May Economic Outlook

At the beginning of the year economists and analysts were concerned about:

- A slowing global economy
- The potential for the Fed raising rates
- A rising dollar
- Credit spreads widening
- Falling oil prices

Some analysts and investors are focused on falling oil prices as they saw oil prices as a barometer for the global economy (weak oil prices are a result of a weak global economic outlook). Low oil prices are causing bankruptcies, and non-performing loans on banks' balance sheets, and widening credit spreads. I do address why some of these concerns are incorrect.

Since February, many of these concerns have reversed and the economic outlook improved in the first quarter causing the markets to recover.

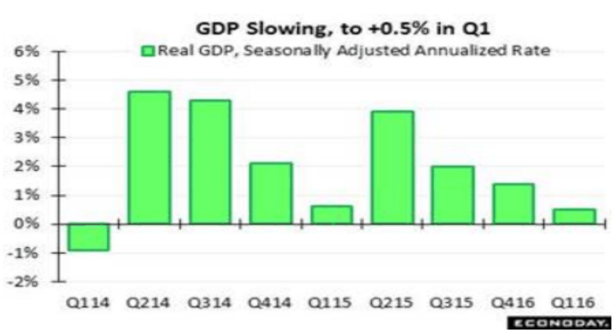
Unfortunately the above concerns are reappearing again, plus a few more including: Brexit (the potential exit of Great Britain from the European Union); uncertainty created by the elections and the potential for dramatic changes in economic policies; changing buying patterns by consumers.

The first quarter we did see weakness in terms of profits, capital spending, economic and employment growth.

Also the Fed raising rates is back on the table. Some analysts believe this can happen in July after the vote by the British regarding them leaving the European Union.

GDP

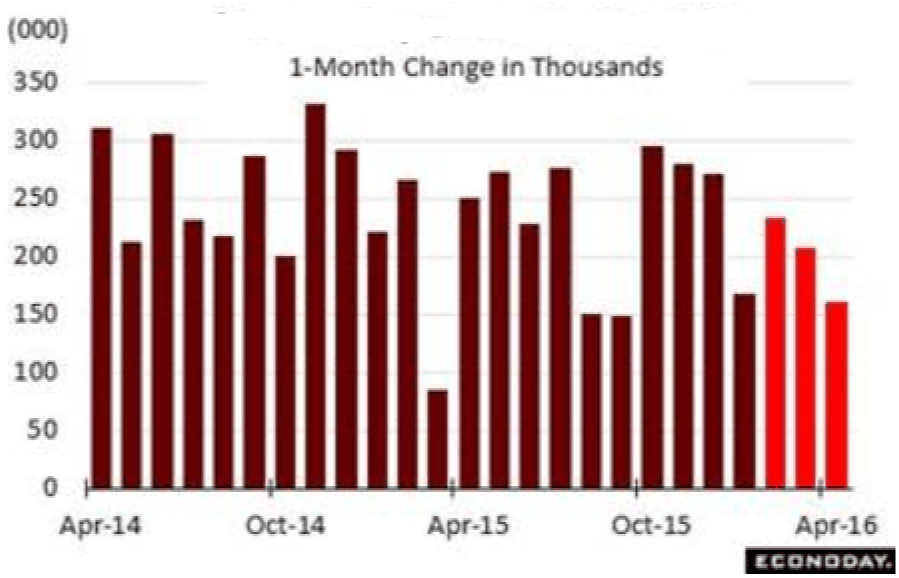
GDP growth is anemic. Here is a chart with the GDP trend:



First quarter GDP was up only .5%. Weakness mostly came from trade and capital spending. The consumer continues to spend, more on this below.

Employment

Below is the employment trend:



Job creation has been slowing. The April report showed a disappointing 160,000 jobs created, one of the weakest months over the last few years.

