2018 3rd Quarter Economic Outlook

With this outlook I analyze the key components of our economy (GDP, inflation, interest rates, and the consumer), and I briefly review the global economy.

Summary

- The stimulus from tax cuts and deregulation has caused a pickup in economic activity.

- Investors, consumers, businesses large and small are optimistic regarding the economy.

- Profits are strong, thanks to the tax cuts

- Job creation continues to grow

- There are trade negotiations with Canada, Mexico, the Eurozone, and China. If the administration has any major successes in trade negotiations the markets and economies could have another stimulus.

- Businesses, economists, analysts are all concerned about growing trade tensions among our trading partners. Trade tensions, and sanctions (against Russia, Iran, North Korea) could slow the global and U.S. economy.

- Inflation, interest rates and oil prices are all rising and are headwinds for the U.S. economy.

- The stronger dollar could be another headwind for the economy.

- Most economists believe the stimulus from the tax cuts will be muted after 2018.

- There are many signs that we are in the late stages of this economic cycle: full employment: rising inflation, interest rates and oil prices; rotation in markets; housing and autos sectors are slowing and are important components of our economy; the length of current economic and market cycle is almost ten years and could be the longest in our economic history

- Last year we had a global synchronous growth economies. This year global growth is slower.

- Last year there was optimism regarding the new pro-business President and his administration. This year is different, trade negotiations will take more time and tensions could continue to escalate; we have sanctions and negotiations against some of our adversaries – Russia, Iran, North Korea that could lead to military conflicts; immigration reform, infrastructure, and fixing health care have been put on hold.

- Deficits and debt will be headwinds for the U.S. economy.

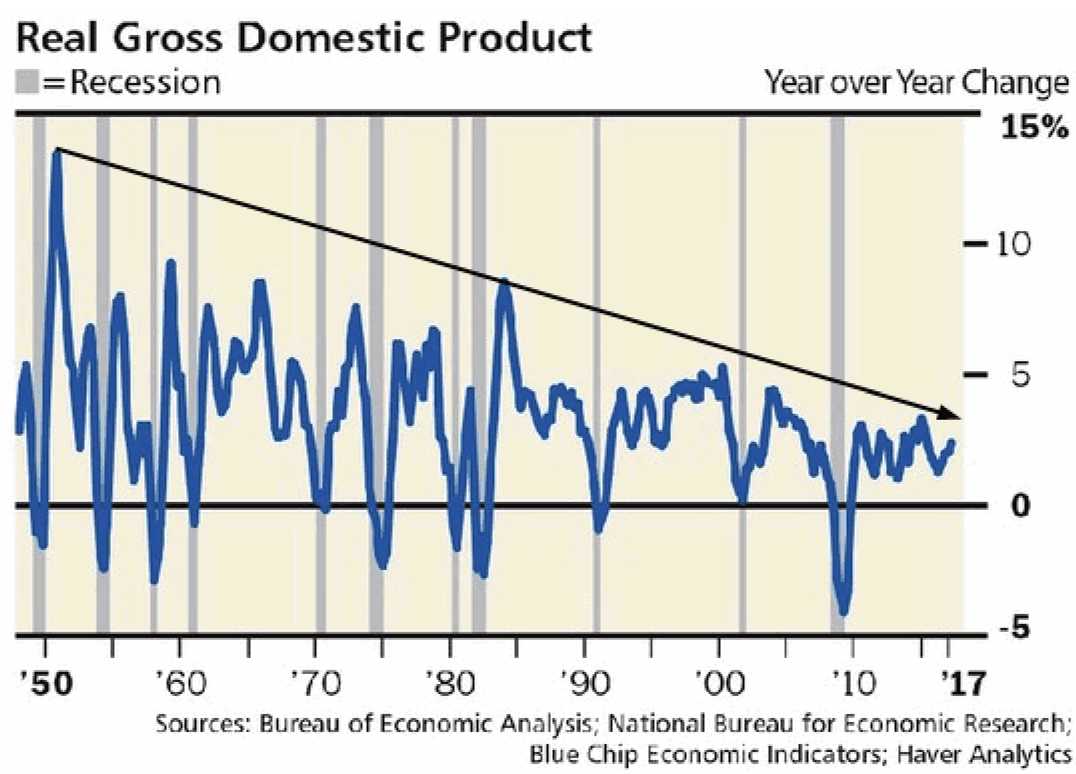
- Economists and analysts have a terrible track record of calling inflection points in the economy. One of the best indicators economists have is the markets, as the markets are anticipatory. Pay attention to my monthly market outlooks that focuses on the markets

Analysts and investors seem to be ignoring the many headwinds the economy and investors face: rising oil prices and interest rates, slowing housing and auto sales, a slowing global economy, our growing deficits and debts, trade wars and rising tensions, volatile global currencies, geopolitical concerns especially with North Korea, Venezuela and Iran, the credibility of our President, upcoming elections, Mueller investigations and his final report.

If the Republicans stay in office (historically this is against Republicans, when a party holds all 3 branches voters tend to vote in the opposing party in mid-term elections) then the momentum for the economy and markets could be sustained. It's likely that the Democrats will take the House, this could be bad for the President and his administration as there will be a check on some of his controversial actions. His administration, economy and markets could struggle. An impeachment (depending on Mueller's investigative report), recession and bear market would be on the table.

GDP

During the presidential campaign, then candidate Donald Trump said his economic policies would make the economy grow 4% to 6%. Recently the President commented that the current "economy may be the greatest in history". Let's look at the historical growth of the U.S. economy to determine how true his statements are. Below is a chart of U.S. GDP that goes back to 1950:



Notice that our economy is cyclical and from 1950 to 1980 recessions (gray shaded area) were frequent. After the 1970s, recessions came about once every 10 years. Also notice that the growth rates slows over time. In terms of growth, the current economy is not the “greatest in history”.

In the 1950s, the U.S. economy was below $500 billion, and it was growing above 5% and for a brief time over 10%. By the late 1980s the U.S. economy grew tenfold to about $5 trillion with very good growth.

