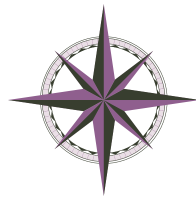

2018 Market Outlook and Beyond

2016 feels like it was here a moment ago. Michael Phelps won the 23rd Olympic gold of his career at the Summer Olympic Games. Social media around the nation was abuzz with the appearance of individuals dressed as "clowns". Great Britain decided to leave the European Union, and Disney released the unforgettable movie, "Moana". For all the things that happened in 2016, the most surprising event was the presidential election and the economic boom to follow shortly after.

From 2015-2016, I was extremely bearish on the direction of the U.S. Economy. My negativity was and is still based on the fundamental debt issues our economy faces. Despite the massive debt problems, 2017 was an excellent year for stocks. We believe President Trump's proposals on deregulation and lowering taxes helped boost the markets to new highs—until early 2018.

We believe President Trump faces too many headwinds which will eventually result in limited or no growth. Anyone with a financial plan based on projections of 6% to 8% average annual returns over the long term may be facing financial difficulties in their later years. Today, America faces mountains of debt, aging demographics, a homeless crisis, and under-funded pensions and social programs. These factors could potentially affect growth here in the US.

The following will discuss what we are up against and address our current conditions so that we may hold realistic expectations.

Historical Returns

To begin, looking at historical returns from January 1, 1930 to December 31, 2015, the average annual total return for the S&P 500 was 9.6%. From 1990 to 1998, the S&P 500 averaged over 18% creating the longest bull market in history. The next decade, 1998 to 2008, the S&P 500 lost an average of .95%. [1]

Since the bottom of the great recession in 2009 to December 31, 2017, we have seen a spectacular bull market rally where the S&P 500 averaged an annual return of over 18% with reinvested dividends. In comparison, from 2000 to December 31, 2017, the S&P 500 has only averaged approximately 3.5% without dividends reinvested and approximately 5.5% with dividends reinvested.

The major stock indices in the US reached all-time record highs in 2017; however, stocks in many of the larger countries have not joined the party. While the FTSE 100 stock

[1] 86 Years of Bulls and Bears. Franklin Templeton 2016

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index and German DAX were near all-time highs by the end of 2017, the same can't be said for many other stock indices in Europe.

- The Stoxx 50, sometimes referred to as the Dow Jones of Europe that holds large-cap European stocks, peaked in early 2000. As of the end of 2017, the Euro Stoxx 50 was approximately 36% below the 2000 high.
- The CAC 40 stock index in France peaked in late 2000. Through the end of 2017, it sits approximately 24% below the all-time high in 2000.
- Stocks in China and Japan were approximately 50% off their all-time highs as of the first quarter of 2017.
- Portugal has struggled ever since the euro crisis in 2011.
- Spain's unemployment numbers and real estate market are still in the dumps.
- Italian banks have 18% non-performing loans.
- Greece is still bankrupt.

Outside of stocks in US, Canada, the UK, and Germany, there aren't many stock indices doing well around the world. [2]

GDP Growth

The US stock markets have experienced a tremendous rally since 2009; however, GDP growth has been tepid at best. World economies have been growing less than half of what was experienced between 1985 through 2003. Since the Great Recession of 2008, we saw an anemic 1.2% GDP growth. This was all that the central banks quantitative easing intervention was able to achieve over an eight-year period. Much of the appreciation in asset prices were generated through an artificially inflated strategy by the central banks. However, there was very little real economic gain made during this period. While globalization was promoted as a solution for the planet to maintain growth, it was obvious now that it had completely failed! [3]

While most Trump proposals appear stimulative in nature, they may not equate into sustained long-term growth in the economy or stock prices. The key factor that has not changed is the national debt, which is now approaching $22 trillion. The fiscal spending proposals by the Trump administration will cause the debt to accelerate rather than to slow. This is likely to be the case for the next several years before the economy can be restructured to achieve substantial gains in GDP growth.