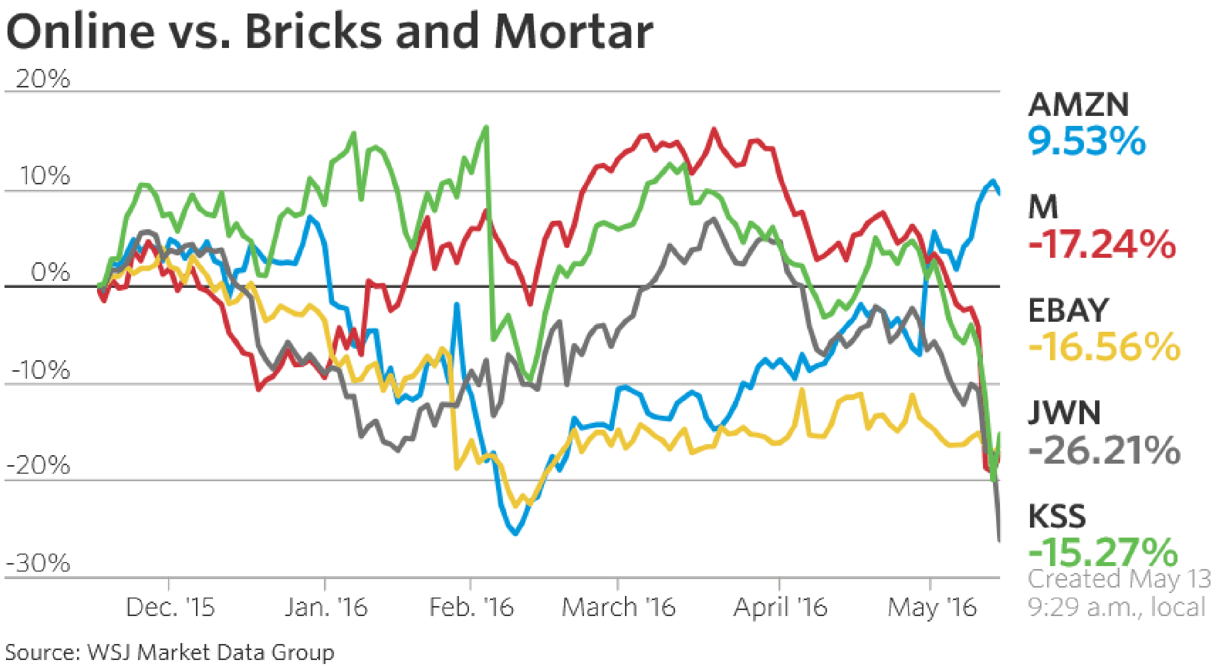
Retail

April retail sales were positive and grew a surprising 1.3%.

We do see changing spending habits by consumers. Consumers are more interested in "experiences" (dining, vacations, spending time with friends and family) versus buying "stuff".

Consumers are also doing more of their buying online and discounters like Walmart. Macy's, Nordstrom's, Kohl's, Target and other retailers had disappointing first quarter sales and earnings.

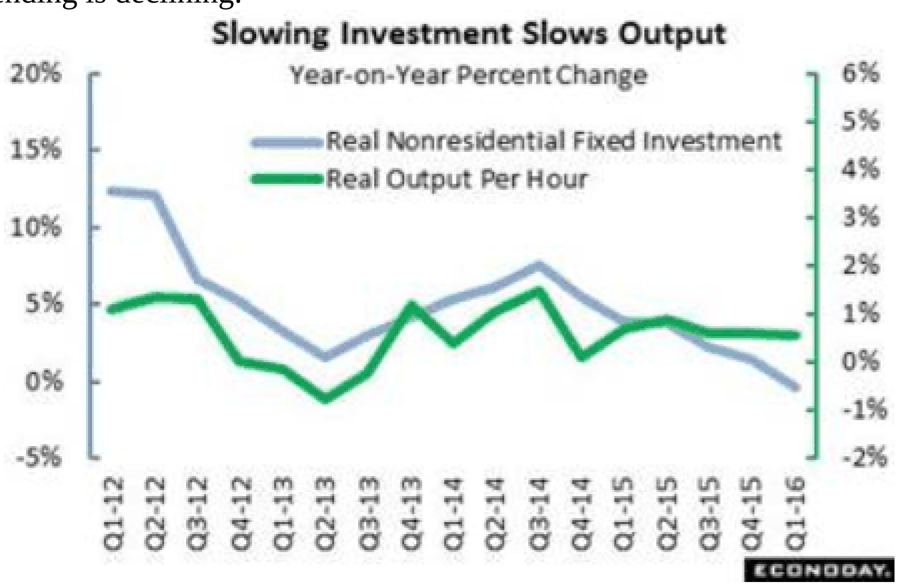
The stock prices of these retailers reflect these changes:



Amazon's stock is up for the year, Nordstrom's (symbol JWN) has entered bear market territory. M (Macy's), EBAY, and Kohl's (symbol KSS) are down over 15%.