The 1990s had consistent growth of over 4% and the economy was about $8 trillion. The consistent strong growth was due to the digital/technology revolution including the emergence of the internet. Technology and the internet created lots of prosperity. The dominant force of the economy for the first decade of the 2000s was real estate and it ended in the popping of the real estate bubble that led to the Great Recession. In 2016 U.S. GDP was about $18.5 trillion.

In 2007, Mohamed A. El-Erian wrote a book, *When Markets Collide*. One of the tenets of the book was that the U.S. would face a period of slower growth, “a new normal”. I updated his outlook and issued a special report. Click here to read the report. Briefly, here are some of the main reasons for U.S. slower growth:

- Law of large numbers. An $18.5 trillion economy will not grow as fast as a $500 billion economy.

- Baby boomers are no longer in their high spending years.

- Millennials have high debt, especially from student loans and when they graduated, the job market had fewer opportunities compared to previous generations, and the cost of living is much higher for this generational group.

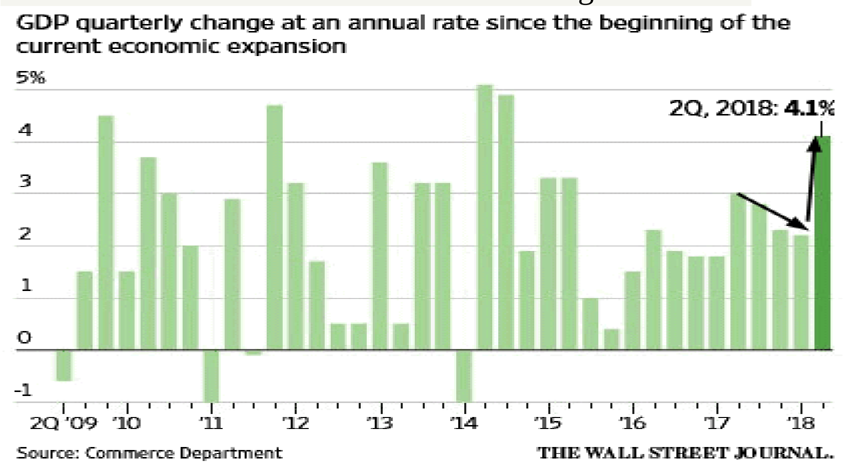
- Consumers, businesses, local, state and the Federal Government have too much debt. When there is large debt capital is used for paying down debt and service interest payments. Too much debt reduces spending, and causes financial pain when we have recessions

- Before the 1990s, the U.S. was the dominant economy in the world. After the fall of communism and the U.S.S.R the world became more competitive and the U.S. had to compete against China, Russia, Eastern Europe, India….

- The consolidation of most U.S. industries creating less opportunity.

- Many jobs have been eliminated due to offshoring and technology.

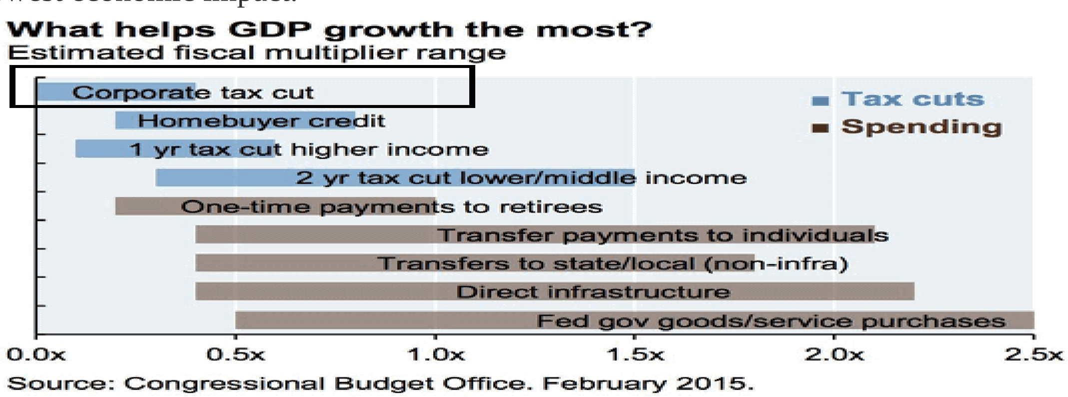
Below is a chart that shows the current GDP growth trend:



The economy did get a bump from the tax cuts, and the increased confidence with the new President and his administration, then growth fell back to the normal growth of this cycle. Thanks to the tax cuts, the 2018 2nd quarter growth rate did accelerate to 4.1%, almost as high as other accelerations in this economic cycle.

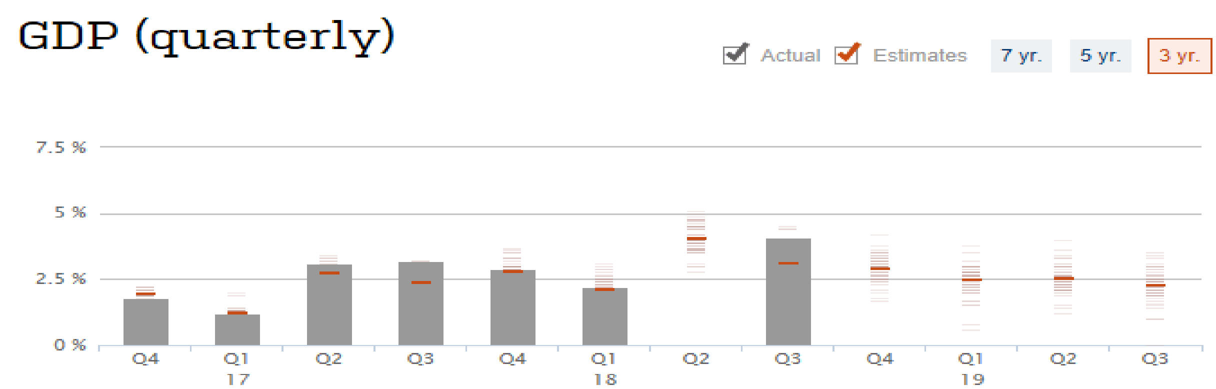
Most economists believe the 4% growth rate is not sustainable. According to Morgan Stanley chief U.S. economist Ellen Zentner says. "The tax stimulus is designed to be very front-loaded in the lift it gives to economy, you have to deal with the hole on the other side." Here are some comments from former Fed Chairman Ben Bernanke. Fiscal stimulus "is going to hit the economy in a big way this year and next year, and then in 2020, Wile E. Coyote is going to go off the cliff".

