THE BEGINNING OF THE END

The basic facts are straight forward but interpretations vary. (William Hazlett)

Economic theorists are notorious (or deserve to be) for ignoring or at least leaving out of their theoretical systems, facts which have been under their noses for generations. (J. M. Clark)

Over the last few years, I have tried to point out what I believed were facts under our noses. At the moment, these come to mind:

- A major part of our population is now much older or already retired; we are an old nation;
- the bulk of disposable income resides with the oldest in our society (the 1% aside);
- the consumption and savings patterns of old and young are markedly different;
- monetary and fiscal policies intended to stimulate growth often, if not always, do more harm than good, as history has lately demonstrated;
- consumers are often not rational in their decision making;
- economic models, even when simple, generally show only correlation, not causation;
- nobody gets up in the morning to pay taxes, as Art Laffer puts it, but policy makers assume we do;
- human behavior is first, last and always influenced by individual biological survival instincts – the lizard brain is always at work;
- human behavior cannot be consistently or reliably predicted;

In this nation we talk of a pioneer spirit, a cowboy mentality of personal freedom – a freedom to do our own thing and make our own mistakes.

As 2017 begins I believe the year will show but one long-lasting result, among many smaller ones:

> *A sense of being in charge of our lives again, true or not, and because of it, a willingness to spend, invest and even trust that has not been present for a very long time.*

Call it a return to the cowboy mentality; call it reckless, unstructured, dreaming and possibly lawless. Call it what you will, it's what originally made this nation.

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What is most needed to be true is that arbitrary barriers will be pushed aside.

This is why I have expressed the idea that if no prior regulation or executive ruling is overturned, the very fact that an end to that behavior could happen will be sufficient for a time. We have all had our fill of policy makers creating endless programs, rules, guidelines and such that reflect not so much a legitimate need as a personal or political job protection decision.

In any case, as a nation, I believe we sense an end . . . and a beginning.

What does it portend? What do we have to deal with, now, to get to better economic times?

An aging industrial world is the strong case for ongoing low interest rates. The demand for funds to invest for growth will be tepid given our aging – and the world's aging – population. Japan, as I've written, is the poster child. This age factor greatly delays a return to "the good old days" of 4% GDP growth. A higher birth rate or a higher immigration rate would help boost long-term growth, but that is an inconvenient truth.

Sentiment moved interest interest rates up late last year, not demand. Even if rates again rose sharply, one barrier would trigger immediate rate suppression. That barrier is servicing the national debt. To clarify: If the 10-year Treasury Note goes to 6% and takes the yield curve up proportionally, the interest on the national debt goes to 40¢ of every tax dollar collected versus about 10¢ today. The structural damage would be severe and many programs would be dropped for lack of revenue. You can guess which would go first. Sharply rising rates would be very destructive right now.

But, you say, aren't we going to run up huge new debts to do "infrastructure" under Trump? Won't that push rates higher to get that debt sold? Well, the link to bond prices (yields) is weak. Reagan ran up huge deficits in the '80s – and yields fell. I expect 50- or 100-year bonds to be a Trump hallmark instead.

What is more important are the other things Reagan or Kennedy did: Tax reform and de-regulation.

Economics 101: When you increase supply via a more efficient road system, for example, or increase funds to spend via tax reform or ease the business regulatory world, you generate a shift right in the supply curve and that means lower prices, not higher; that means a deflationary bias, not inflationary. It doesn't necessarily boost demand; it increases supply and lowers costs.

If a Trump plan triggers higher productivity through renewed capital spending, that's deflationary; if long debt is used, all the more deflationary.

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Deregulation in and of itself reduces business costs, thus creating deflation at the source of goods creation (and better earnings). Over the last 8 years, corporate profits rose 9% on an average annual basis. Goods inflation? No.

There is enormous spare capacity out there. That plus age and weak population growth (and huge personal debt loads) all argue for lower, not higher, goods prices. That will initially hurt earnings. (Data: D. Rosenberg)

There is the argument that we are at full employment and therefore wages must rise. The logic is that the shortage of skilled labor argues for broad upward pressure on all wages. There are 6,000,000 Americans working part time who want full-time work. On a private labor force of +/- 125,000,000, that's +/-4%. Another 4%, some 6,000,000 more, are sitting at home and would take a job if one came up. That's 8% of the labor force underutilized. Skilled? Not likely.