Slowing Capital Spending

Capital spending had picked up in 2013, 2014, helping the U.S. economy, but now capital spending is declining:



Many of our large international companies are seeing slowing global growth, and in response they are cutting back on their capital spending.

The energy industry has dramatically cut back on capital spending because for most energy companies their costs are greater than the prices they can get for their oil and natural gas in the markets.

Some analysts point out that with lower capital spending we will lead to lower worker productivity, the green trendline in the chart above.

The Big Short: Two Valuable Lessons

My Godson talked me into seeing *The Big Short*, a film about the housing bubble and the financial crisis of 2008. Click here to read a BusinessWeek review of the movie. I did like the movie. I believe every investor needs to see this movie.

Although I do not fully agree with the movie, it did point out several important lessons for investors:

1. Patience is essential. There is an old adage that "investors are never wrong, we're just early". In the movie, one of the main characters identified the real estate bubble in 2006, but the fear phase of the bubble didn't occur until the announcement of Lehman Brother's bankruptcy on September 15, 2008.

From 2006 to 2008 the investors, speculators in the movie had to endure positions going against them, margin calls, irate clients, and questions about their judgement, intelligence and convictions.

2. Leverage and derivatives are a double edged sword. Leverage can increase revenues and profits. Derivatives can leverage profits and hedge positions.

Too much leverage and the use of derivatives can distort the economy and markets. Derivatives and leverage were variables that caused the market crashes of 1987, 1994, 1998, and 2008.

3. One of the praises of the movie was how the movie explained complex investments and concepts using celebrities (see BusinessWeek movie review). Derivatives were an important cause of the financial crisis of 2008, as they were complex and few investors understood them.

Here is the lesson: WHEN IN DOUBT, STAY OUT!!

4. Don't accept conventional wisdom. Here the conventional wisdom was that real estate prices never go down, and you can always refinance your mortgage. These two illusions proved to be catastrophic to many home owners, real estate investors, our economy and markets.

There are many examples of conventional wisdom turning out to be wrong. In the 1980s, the conventional wisdom was that default rates on junk bonds were very low. Mike Milken and Drexel Burnham Lambert built a huge business from this wisdom and talked many companies into issuing junk bonds and sold these junk bonds to investors especially to Savings and Loans.

This eventually led to the bankruptcy of the Federal Savings Loan Insurance Corporation and the end of the Savings and Loans industry.

Today the conventional wisdom is that the U.S. economy is doing well, and that watching oil prices is a key to the directions of the economy and markets. Let's look at these accepted viewpoints.

Today's Conventional Wisdom

Conventional Wisdom: The U.S. economy is doing fine.

The U.S. economy is doing better than most of our trading partners, but U.S. investors are too U.S. centric and are not factoring in the many global risks that should be a concern:

- China's economy is slowing and its transition from an investment, export, manufacturing focus to a consumer, service driven economy is causing many dislocations in the global economy.

China was one the biggest global buyers of natural resources: iron ore, copper, natural gas, oil, food. China has stopping buying many of these commodities and the countries (Australia, Canada, Brazil, Russia….) that sold these goods to China are suffering

- Middle East tensions and dangerous terrorists who are killing innocent citizens all over the world.

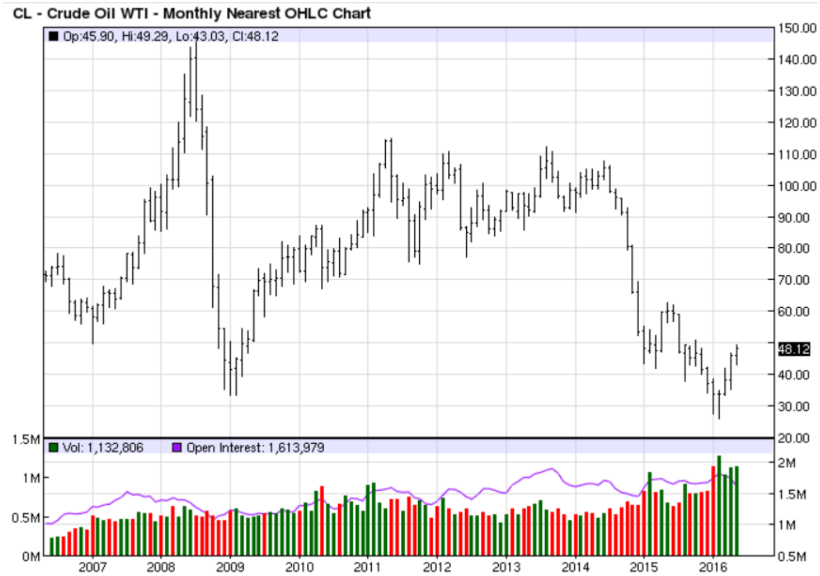
- On June 23, British citizens will vote to stay or leave the Eurozone. Some analysts believe if Britain leaves, it will cause disruptions in the European and global economy.