Even if Trump's agenda is successful, we still need to overcome the massive debts, aging demographics, underfunded pension plans, and in my opinion one of the biggest problems – China.

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[2] Europe Indices Fire Warnings. Harry Dent March 18, 2017
[3] 2017 Outlook Deglobalization – The Final Countdown. Robert Kendall 2017

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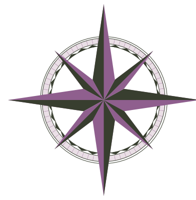
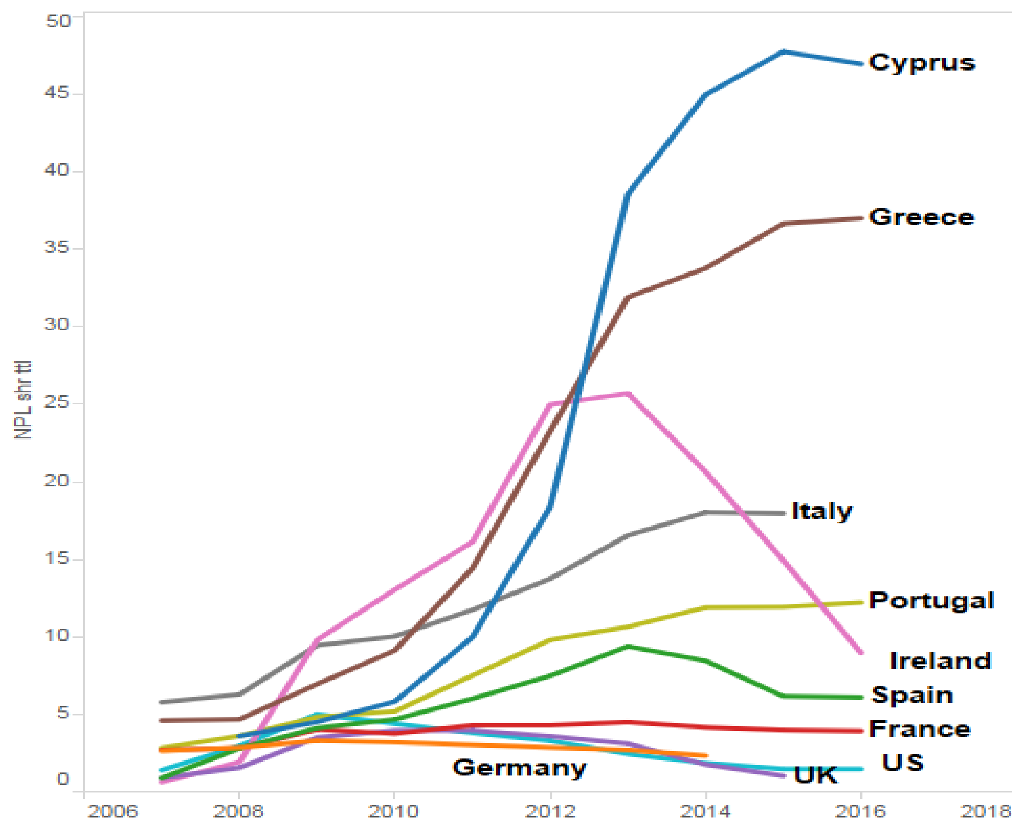


Debt Could Cripple Growth

Our national debt exceeded $21 trillion early in 2018 (it was less than $9 trillion in 2007). Between 2000 and 2014 China's total debt grew from $2.1 trillion to $28.2 trillion, an increase of $26 trillion – greater than the GDP of the US, Japan, and Germany combined.[4] Non-performing loans at Chinese banks have ballooned over the past three years following a government-led credit binge starting at the onset of the global financial crisis. Investors estimated in 2016 that the volume of bad debt in the country had reached $3 trillion. [5] At some point, market participants will realize that the debt is unsustainable and many of Trump's new policies could cause an acceleration of the debt. Ultimately, we believe this could end the bull market.

