TRINITY

CAPITAL For the last seven years the number one economic topic has been money. Not enough, said the experts; print more and it will jumpstart the whole world. Low interest rates? Make them lower; some magic will create a new prosperity. No inflation? Create some. More money was the game. Easy money, cheap money. On and on.

LABOR In my recollection of events the number two topic was employment or lack thereof and the cure for that was to print more money, as above.

LAND The number three topic was to instigate spending on new plants, equipment, and infrastructure. Somehow more money on that (see above) would then induce more consumer demand for goods and then new supply would be needed. Somehow.

Thus, the Trinity of Land, Labor and Capital. That trinity is as old as economics itself. Land was just that when we were an agricultural society, but has broadened over time to mean all our productive ability – plants, machines, the infrastructure, all of it. Labor and Capital mean the same today as always – people and money.

Lost in the dialogues about parts of the Trinity was the simple fact that all three were in oversupply, not just money and industrial capacity, as we shall see. The Central Bank narrative was wrong on all three counts and Congress let them get away with it by default.

Labor in the World Economy

Twenty-five years ago the worker pool of the world was about 685 million souls. As China and Eastern Europe blended into the global economy they came with a further 820 million workers who left farms and small villages to join the global Industrial Revolution. That was the largest numerical and percentage jump in workers ever recorded.

We now know it led to 25 years of wage stagnation. Every corporation found cheap labor someplace. Even if they didn't move their plant to China, the threat was often enough to contain wages both here and abroad. The result for the United States is this: U. S. corporate profits at 10% of GDP are twice their post-war average.

This labor phenomenon was then further levered into a higher gear by China. A binge of factory building at very low interest rates added excessively to world capacity and concurrent world demand for raw materials. We know how this last bit is playing out. From this expansion of capacity came cheaper clothes, electronics, steel, solar panels, oil – a long list that continues to this day. Cheap labor, cheap money, excess capacity – a potent mix then further inflamed by cheap consumer credit and eager credit-card issuers.

We see clearly (and have for years) how more money, save for the few months after Lehman, was not the answer and was, in fact, fuel on the fire. Anyone that has read

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Keynes saw his “money stimulus” solutions as short-term tools only and never designed to replace a free market – or Congress, for that matter.

It is not hard to see how deflation – falling prices for near all manufactured goods – came to be. The double-barreled shot of cheap money and excess labor has run its course, though. Wages in China, for example, have been rising at 16% annually for a decade, but an even bigger barrier to ongoing cheap labor is the global birthrate.

At about 2.1 live births per woman, world population would be more or less static as deaths offset births. Back in 1970, and leading to the noted surge in labor, the birth rate was 4.8 live births per woman. Today, it is 2.4 globally with the bulk of the decline having taken place in East Asia.

It looks like this today for key countries:

India 2.5	UK 1.9	Canada 1.6	Germany, Italy & Japan 1.4
France 2.1	Brazil 1.8	China 1.5	Poland 1.3
U. S. 2.0	Russia 1.6	Spain 1.5	Korea 1.2

With few exceptions, we are watching both the Developed World and the Emerging Nations approach a population slowdown. Consider this also: That period of 4.8 births in the 70's is the leading edge of all current global aging. Gradually the number of elderly and all of their attendant costs will rise just as the number of young workers declines. Economists call this the dependency ratio – how many elderly each young worker supports, primarily via taxes on their wages.

China, and its “one child” policy, is the extreme case. It was 15 years overdue to change and now she sees her labor force shrinking by 3,000,000 workers a year, births falling behind deaths and wages rising.

The false assumption is that this demographic crunch will foster even more deflation and Japan is frequently proffered as an example. Their current massive government debt belies that.

The opposite is more likely. Health care and the cost of aging worldwide will require significant government help and scarce skilled labor will simultaneously drive wages higher. Higher wages arrive, sadly, too late for those near retirement.