- The oil price collapse is causing hardships in many oil producing countries. There are reports that the Venezuelan economy is close to collapse.

Yes, conventional wisdom is correct that the U.S. is doing better than the rest of its trading partners. This outlook causes investors to stay fully invested, when global risks are rising and are impacting our economy and markets.

Conventional wisdom: Oil prices are an indicator of the strength or weakness of the global economy.

Below is a 10-year chart of oil prices:



Oil prices crashed in 2008 during the financial crises. Oil prices have crashed to the same level as in 2008. Does this indicate that we are in a recession, or deep financial crisis? No!

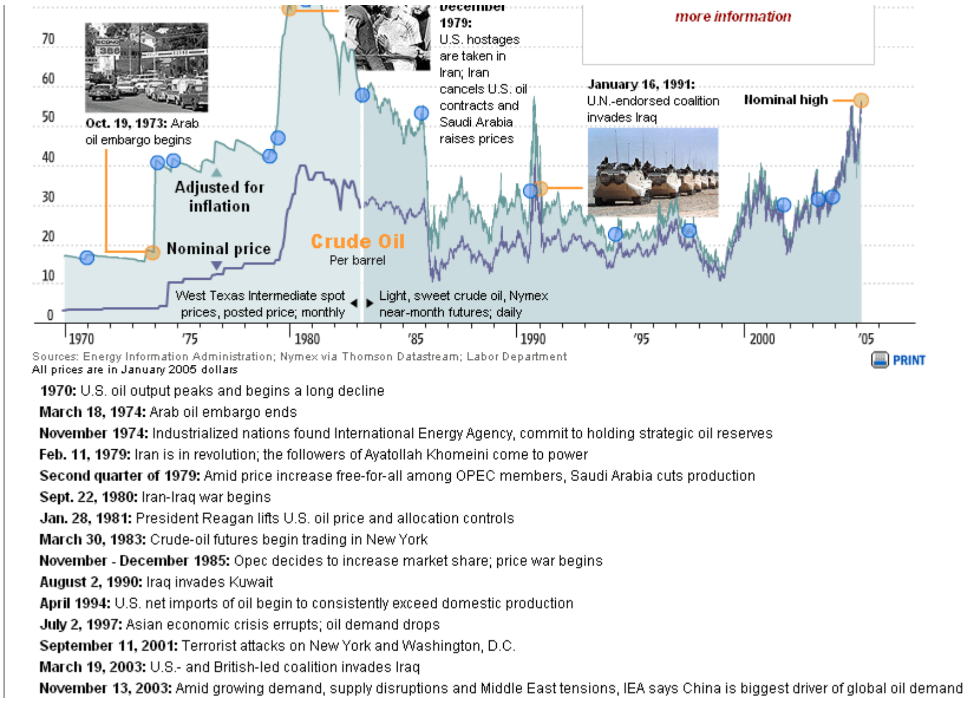
Oil prices collapsed in 2014 due to: too much supply, Saudi Arabia and OPEC producing at full capacity to keep prices low (similar to 1985, see long-term chart below), leverage in the oil futures market is exaggerating the bearish trend.

The current conventional wisdom that oil prices are a good indicator for global growth is incorrect.

Conventional wisdom: The dollar is key to the direction of oil prices.

Briefly, there are many variables that determine the price of oil: finding and development costs; supply, demand; disruptions from wars, terrorists attacks, weather, labor strikes, maintenance issues, oil spills; news events from the Middle East; OPEC (they can influence supply and price); speculators in the futures market (its real); the dollar (oil is denominated in dollars); inflation trends….

Below is a long-term chart of oil with notes on price spikes and crashes:



The chart does show some of the reasons for the major spikes in oil since 1970. Most of the spikes were due to problems or threats to supplies from the Middle East. Notice that when prices spike up or down, there is no mention of the dollar.