The likely explanation is that low-pay, repetitive jobs are being lost to automation, creating this pool of 12,000,000 souls. That's not news and it's sure not full employment. What can't be ignored, of course, are the 5.5 million job openings still out there that likely need some skills. Many of those 12,000,000 souls will be needed if "infrastructure" spending ever begins but the point is, despite the low unemployment index we are not at full employment no matter future infrastructure needs. The focus has been on the 5,500,000, not the 12,000,000.

The longer-term question, of course, is training an aging, unemployed segment of Americans. Inducing them to work is easy once you accept that if you pay people not to work, they won't. In brief, very little wage pressure, in general, and only a bit in the skilled sector for 2017. "A bit" I define as 2.5% to 3.5% wage gains.

Oil remains a key issue for 2017. Two key issues, shale and Russia, will be the drivers.

Shale is ramping up again. This sector is becoming more and more profitable at current oil prices, thanks to their uninhibited use of technology. Their trend is lower and lower cost of production and, under Trump, more liberal drilling restrictions. The existing rules and regulations make us feel good but do nothing to wean us off oil from other nations, much less reduce terrorist funding . . . as some OPEC members do. Yes, yes, California, clean water is important, but the two are not mutually exclusive.

Russia should not be relied on to honor the production-cut deal that OPEC put together. As a failed, one-product economy, Russia can't live with selling less – it has to move oil whenever it can or Putin is out of a job. Let's go with a $50-$55 peak per-barrel price for crude this year.

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Shale will be the pressure on prices domestically, Russia on global cartel pricing.

The consumer is the victim. He sees inflation in services, deflation in goods, rising credit-card interest rates guaranteed to hurt the $12.3 trillion of debt he already holds and, likely most important, what deflation he does see is in toys, not homes or cars or medical care. Further, his credit-card debt is rising at twice the rate of his wage gains and that can't continue much longer. The Trump euphoria explains part of recent spending, but it will be a long while before Trump Words (TW) become Trump Actions (TA).

Add to that the fact that older consumers spend on health care and insurance far more than they spend on toys and you can expect limited positive growth from the consumer sector. The middle – the debt holders – may spend only on necessities. I don't see a great consumer "recovery" in 2017.

So far, hard data flat out does not justify the high sentiment levels (TW). Improvement in manufacturing, in capital spending, in retail sales and the like does not, after 90 months of recovery, yet close in on the prior peak levels.

The great global economic engine is slowing. The overall decline in birthrates coupled with aged populations in the developed world, are drags that will keep our GDP in the 2%-3% range. The 3% handle will come when tax relief kicks in, is not just dreamed of, and when business sees, via regulatory reform, that it's worth investing.

The business cycle is back, though. For 8 years, only parts of it worked and even then it was bastardized. Recall cash for clunkers? In the end, a process that fueled an auto recovery but did it by stealing sales from the following year or so. Fed intervention via Alan, Ben and Jan distorted the cycle. We shall see what the new Fed does, but I don't see more of the same.

Much the same with homes: Defaults created a rental-building boom (and soon, a bust), but low mortgage rates kept new and used housing on life support, save for pockets nationally, and California is the extreme exception. Now we shall see how national housing does with higher rates. Not well, I expect. Oh, it will be positive gains, but the big numbers I still expect won't kick in until the millennials have the courage to jump. Apparently very little income allows jumping into a home of late but, as I said, the courage is still lacking.

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All well and good, you say, but just exactly where are we? What happens to bonds? Stocks? Can we have inflation and low interest rates?

According to FactSet, aggregate industry earnings for 2017 will touch $132 (S&P 500 aggregate). Some have it as high as $140. FactSet notes that analysts usually are 7% or so high so maybe $122-$124 is a good bet for earnings. All in all, an up year for earnings at last. A forward P/E of 17 is the result as of the moment. My aggregate is in the lower ball park so, in summary, an up year for stocks is likely and I'm going to call 3% a worst case. Give me tax reform . . . meaningful tax reform . . . and 3% will BE the worst case. Recall that times of low interest rates and low inflation support higher P/E ratios via the discount mechanism of future cash flows.