That stash of cash many companies have? Look for it to go to every variation of labor cost savings you can think of, from nobody waiting on you at McDonalds to robots running your personal stock portfolio.

The proposed solutions, so far at least, warrant listing:

1. Massive (more) Quantitative Easing – print, print, print – QE infinity;

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2. Robots rapidly replacing workers with "rapid" being the key;
3. India and/or Africa doing the China thing and filling the worker gap;
4. Immigration, globally, becoming a necessity, and
5. Very high birth rates in 4th world countries like South Sudan, Yemen, Somalia, etc. as a future worker pool.

In any case, the period from now until 2020 or so will be one of:

1. Weak, cheaply-funded companies failing under higher wage, medical retirement benefits and money costs, thus freeing some workers to move elsewhere;
2. Strong, well-capitalized firms becoming even more profitable and using some of the freed-up workers, and
3. A squeeze on aggregate corporate profits reflecting wages, medical and money costs.

Number (2) seems counterintuitive given the cost pressures about to begin, but consider this: Fewer firms – much fewer – facing less competition in their space and even with flat demand can do very, very well. Now look back at the record number of mergers and acquisitions we are already experiencing. Note the U. S. firms moving headquarters to more benign tax environments. Toss in economies of scale with less competition and you get near monopolistic pricing power.

It will be a while before India or Africa will have the infrastructure, force of law, political will and investment savvy to replace China. Remember – China is a dictatorship – a fully top-down, managed economy. That was her edge to get it all done in a few decades. In the meantime, in the rest of the world, stronger firms will eat the weak, flex the pricing muscle and boost goods inflation – and that won't take long at all.

"The last time Europe's serfs suddenly found themselves in huge demand was after the BLACK DEATH in the mid-14th century. They say it ended feudalism." Recall for a moment what feudalism was.

(Ambrose Evans-Pritchard at *The Daily Telegraph*) (Further credit to Professors Goodhart and Manoj Pradhan in a Morgan Stanley paper for data.)

Labor in America

David Rosenberg produced some interesting data about our domestic labor force.

One current myth is that the new hiring here, the improvement in jobs data, is only for menial jobs and the majority of new hires are over 55.
Now in part, it's true. Boomers aren't dropping out of the labor force en masse. The less obvious answer is that this greater number of over 55 workers simply reflects employed people moving into an older age bracket. Most know we have a Boomer "bulge" in the population. As they move through time into older-age cohorts it's bound to show significant

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increases in those age cohorts. As a matter of fact, in all the other age groups (20-24, 25-34 etc.) employment by each group has outpaced population change. Put another way, wage distribution of employment has actually shifted less than population shift and has simply followed an aging work force.

Dave goes on to note that Boomers are not staying in the job market longer – they are almost exactly the same ratio to total labor force participation (39.9%) as they were 6 years ago. Simply put, there are more of them and, accordingly, make up a bigger share of the labor force.

Tie this all back to the global aging trend. Add to it the improvement in general health, which is clearly leading to longer lives. Toss in limited immigration and you begin to see our longer-term issues, mainly the higher number of elderly to young workers and the ensuing fiscal strain.

To put this into a global context, note this table from the Treasury Department of Australia via *Patrick Cox's Tech Digest*: It's the number of workers age 15 to 64 versus the number of people over 64:

Japan	1.4 workers per retired person
Europe	2.2 workers per retired person
U. S.	3.0 workers per retired person
China	2.5 workers per retired person
India	5.0 workers per retired person

Among other points, note how much younger India's population is (birthrate now 2.5) and what no immigration at all has done to Japan. The days of 10 or 12 workers to carry a retired worker have been gone since shortly after WW II.

As societies grow richer, fewer children are born. Wealth has brought world population growth down to a barely positive number. High birth rates in Africa persist, but low nearly everywhere else is leading us to a global population plateau. (By 2100, Africans under 14 will be 48% of all children worldwide under 14. The United Nations calculates this and further notes that 46% of the world population lives in countries with below-replacement birth rates).