One of the reasons why the growth is not sustainable is that the significant tax cuts that corporations got is not being put to productive use. Most of the tax savings is used to buy back stock at very high prices, increase dividends, and mergers and acquisitions at very high valuations. I have posted the chart below several times, and it shows the multiplier effect of different fiscal policies. Tax cuts to corporations have the lowest multiplier effect, it has the lowest economic impact.



Corporate tax cuts don't give much bang for the buck.

Below is a consensus economic forecast for the rest of this year and part of 2019:



Source: WSJ, consensus of more than 60 economists

Most economists see the economy slowing after this quarter.

Here is an analogy for this economy and what this economy could be facing: Let's say you were making $180,000 (tax revenue) but you deficit spend about $230,000 and your debts are about $220,000. But to gain more income we will borrow money, and lower our income (we are borrowing money to pay for tax cuts). So now our income will be reduced and our debts will increase. In the real economy, this is while 10,000 baby boomers retire EACH DAY. They will be applying for Social Security and Medicare increasing our deficits and debts. When we go into a recession, tax revenues would fall and unemployment insurance would have to be paid. Revenues could go down to about $120,000 spending could climb to $300,000 making a recession, debts and deficits worse.

Tax cuts, stimulus are normally done at the beginning of a cycle and not towards the end. Cutting taxes at the end of a cycle, with boomers retiring in large numbers is a very risky economic move.

Here are a few questions to consider: Will this President blame others when the economy goes into a recession? Will he take responsibility? Does he have the ability and skills to pull us out of a recession? Will he listen to his economic advisers? Personally, I could not provide positive responses to these questions.

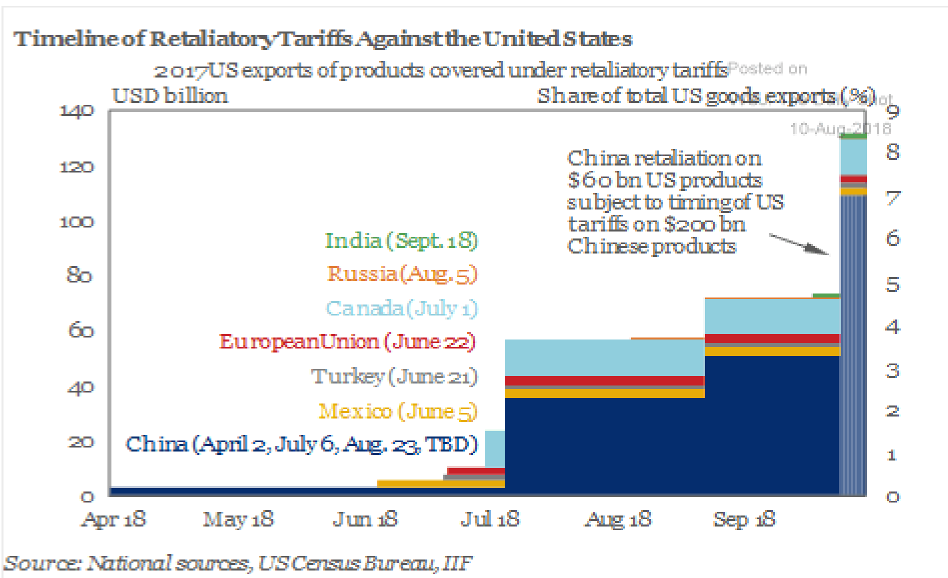
Trade Wars?

Dr. Navarro is the head of President Trump's National Trade Council, and he believes free trade has hurt America, especially its workers. Dr. Navarro is a public policy professor at the University of California at Irvine. He is also an author and his book, *Death by China* is very critical of China on many levels. He does have some interesting, non-conventional ideas on trade deficits.

If we look at the components of the U.S. GDP, they are: GDP = the consumer (about 70% of GDP) + business investment (about 12.5%) Government (about 21% federal, state and local) + net exports (exports minus imports, about -4%). Dr. Navarro's idea is, to make the economy grow faster export more, and import less. This means renegotiating our trade agreements and to go from trade deficits to trade surpluses. As the President always states, we want free trade, but also fair trade.

The fear among many business leaders and economists is that these trade negotiations could lead to tariffs, trade wars and a global recession. There is a debate among analysts and economists about whether we are in a trade war or not.

Below is a chart that shows the retaliatory tariffs against the U.S.:

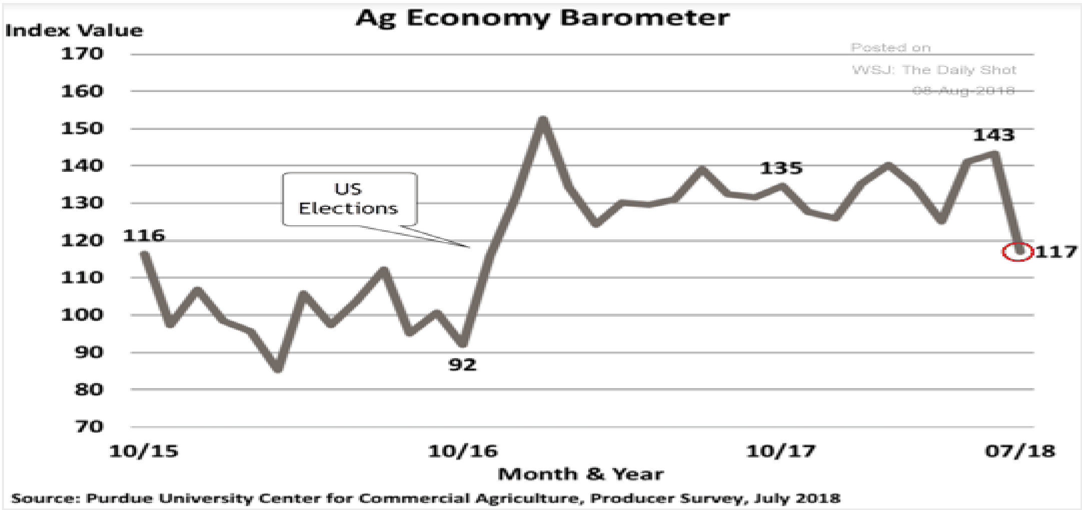


Source: @IIF

If we look at each individual tariff against us, it does not seem like seem like much, but if we look at them collectively, it could reduce our GDP and make our trade deficits worse. Collectively the retaliatory tariffs is one of the reasons that some economists believe we are in a trade war.

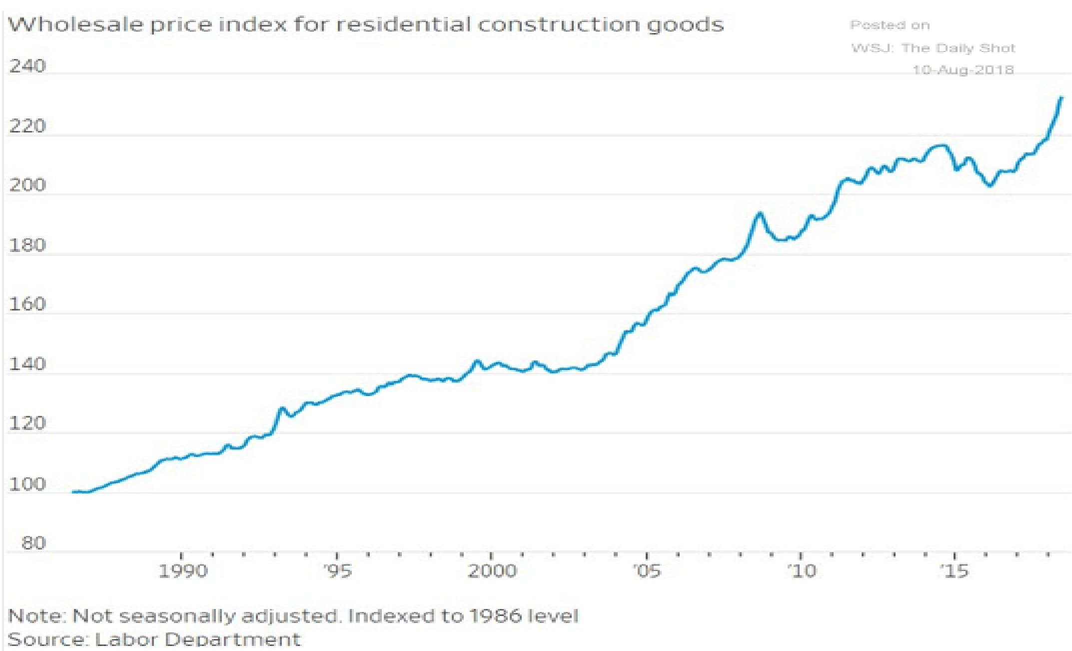
There are many reports around the world and in the U.S. that businesses are holding off many new investments/capital expenditures because of the uncertainty of trade tensions and tariffs.

Some of the retaliatory tariffs go after President Trump's supporter states and industries including soy bean farmers, Kentucky whiskey, pork, some fruits. The chart below show the impact the tariffs are having on farmers:

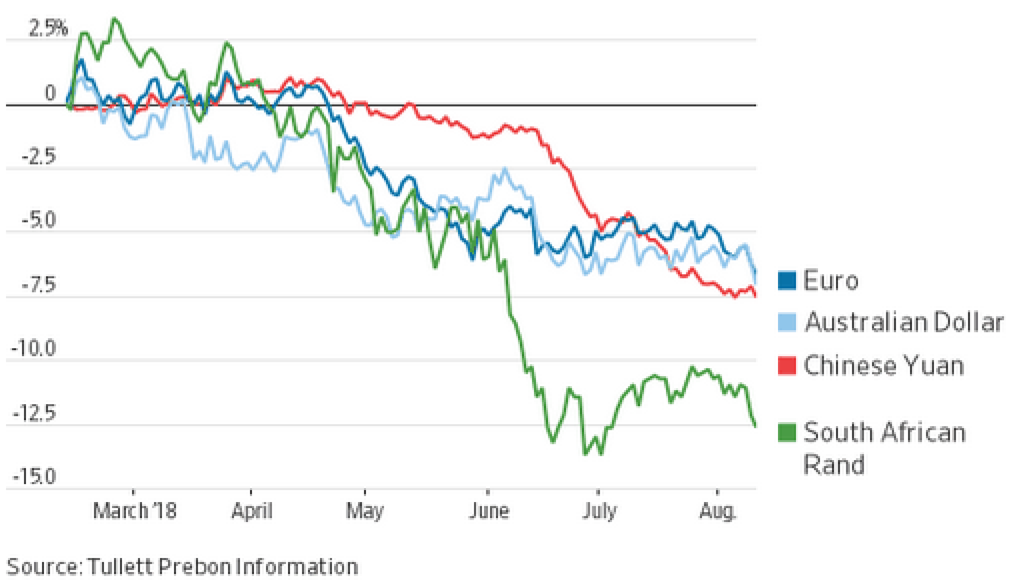


Some of the tariffs and other policies are having unintended consequences. Countries and their citizens like Canada, Mexico and China have anti-American sentiment and are boycotting all American products. For example, the Chinese are slowing trade from the U.S. by more border checks, customs delays, and audits.

Another unintended consequence is the cost to build a new home is rising because the U.S. placed tariffs on Canadian lumber and there is a shortage of temporary workers, especially from South of the Border.