The last page of this *Quarterly* is a display of annual stock price changes arranged left to right across the bottom from losses to gains for the period 1815 to late 2016. The vertical axis is the number of times (and what year) each level of gain or loss was seen. Two big points: One, the majority of the time annual returns range from 0% to 10% and two, the red boxes are recession years.

Please note that recessions can occur in years with returns in stocks greater than 10%. My point is that yes, recessions cluster around the far left and the big losses, but can also occur in big up years. Should we draw a recession from Fed blundering, I believe we can still do well given the public confidence shift. Do well means a “contained” brief recession. Not a prediction, just a thought should it occur. By the way, the chart does not show the growth power of accumulated dividends, reinvested steadily over time . . . recessions be damned.

In the immediate months to come, though, the domestic outlook remains weak. Pockets of strength, but weak. Whether it moves to a 3% GDP level depends on points made prior: Do we actually <u>get</u> tax reform and regulatory relief? Once again, “feel good” sentiment is not factual progress . . . it paves the way, perhaps, but only fundamental, hard data, matters.

Interest rates seem, to me, to be range-bound for now and unlikely to go much higher given the lack of significant new demand and the excess capacity for production worldwide. At this writing our benchmark 10-year Treasury Note has backed away from the 2.55% range and settled back around 2.30%. This is much the pattern I expect for this year – volatile and trading in a range.

Inflation will, I think, stay localized to areas without wide scale competition, i.e. services such as dental, funeral, tax, legal, etc. Overall serious inflation? No. As a guess, 2% to 4%. At 4%, by the way, P/E ratios have historically begun to retreat.

The Fed is going to face more and more pressure <u>not</u> to move rates up because the recovery, such as it is, is still weak and they know it – the facts are all out there. What I think they are trying to do is give themselves room for future rate cuts. To do that, of course, they have to raise rates now. That, and the fact that they are 4 or more years late and at risk for being widely seen as negligent. If they go so far as to return to stimulation, rate cuts even to negative

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(QE again), then I think we have to call into question the still-elevated dollar. I can't see a strong dollar if the Fed fights a weak economy with more easing. Chances, to me, look like this: 2 or 3 more rate jumps, 30%; do nothing, all stays as now, 50%. Last and worst, more QE, 10%. The Black Swan event gets the last 10%.

That last bit is my primary worry. If the Fed returns to easing, expect gold to move sharply higher, stocks to quickly correct and bonds to rise in price, fall in yield in the Treasury market.

Which raises another issue. In that scenario, poor quality debt will drop in price. The "bond market" will, in my view, bifurcate and be a tough place to maneuver.

What we have is an environment developing much like Japan: Slow growth, low rates and no relevant inflation. The *Financial Times* noted a 1.1% inflation rate in Europe was worthy of being called "surges." Well, no, it's not. Europe has the same issues we do and some worse.

I suspect our inflation will rise and hover around 2%. I think interest rates will remain low, as now. I think the Fed is, once again, reacting to a spasm of optimism, calling it a precursor of a great recovery and they stand ready to douse the party with rate increases. The optimism spasm will ease up; the Fed, ever ready to miss the obvious, won't.

There is <u>so</u> much wrong with their knee-jerk reactions. Solid, inflation-creating growth requires significant demand; demand I just don't see. The Fed, fighting the last war, says otherwise and is ready to push rates up to cool us off. If they do, we won't have a chance to ease away from "muddle" to "pretty good" as they will push us back into muddle. "Pretty good" is the best we can do if I have the background right.

The next few months will be poor indicators of the year as there are many elements already in place for slow growth. Issues around Congress, business spending, Fed activity, consumer confidence, etc., all will prevent a clear picture until well into the second quarter. My bet is "pretty good" will replace "muddle" and low rates, low inflation and growing confidence will out. It's just going to be a slow, ugly trip there. Now, as to the Middle East, China, Syria, Russia, jihad – that's for the *Weekly's* to come.