Globally then, it comes down to immigration – moving poor, excess current populations to where they are needed, where an opportunity for better health, food and family life is significantly greater.

We here in the U. S allow immigrants to work immediately. Assimilation is a generation, maybe two. In Europe, asylum seekers are kept waiting for years just to become a refugee. They get welfare and shelter, but are barred from work. They become an immediate cost – on many levels. Think France.

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Few methods exist anywhere to assess refugee or immigrant or asylum-seeker skills. Need I write why we fight that solution? When skills are claimed, Europe is the worst for demanding endless credentials and, in most cases, even credentials are not easily equivalent to any country's existing protocols. (Mertule Mariam – *The Economist*)

Put the smart phone and global Internet into this stew and, as *Strategic Economic Decisions* puts it:

> " . . . some 2 billion people worldwide can taste, see, hear and feel The Good Life that is denied them by the thugocrats who oppress them . . . Millions of refugees from all over the world will say "enough" and vote with their feet and will migrate despite the risks of doing so. Many millions more."

This problem will grow ever larger in 2016 and beyond. Young people for terrorist organizations are about to shrink also so, maybe in time leaders will have to expose themselves to the risks they make children take.

Millennials and the Middle Class

In the United States, two issues that will see even more press for next year are the Middle Class and the Millennials right on their heels.

Who are these people and how many are there?

The Census Bureau and major research centers divide the U. S. population in this manner (data is approximate):

MILLENNIALS:	Born after 1980, they are by most counts some 83 million in number and encompass the 13 to 34 age group;
GENERATION X:	Born between 1966 and 1980, they range in age from 35 to 50 and are about 65 million in number;
BOOMERS:	Until recently the largest group, some 75 million, they were born between 1946 and 1964, and are now between 50 and 68 years old;
THE SILENT:	Born between 1928 and 1946, they are 69 to 86 and about 55 million in number.

The Middle Class, says Pew Research, is for the first time less than half the total population and crosses all four of the age brackets noted above. In the 60's, they were over 60% of the population.

Middle Class, defined by income in 2015, was approximately $42,000 to $126,000 for a 3-person family. This is the national range. This range captures the middle array of wages

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from topmost to near zero. It is not a normal, bell-shaped distribution. It is skewed to a large number of lower income levels.

By and large, the older the age group, the better off they are. Households over 65 are the biggest economic gainers since the 1970's. With that comes spending, projected by McKinsey to drive half of all U. S. spending growth through 2030.

But just what is "Middle Class"?

> Is it the 60% of the population by age?
> Is it defined by life goals?
> Is it, in fact, a combination of lower, middle and upper middle, by income?
> Is there movement within this rather broad range?

Not surprisingly, most Americans (53%) claimed Middle Class status back before the Great Recession, now only 44% do. This implies "moving up" has stalled for many, be it in the self-defined Middle Class or even moving out of it – in both directions.

Clearly, stagnant wages and the perception that others are doing far better is also partly responsible for this shift in self-perception. Income seems to be the major determinant, though, and one test is whether your income is within plus/minus 50% of the local median income. Refresher: Median is the midpoint of an array of wages; mean is a simple average of the same data.

By this definition, Middle Class in California is $40,000 to $120,000, median of $80,000, while in Ohio or Michigan it's $32,000 to $90,000 with a median income of $61,000, some 25% less. Obviously, where you live matters.

The issue though, is jobs and wages. The unspoken is this:

> Over the next decade, the "Services" sector will provide 95% of all new jobs. Manufacturing will shrink to +/-7% of the work force. ***Service, though, strongly implies skills not held by the customer. It does not imply degreed individuals.***
>
> Of the 15 occupations in manufacturing and service sectors with the most projected growth, only 4 ask for a Bachelor's degree, 8 require no formal education credentials and 9 offer wages under $30,000.
>
> Overall, middle-income wages are stagnant, but for upper-middle and upper-income, income has doubled since the early 1980's. Suffering in the Middle Class has been specific to the less well-trained bottom third or so. (Bureau of Labor Statistics, W.A. Galston)

The hard fact is that with an older labor force, much like the rest of the world, and a declining birth rate, retirements here are just about offsetting new employees.