Tariffs are also causing volatility in the currency markets:



Tariffs, tight labor markets will probably cause some inflation and a slower economy.

Farmers and other businesses are concerned that once they lose business to other competitors because of tariffs, it will be difficult to get customers back.

Another concern some investors have according to a recent article from Bloomberg, they write about President Trump, "his actions are eroding trust among both allies and rivals. Once gone, trust is hard to reestablish".

CPI and Interest Rates

Below is a chart that shows the inflation trend:

In 2015, the Fed was concerned about deflation, a very hard trend to reverse. The Fed lowered rates to historic lows, and increased their balance sheet in an effort to reflate the economy. Inflation is starting to accelerate since last year.

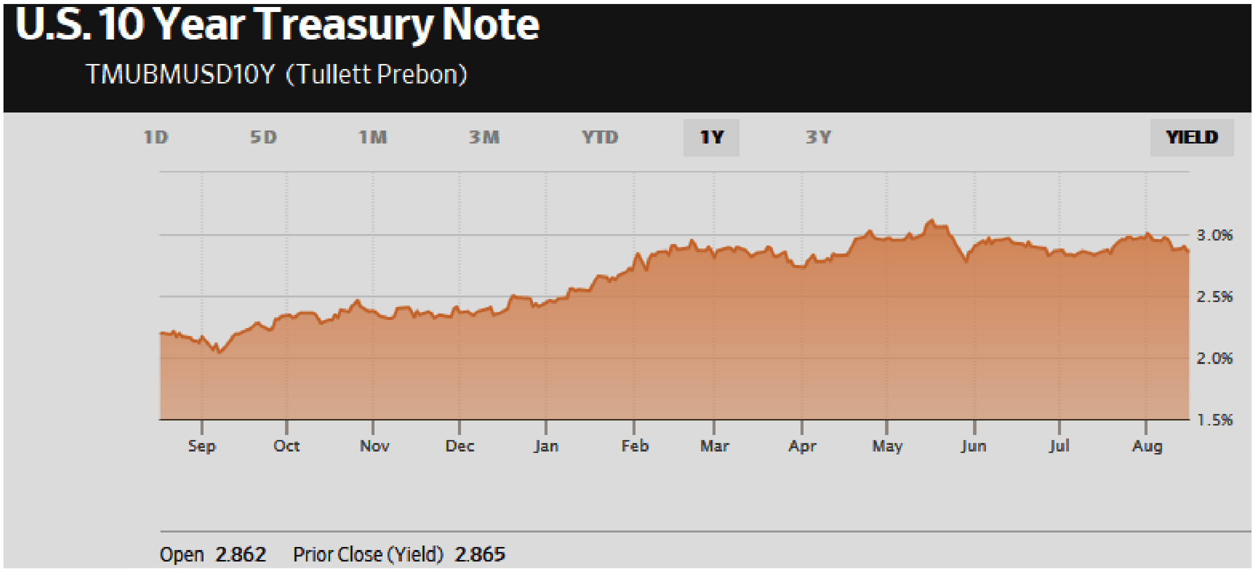
The Fed will probably raise interest rates twice more this year (September and December) and probably one or two times in 2019. Normally the Fed funds rate is about 1% point above inflation. This means the Fed Funds rates should be about 3%. Currently it's about 2%

Our stronger economy is leading to increased inflation, and interest rates and both have caused the dollar to move higher.

Source: WSJ

The stronger dollar will make U.S. goods and services more expensive globally, and could cause losses when foreign sales in weaker foreign currencies are converted into a stronger dollar.

The stronger economy, higher oil price and inflation has caused interest rates to move higher:



Source: WSJ

Interest rates have moved up around 50% since last year, from around 2% to 3%. Investors, and many small businesses don't understand that these rates seem low but could go higher.

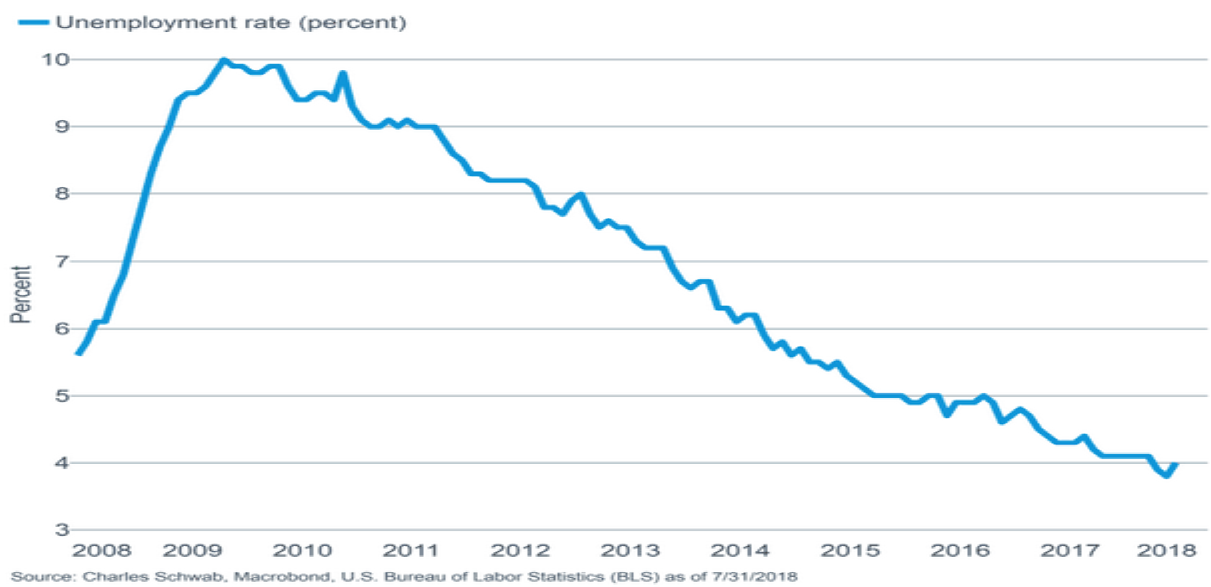
If you own bonds, you could suffer big losses as rates have gone against you and will probably continue to. If you need help with your bond portfolio, feel free to contact me at danhassey@yahoo.com.