Bad bank loans

Nonperforming bank loans make up less than 5 percent of loans outstanding in the U.S., U.K, Germany and France. But the levels of bad loans have risen in other European countries. Nonperforming loans as a share of total loans outstanding. SOURCE: World Bank



[4] China's (Not so) Great Wall of Debt: $28 Trillion and Counting. Atif Ansar, Bent Flyvbjerg. November 28, 2016

[5] Global Investors Return to China's bad debt market. – Financial Times March 7, 2017

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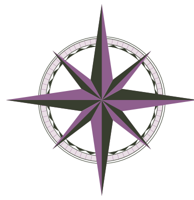

Aging Demographics

Another thing to consider is the aging demographics around the world. How will this impact the larger economic picture? In 2030, 25% of Europeans will be above age 65. The aging trend will mean increased strain on European health care and pension systems as well as the continent's economies, many of which are struggling under-employment rates averaging around 10% and old-age dependency ratios that are the highest in the world. [6] In 2015, the number of people over 65 in China (136.9 million) exceeded Japan's total population (126.9 million). [7] Here in the US, approximately 10,000 baby boomers retire each day.

According to research by the Insured Retirement Institute, 24% of baby-boomers have no retirement savings – the lowest since the study started in 2011. Only 55% of baby boomers have some retirement savings, and of those, 42% have less than $100,000. Thus, approximately half of retirees are living off of their Social Security benefits. [8]

Underfunded Pensions

Furthermore, there is the issue of underfunded pensions. Beginning in the early 2000s, many companies eliminated their pension plans in favor of 401k plans. This was great for the company as they were no longer on the hook for retirement benefits when an employee is terminated. But this forced the burden on the employee to fund their retirement and many of have failed to save even a fraction of what they need.

For those employees who are fortunate to have a pension plan, there are still potential problems created from aging demographics, mismanagement, and low returns in the underlying investments.

The credit-rating agency Moody's says state, local, and federal governments are about $7 trillion short in funding the coming pension payments.

"The unfunded liabilities of the various federal employee pensions systems, covering civilian and military employee benefits, amount to about $3.5 trillion, or 20% of US GDP," a release from Moody's said Wednesday.

"Additionally, Moody's estimates that unfunded state and local government pension plan liabilities are of the same magnitude, bringing the total shortfall to 40% of GDP."

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[6] Europe's Population Aging will Accelerate. Population Reference Bureau. July 2006
[7] This is a pretty worrying chart for China's Demographic Future. Business Insider. Elena Holodny Mary 16, 2016
[8] Are We in a Baby Boomer Retirement Crisis? Investopedia. Barbara A. Friedberg. March 8, 2017

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Moody's also said the public pensions were only one piece of the growing retirement problem in the US.

"The bigger challenge to the US comes from the unfunded liabilities for the Social Security and Medicare programs," the report said. "The Social Security funding gap is estimated at $13.4 trillion, or 75% of GDP, while the shortfall from the Hospital Insurance component of the Medicare program amounts $3.2 trillion, or 18% of GDP."

That means between the pension shortfall and the benefits shortfall, the US government is $20.4 trillion short in funding for retirees. [9]

Many of the pension plans in the US are underfunded. While many are projecting 7% average annual returns, CalPERS, one of the largest pension plans in the country, had a total return of 3% for the two-year period ending 6/30/2016. Many other pension plans had similar returns during that 24-month period.

As 2018 unfolds, we are likely to see new stressors in the public pensions as they are under massive pressure from underfunded liabilities. A key pension fund in Dallas froze assets in 2017 from any withdraws because of this illiquidity. This is potentially the Bear Stearns moment for the public pensions system. Major cities such as Los Angeles, Houston, Chicago, and New York are also under extreme stress. Virtually all public retirement systems are underfunded which is causing market participants to question the viability of the systems.