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The hard fact is that the Middle is fracturing again and perhaps a third are seeing increased wealth and moving into yet a higher income segment.

The hard fact is that new employees are far cheaper and what few high-wage jobs open up are going to the educated and experienced.

As our birth rate slips below replacement and Boomers give way to Millennials we see the bulk of the Middle Class economically shrinking further.

The Millennials

The Millennials are better educated than the Boomers and particularly in all things digital. They will likely continue to garner the higher-paying jobs if not right out from under the Boomers still working.

But all is not lost. I, for one, do not believe a growing shortage of skilled and/or experienced workers here can be replaced by machines or robots all that fast. An economy that is substantially manufacturing may well benefit rapidly from such a conversion. An economy now substantially service based offers far less room for job replacement with machines – or Millennials.

Better data? Yes. More data? Yes. Need for technologically trained workers? Yes. Readily available experience to maximize all that data? No.

The older segments of the remaining Middle Class won't all benefit as much as those retrained. Some have the experience curve, but not the breadth, of technology. This is no secret. The focus, though, has been on the damage done to the entire Middle while ignoring the size, ability and the aspirations of the remaining Middle Class and Millennials right behind them. The new Middle Class now includes the Millennials. They join a fraction of the older Middle Class now in place.

In short, the growing world labor shortage will be solved one way in industrialized countries (robots, et al) and quite differently in service-based countries such as ours.

A crude analogy might be this: The men and women who came home from World War II contributed greatly to America's industrial resurgence for a goods-oriented, consumption-based economy. They are now giving way to their successors, the Millennials, who are taking this nation fully into a service economy.

Millennials have been studied in depth. How they think or feel about work, marriage, their future and their personal security have been crosschecked and tabulated. Racially diverse, mostly politically independent, god-fearing, it's all been measured.

In reading the Pew data, I came to the realization that 6 words near totally represent them:

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DIGITAL – this is the technology generation;
DEBT – they have plenty of debt;
DISTRUSTFUL – mainly of individuals and large social groups;
DETACHED – they don't identify strongly with religion or patriotism;
DIVERSE – racially and geographically;
DEMOCRATS – when they vote, and they see little difference between the Parties.

I believe we have at least the following elements before us both short and long term:

- A growing shortage of skilled, experienced workers both globally and, soon, domestically, in spite of the number of Millennials:

- The Boomer and Silent cohort retiring after having built our manufacturing base and now suffering its demise via their wages;

- The Middle Class, heavy with Boomers, facing stagnant wages for lack of needed skills of all kinds, not just computer based;

- A new generation, the Millennials, arriving alongside a new, service-based economy for which they are better prepared and the key to our continued economic growth;

- Millennial Middle Class workers facing one of two roads: Dead-end jobs or training for any chance to move up;

- Boomers, with the largest pool of saved wealth, driving consumption growth;

- Upper-income Boomers, Silents and Millennials shaping politics as their common goals are gradually discovered and exposed, and

- Day-to-day events in the markets, in the economy and in global politics deviating from, but not altering, the realignment of a global shock to labor and the evolution of a fully service-based economy here in the United States.

In the Various Economic Sectors

As females empowered themselves in the '60's and '70's major advances in the diagnosis and treatment of their particular medical needs followed. Later, in the early 2000's, a similar but weaker trend began for men.

When the two trends combine, as is the case with a rapidly aging population, one may expect their shared wealth, experience and voting power to lead to significant improvement in both quality of and length of life. We see it already in organic foods, in increased focus on physical fitness and declines in smoking, drug and alcohol use. ("Light" beer, however,

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is just going too far, IMHO.) Of interest is that the push or demand for improved, longer lives seems to be originating with women.