As the CPI chart above shows, inflation is running about 2.4%. Historically, the spread between inflation and the 10-year Treasury has normally been around 2% to 4%. This means that the 10-year should be about 5.4% (2.4% inflation plus 3% historically average premium). Right now investors are barely being paid for inflation and are not being paid with a time premium for locking up money for 10 years. Investors don't realize long-term rates will probably go higher, probably to around 5%. A rise to 5% could be very disruptive to the economy and especially the markets.

Investors and businesses seem to be ignoring the Fed Funds rate will probably reach 3%, the 10-year treasury could move close to 5% and the strong dollar should all be headwinds toward the end of this year and certainly in 2019.

Employment

One of the main bright spots in the economy is employment:

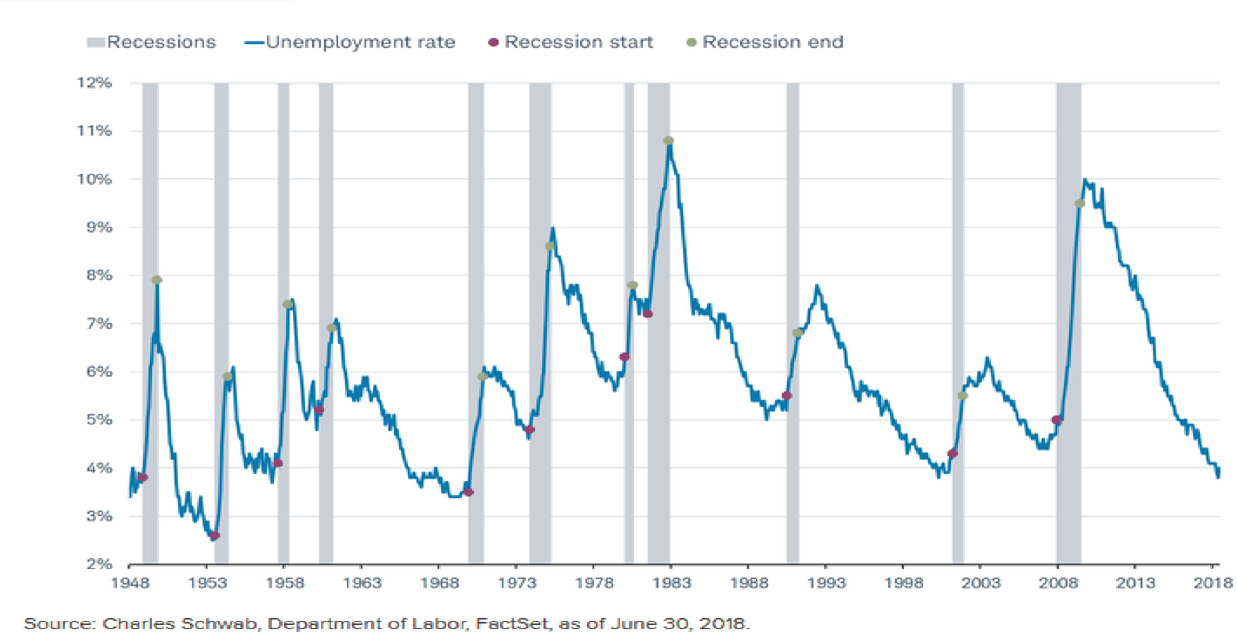


Unemployment peaked in 2009 at about 10% and fell to about 4.7% during the last administration, more than a 5% point drop.

The tax cuts and the stronger confidence has caused the unemployment rate to fall further, from around 4.7% to about 3.9%, about a 1 point drop since 2017.

Full employment is considered at 5% or below. The economy is at full employment. Employers now are having a hard time finding qualified, experienced workers. Economists call this a skills gap. The good news is that employers are giving Blacks and Hispanics a chance at some of these jobs. The other good news for workers is that the tight labor market will probably continue to increase wages.

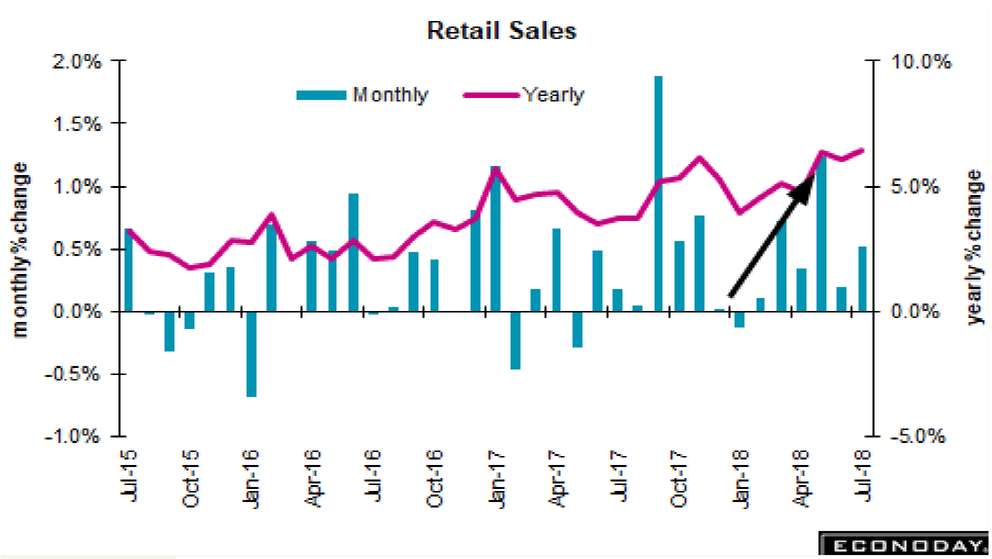
The bad news is that full employment is a sign that we are near the end of an economic cycle, as the chart below shows.