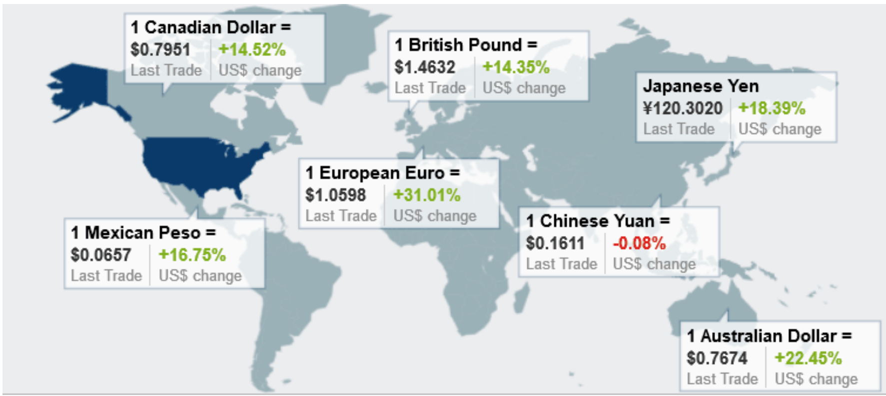
Notice November-December 1985 “OPEC decides to increase market share: price war begins.” This is similar to what happened to oil prices in 2014.

For the last decade there is some correlation between the dollar, and commodity prices including oil.

Briefly, many commodities (including oil) are denominated in dollars, and therefore if the price of the dollar goes up, foreign consumers will pay for a commodity like oil at higher prices, potentially creating less demand and lowering the value of the commodity - theoretically. This would be true if the commodity prices remained stable, but when prices fall substantially more than the dollar, the reason for the correlation does not make sense.

It is not clear how much of a move in the dollar will lower the value of a commodity. For example, the dollar was down about 40% from its peak in 2001 to its trough in 2011, but oil prices went up about four fold from the lows of the early 2000s to the average over the last decade. The increase in prices have more to do with the first four variables mentioned in the list above. Rising finding and development costs are one of the main reasons for the rise in oil prices.

Below is a map that shows how the dollar is doing against some of our major trading partners:



Let's reviwe the chart:

- The Chinese Yuan is barely down, so we would not expect the strong dollar to impact the demand for oil. The Chinese are major consumers of oil, and their demand is expected to increase about 3% this year.

- The dollar is stronger than the Mexican Peso and Canadian oil, but both countries are major oil producers and are able to domestically produce their oil needs. What happens to the dollar and their oil demand is basically irrelevant.

- The dollar is the strongest against the Euro, so we would expect less demand from Europe. Here is where the case for a strong dollar leads to higher costs and less demand falls apart: the euro is valued less this year (because the dollar is stronger) by about 30%, but oil prices are down close to over 50% - oil is still cheaper to buy in Europe, not more expensive.

The link between the dollar and oil prices is very weak over time.

Why does there seem to be a link? If enough people believe something, then it can become a self-fulfilling prophecy. Related to a self-fulfilling prophecy, there now pair algorithms that when the dollar goes up, dollars will be bought and oil will be sold, and vice versa.

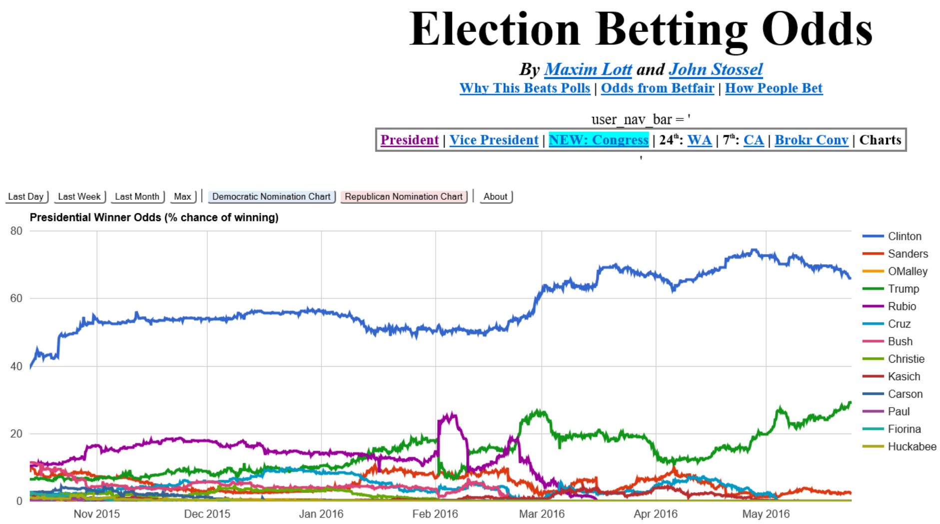
Think about it, the dollar is stronger and oil prices collapsed, as Americans we are paying much lower prices than we were in 2014. Are you paying higher prices today because of a stronger dollar? No!