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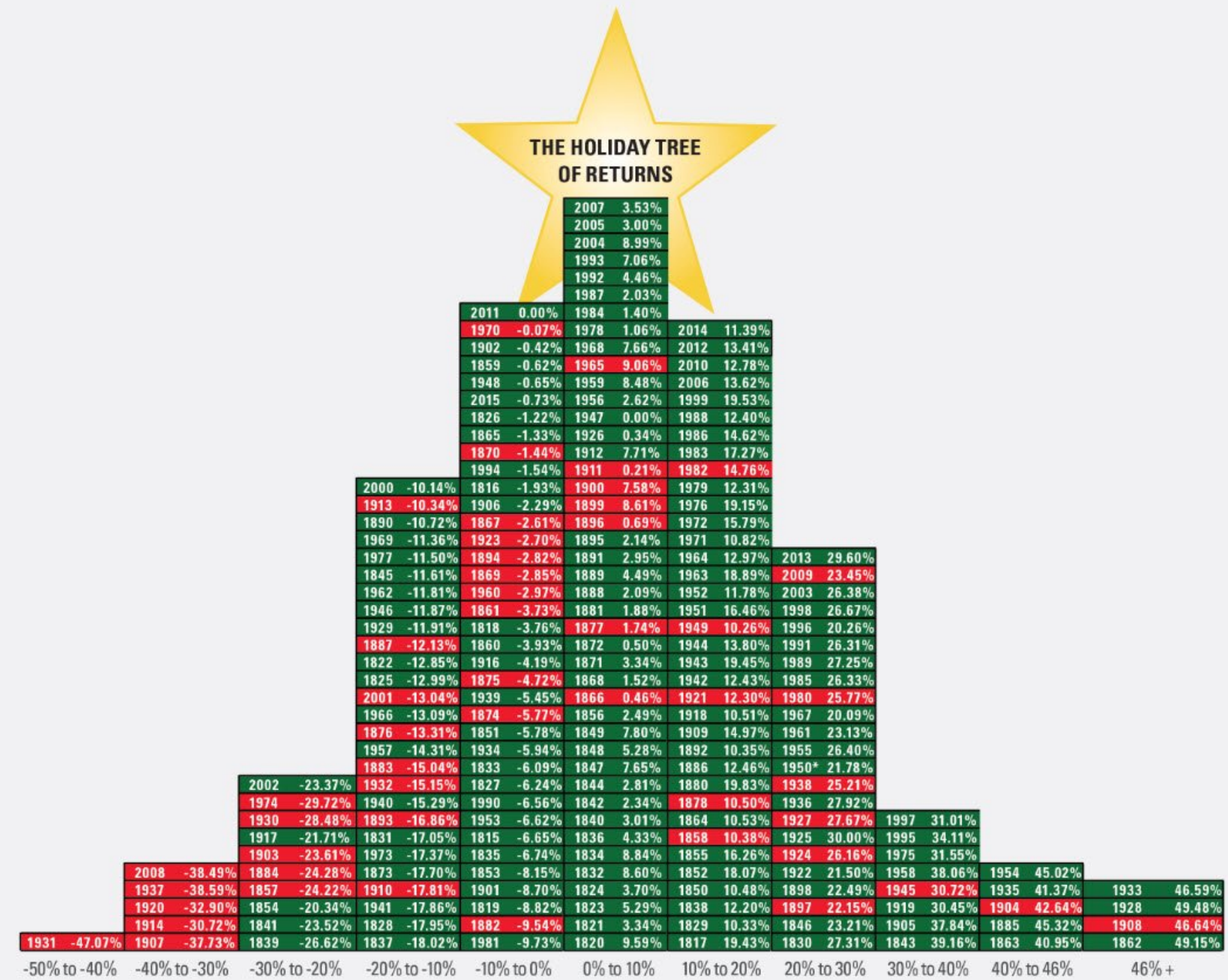

Source: LPL Research, Factset, NBER 12/19/16

1815–1896 NYSE, 1897–1927 Dow, 1928–2015 S&P 500

*Please note: The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

RED indicates a recession.