As the chart shows when unemployment bottoms a recession normally follows. Also, notice unemployment has been lower.

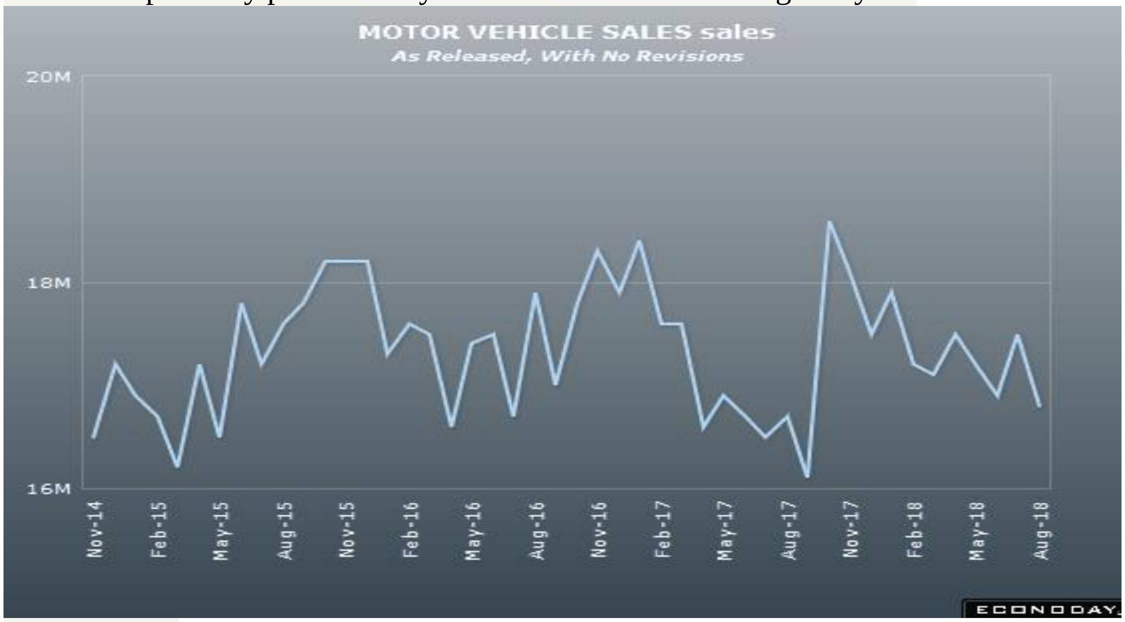
The Consumer, Retail Sales, Housing, Autos

Consumer confidence is high because the jobs outlook is positive, wages are rising, some got tax cuts, and the economy is doing better. Retail sales have picked up after a weak start in 2018.



Source: Econoday

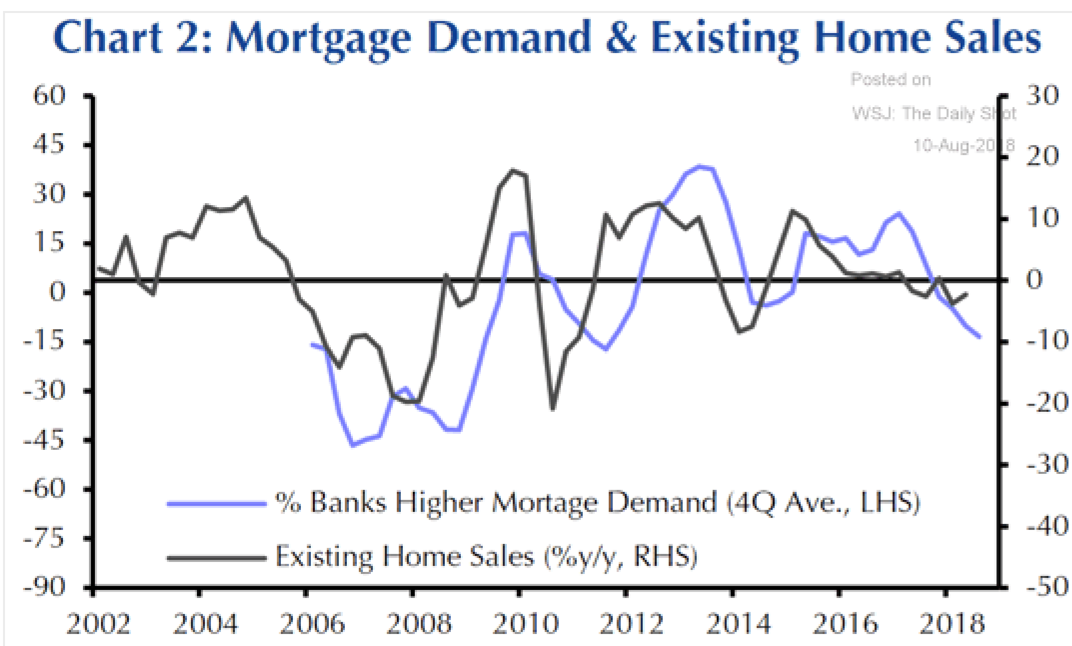
Auto sales probably peaked last year and have been declining this year.