The conventional wisdom that the strong dollar will cause the price of oil to increase and lead to lower demand does not make sense during this cycle.

Elections

Since this is an election year, and the economic policies could change dramatically, we should keep an eye on some of the betting sites where participants can put money behind their views on the election.

Here is the current presidential odds from the website electionbettingodds.com:

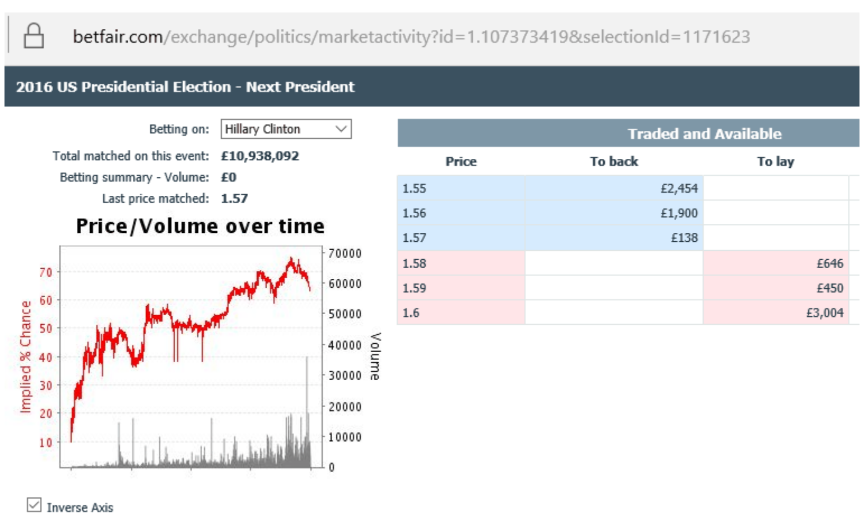


According to the electionbettingodds website, Hillary Clinton's odds have come down and Donald Trump's odds have increased, but this site's odds have Ms. Clinton winning the election.

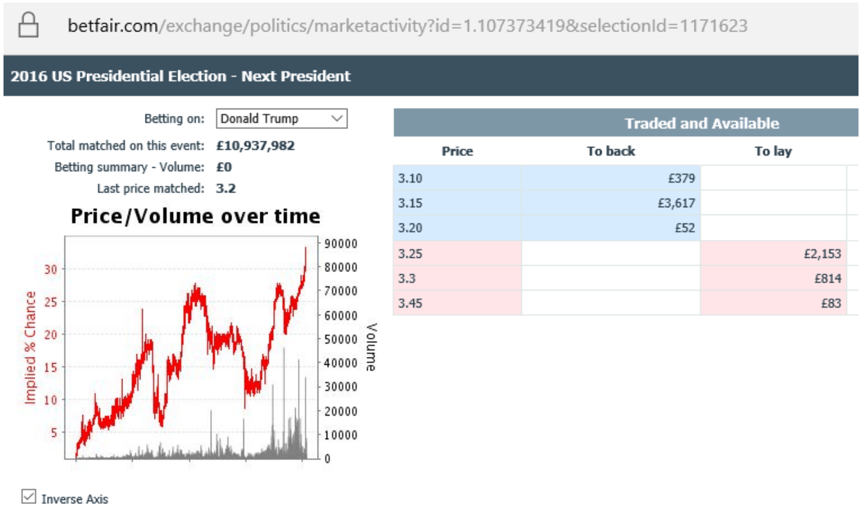
[Click here](#) to go to electionbettingodds website

Below is an international betting site with odds for the U.S. Presidential election:

Clinton is the odds favorite, but her numbers peaked and are falling:



Here are the odds for Donald Trump:



Donald Trumps odds have improved, but remain below Ms. Clinton.

About $16 million in bets have been placed for the U.S. presidential elections on this site.

It’s still early for these numbers to be taken too seriously, but as we get closer to the elections “the wisdom of the crowds” could be a clue to the outcome of the elections.

Click here to go to the betfair website.