Also of interest to me for the next few years will be the impact of healthy living on drug stocks, particularly the over-the-counter products. Many times I have watched the ads for treating diabetes, acid reflux, muscle ache and the like and think how easily all of that can be minimized if not “cured” with weight loss, exercise and elimination of sugar, oils, processed foods, etc. Food stocks will also bear watching.

To some extent, then, a labor shortage can be addressed with a population healthy enough to work longer.

The trend, however, is anti-aging and I suspect it will be the dominant topic in 2016 and beyond.

In the Commodity Space

The recent cuts in oil production here in the States argue for a near-bottom in oil prices. For the record let’s say oil bottoms in price at $32/barrel.

In the metals area, however, prices for titanium, lithium, cobalt graphite and a few other very exotic metals beyond these go higher. The demand from carmakers, battery makers and the electronics industry in general is expected to continue the search for lighter, faster, longer.

For the Gross Domestic Product

I expect another +/-2% year, another muddle along. That said, I continue to doubt the value of even estimating it.

I am increasingly convinced that the GDP data is near worthless given what and how it measures our evolving economy. All the prior text considered, I am finding it less and less useful. It is what makes headlines however and is a huge influence on people’s perception of our National health, facts be damned.

Our inflation data is similarly deficient what with heuristic adjustments, seasonal adjustments, sampling bias and disparate consumer tastes. The combination of wage income growing over 3% and the ensuing price inflation that will trigger suggests the big headlines in 2016 will be around the 3%+ inflation and the uneven but high wage growth. Services will see higher wage increases (4%? 5%?) than manufacturing (2%?). There are simply too many “I quit” and too many skilled-labor shortages to see it otherwise.

For unemployment, I think we are there at 4.8% to 5%.

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On Wall Street, great disparity. Strong earnings growth in technology (broad) of 8% or so will surpass most other firms' 1% to 3%. Sectors like healthcare and high-end retail will likely do nearly as well as tech. I expect more investors will continue to see not "the market," but its specific sectors. With luck, we will all ignore what the Dow or S&P did each day/month and concentrate on what we hold in our portfolios. By no means will it be an easy year. I am seeing guesses of 4% to 8% up and doubt that for the broad market. Once again, we see distorted Indices creating false impressions. Losses this year approached 30% in many portfolios and funds. Recovery will take longer than just next year.

Bonds, on the other hand, are in for an even worse year. I have written of the risk to longer-term debt and especially the junk-debt world when interest rates rise. The siren call of high yields should be ignored until late in the year when, most likely, higher inflation will provide a higher yield and higher quality to buy. Unless you trade bonds professionally, now would be a good time to shorten your portfolio and move out of unrated or low-rated debt. Bond mutual funds should be very carefully reviewed, as they are large holders of junk debt.

I expect 2016 to be the year the Euro goes very near parity with the dollar, the Yen weakens further, the stock markets produce an overall rise of 2% to 4% and the media is surprised that any of this happened. They have been focusing on what makes headlines, of course, rather than what makes news.

The question of the year will be about interest rates. It will be focused on whether the Fed keeps raising rates all year or is "one and done." I suspect they are as doubtful about that as the world at large. My guess is they raise rates a few times, more to create headroom – an ability to lower rates if things get ugly again – than to slow a fast growing economy. As a group they are afraid of high growth rates, but more afraid of having no ability to cut rates as is now the case. Let's just accept the fact they are still in a corner, are guessing at ways out of their bloated balance sheet and biased to do nothing rather than threaten the anemic recovery under way. That implies a few very small rises rather than the half point (or more) jumps they should have made years ago. The year will be tough but I'm not negative about it. Some thoughts on why in the January 8th Weekly.

There are no "ENTER HERE" or "EXIT HERE" signs in the capital markets.

Position portfolios instead for the Trinity of 1) our durable nation allowing 2) all humans to better their economic situation and 3) the accompanying desire for a better quality of life, whatever individual form that takes.

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