Source: Econoday

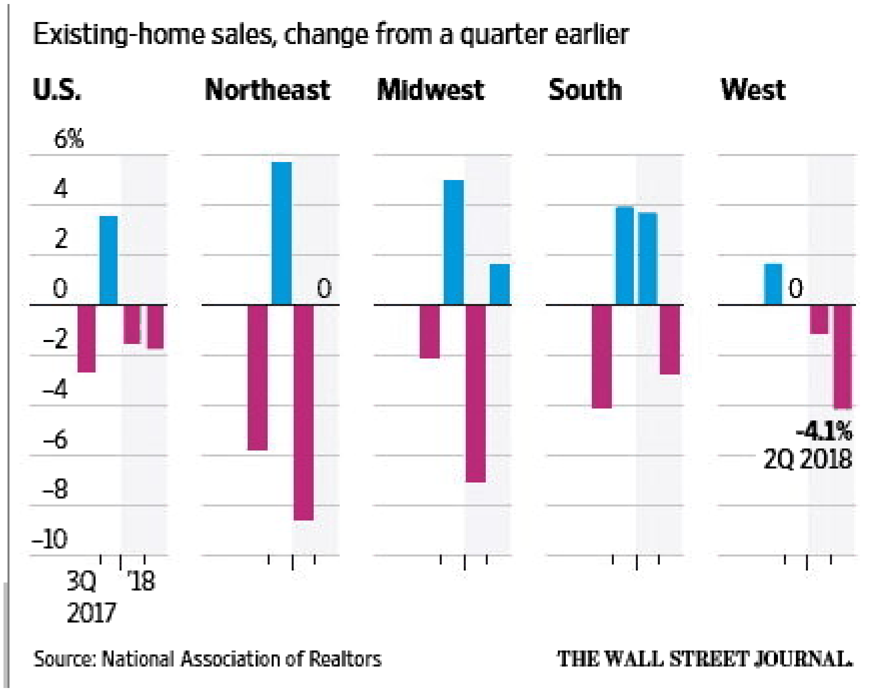
Auto sales are an important component of the U.S. economy and its slow growth could eventually impact GDP growth.

We are also seeing negative trends in housing due to rising home prices, rising mortgage rates, and many new home buyers can't afford a down payment.



Source: Capital Economics

The only area where there is growth in existing home sales is the Midwest:



Slower home sales could be a drag on GDP in future reports.

Global Economy

Last year we had a growing global synchronous economy. Unfortunately this trend has reversed. The causes for the reversal include;

- Trade wars are causing tensions between our trading partners causing uncertainty and the delay of some capital spending plans.

- The U.S. dollar is stronger than most currencies causing capital to flow to the U.S. causing dislocations in the global economy.

- Europe is having many problems: Turkey, Brexit, banks with risky assets on their balance sheets, Italy and its political issues, debts and productivity issues.

- Venezuela is collapsing economically and socially. Things are so bad that Venezuelans are raiding neighbor countries seeking refuge. Venezuela has the largest oil reserves in the world. Their declining oil productions is one of the reasons why oil prices are higher this year. Things probably won't get better there and oil prices could go higher.

- Similar to the United States, many countries are becoming protectionist, nationalistic, and anti-immigrant. These trends are hurting global growth, inflation, and labor productivity.

Below is a table that shows global economic trends and the last two columns are forecasts:

FactSet Economic Estimates – Median Consensus Estimates

GDP growth forecasts

	2012	2013	2014	2015	2016	2017	2018	2019
Americas								
Canada	1.7	2.5	2.9	1.0	1.4	3.0	2.0	1.9
United States	2.2	1.8	2.5	2.9	1.6	2.2	2.8	2.4
Asia Pacific								
Australia	3.9	2.2	2.6	2.5	2.6	2.2	2.9	2.9
China	7.9	7.8	7.3	6.9	6.7	6.9	6.6	6.3
India	5.5	6.4	7.4	8.2	7.1	6.7	7.4	7.5
Indonesia	6.0	5.6	5.0	4.9	5.0	5.1	5.3	5.5
Japan	1.5	2.0	0.3	1.4	1.0	1.7	1.1	1.0
New Zealand	2.5	2.2	3.6	3.6	4.0	2.8	2.8	2.8
South Korea	2.3	2.9	3.3	2.8	2.9	3.1	3.0	2.8
Europe								
Eurozone	(0.8)	(0.2)	1.4	1.9	1.8	2.5	2.2	1.9
France	0.4	0.6	1.0	1.0	1.1	2.3	1.9	1.8
Germany	0.7	0.6	1.9	1.5	1.9	2.5	2.0	1.9
Italy	(2.9)	(1.7)	0.2	0.8	1.0	1.6	1.3	1.2
United Kingdom	1.4	2.0	2.9	2.3	1.8	1.7	1.4	1.5

Source: FactSet

The above data covers over 75 countries, over 400 global contributors, and includes over 1,000 data points.

Notice that 2017 economic growth for most countries was better than 2016.

The forecasts for 2018 and 2019 for most countries is lower. The countries that are forecasted to grow better in 2019 is minimal.

It will be difficult for the U.S. to count on global growth, and slower growth could be a headwind.

Summary and Conclusion

- The economy is performing well, corporate profits are strong, and job creation continues.

- Most economist forecast slower growth after 2018. One of the main reasons is the multiplier effect of corporate tax cuts is low, and our growing deficits and debts and our debt financing needs will be headwinds.

- Economists are bad at forecasting important inflection points for the economy

- Tariffs and trade wars are a major concern among farmers, businesses and investors. We are starting to see unintended consequences of the trade war: pushing up the cost of a new home, boycotts of American goods and services from some of our trading partners, a stronger dollar that could lead to economic headwinds and lower corporate profits.

- The consumer is spending and most retail sales have improved from the start of the year. Two important components of the consumer, housing and autos, need to be followed as they are showing signs of weakness.

- If the Republicans stay in power then the momentum of the economy and markets could be sustained for at least another year. If the Democrats take the House, then the momentum could reverse, especially if the Mueller investigations report reveals major crimes and misdemeanors.

- The global economy is starting to slow. This could be another headwind for our economy. Businesses and investors need to pay attention to the many hot spots (Turkey, Italy, Venezuela, North Korea, Iran….) around the world including the trade war.

The end of a cycle are the hardest to analyze and manage through. There is a lot to watch: inflation, interest rates, the dollar, housing, auto sales, mid-term elections, Mueller investigation news, international trends, employment trends and the skills gap, corporate earnings and revenues…. I will continue to analyze these data points and provide my monthly market outlook and quarterly economic outlook. It's best to stay cautious, and nimble. We are sticking to our strategy laid out last year. Briefly, trade stocks that are in bear markets that are basing and pay a dividend. Target, Occidental, and Kimberly Clark have been mentioned, and all three have worked out very well.

If you need help with your stock or bond portfolio, or need a second opinion, feel free to contact me: danhassey@yahoo.com