to stimulate the economy. Below is a chart that shows the economy, interest rates, and recessions:



Notice that after every recession, shaded areas, the Fed lowered rates to stimulate the economy. Lower rates makes it cheaper to finance large purchases (cars, homes, appliances…), and for businesses to finance expansion, growth.

If we go into a recession, the Fed will not be able to lower rates to stimulate our economy. This means that a recession could last longer than most recession, rates can stay lower longer, and the market could struggle.

Most of our major trading partners also have low rates, so other central banks will have a difficult time lowering rates to stimulate their economies.

Elections

The financial press has been concerned about the elections, and the popularaity of Bernie Sanders and Donal Trump.

Analysts and investors are concerned with Senator Sanders costly proposals: Free college at state colleges, single payer health care, paid family leave, combating climate change, strengthen and expand social security, break up the banks and more regulations and taxes for Wall Street.

Analysts and investors are concerned with Mr. Trump's proposals: bringing back jobs to America (could lead to trade wars and barriers), cutting taxes and increases in military spending would lead to greater debt and deficits, deporting millions of undocumented workers and the social chaos that would create.

Click here to read, *Trump and Sanders: Are They Killing the Stock Market?*

Click here to read *Trump Is Wrong on China*

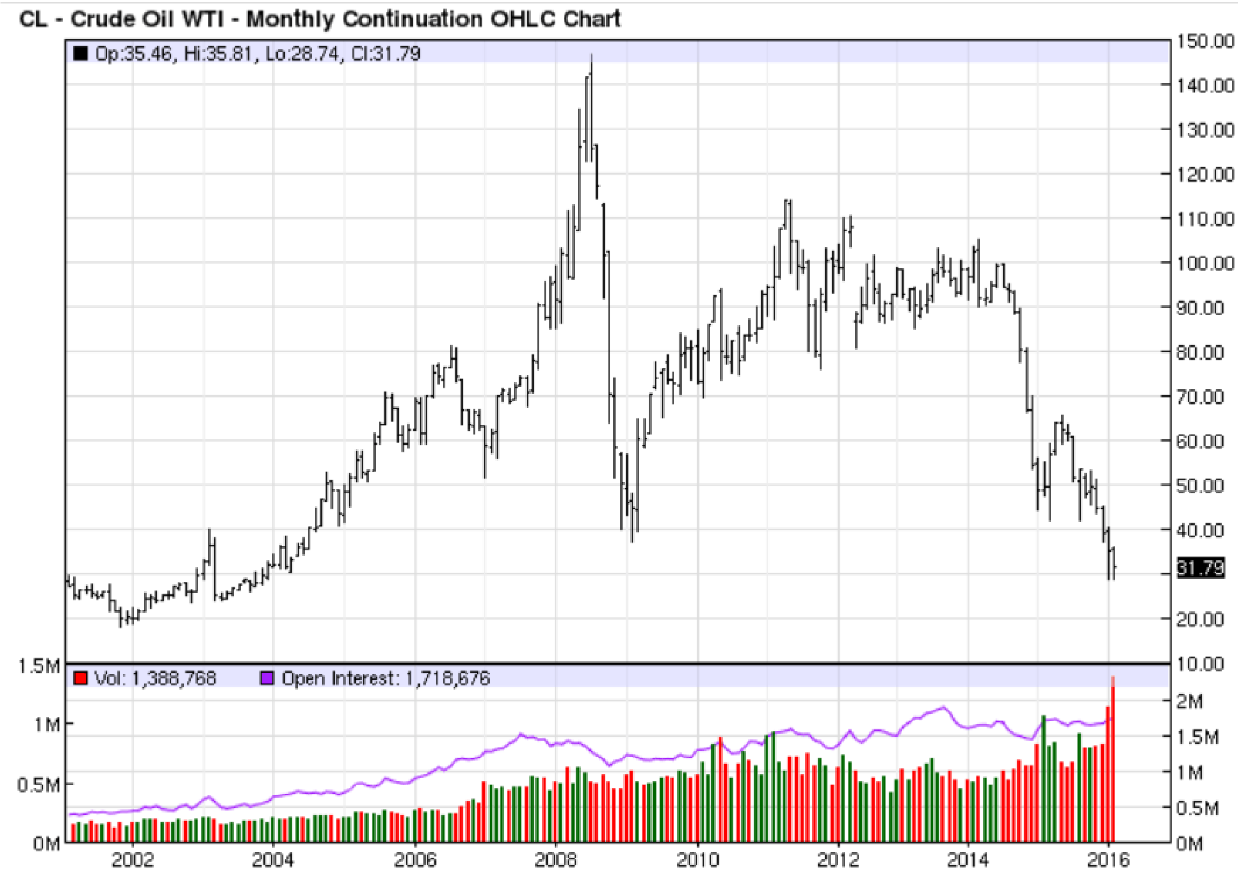
Click here to read *Trump's America* . This is an interesting article that tries to explain why Americans' are for Trump, and why so many Americans are being left behind. The author misses several important reasons why America is different today: 1. A higher cost of living for young adults, especially for education, healthcare, childcare, housing…. 2. It is high school graduates and high school dropouts who are doing the worst because of outsourcing, and automation 3. The consolidation and downsizing of many corporations and industries.

The year after an election is normally a difficult year for the markets, especially if there are major economic policy changes as we would have with Donald or Bernie.

Oil and the Markets

For much of 2016, the equity markets have been following the oil markets. According to the financial press, this is because energy is one of the major weak spots in the domestic and global economies. When oil is up, the markets tend to be up, and when oil is down, the market tends to go down.

Another reason for the focus is that some investors, analysts believe oil will give a clue as to the health of the global economy, and the collapse in oil prices is a sign that the global economy may be headed for a recession. If this were true, then oil is saying we're headed for a global recession. Oil is down over 70%, suggesting a Great Recession. Below is a chart of oil:



In 2014, oil prices were over $100, today prices are about $30, lower than prices during the start of the Great Recession.

The reason for low oil prices are many including:

- Saudi Arabia and OPEC won't lower production to stabilize prices because it would mostly benefit non-OPEC countries like the U.S., Canada, and Russia.
- There is speculation that the Saudi's (Sunnis), and OPEC won't lower production to keep prices low to hurt Russia and Iran (Shiites) economically.
- Price discovery is made in the futures market. The futures markets are highly leveraged and attracts speculators who are short-term focused, and they tend to exaggerate trends. The trend to make money in the oil futures market is bearish. Bulls have been crushed, and have probably been sold out due to margin calls.
- Saudi Arabia and the futures market are keeping oil prices artificially low.
- Iran is now allowed to produce, and will add to global supplies by about 500,000 barrels of oil for the year.
- There is too much supply and weak demand. I will do my usual annual domestic and global outlook and the outlook is not as bearish as prices suggest. We've been through worse supply, demand conditions and prices did not come down this much. The outlook should be out in March or April.

- There is not sufficient storage for the oil being produced. The world is producing about 95 million barrels a day, and demand is close to 95 million barrels a day, the most in history. In 2009, during the Great Recession, the world produced about 85 million barrels a day. Storage capacity needs to be increased, and this would resolve the concerns of not enough storage capacity.

It does not make sense for the equity markets to look at the oil markets for clues to the global economy. Again, the oil markets are artificially extremely bearish.