Should these funds experience further compromises, this could trigger a loss of confidence in not only the pension funds but the bond market and other financial sectors. Looking back at 2000, an asset bubble was created by the mispricing of assets in the Internet sector before triggering more than a 40% decline. In 2006/2007, it was a mispricing of real estate and abuse in mortgage securitization combined with excessive leverage forming yet a second bubble. As we know, this took a massive bailout to keep the system afloat combined with a huge asset purchasing program by the central banks across the planet. This, in our opinion, sets the tone for the public retirement system to be a potential failure point for the next crisis. [10]

On March 15, 2017, CalPERS voted to reduce pension benefits by up to 63% for about 200 former employees of the East San Gabriel Valley Human Services Consortium, a job training program that was known as LA Works. The vote followed a November decision by the CalPERS Board to trim benefits for a handful of retirees from the city of Loyalton in Sierra County. In each case, a local government fell behind on CalPERS payments. [11]

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[9] The US Government has a $20.4 trillion retirement problem. Business Insider. Bob Bryan April 6, 2016
[10] 2017 Outlook Deglobalization – The Final Countdown. Robert Kendall 2017
[11] Grudgingly, CalPERS cuts pension for 200 worker of defunct LA agency. The Sacramento Bee. March 15, 2017

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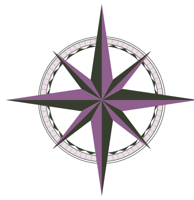

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Homeless Crisis

While the City of San Diego is projecting $324 million of their $1.4 billion annual budget to pension obligations (a $63 million increase from 2017), their homeless population continues to climb and has soared by 58% since 2007.

The City of Sacramento currently allocates over $13 million annually for approximately 3,600 homeless. There are approximately 135,000 homeless people in California. In 2017, the City of Los Angeles passed a half cent sales tax increase for the homeless. The San Diego Housing Commission recently proposed a three-year $80 million plan to move 3,000 people off the street. The State of CA is currently working on a $1.5 billion budget for the homeless.

We have not had a recession in over nine years. Of the baby boomers, 24% have no retirement savings. What happens in the next recession when jobs are eliminated? What happens when many of the 24% of baby boomers who don't have any savings lose the ability to work due to mental or physical conditions? I can only imagine the homeless situation getting much worse. How will that help the economy grow?

The Potential Landmine - China

Rising debt levels… aging demographics… underfunded pensions… homeless crisis… what else could possibly go wrong? Let's talk about China.

Over 20 years ago China embarked on a massive stimulus program to promote growth. The results have been phenomenal with annual growth well over 7% through 2015. At one point they were building 10-12 new cities per year. The results – ghost towns, 64 million vacant houses, abandoned construction projects, and 500,000 layoffs projected this year in the steel industry. There are over 600 million people in China earning less than $1,000 per year.

Chinese foreign exchange reserves topped $4 trillion in 2015 but have fallen 25% (below $3 trillion) since then, reflecting the desire of businesses and individuals to get their money out of the mainland. As people trade in their yuan for dollars, yen, and euros, the Chinese government has to use its foreign reserves to make good. [12]

Money is flowing out of China. Many Chinese have doubled and tripled their money in real estate and they have taken the money out of China to buy… real estate in Australia, Toronto, Vancouver, New York City, Washington, and California… often with cash. They have caused many prices to soar in these markets. How can one compete with an all-cash buyer?

[12] Dent Digest – Harry Dent February 10, 2017

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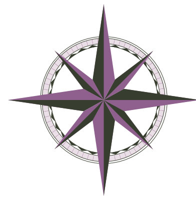

On March 5, 2017, China's premier warned that the world's second-largest economy faces "grave challenges", signaling a further deceleration as he announced a trimmed 2017 GDP growth target of "around 6.5 percent." [13] Based on the 64 million vacant houses, ghost cities, abandoned construction projects, rising bad debt loans, and Trump's goal to bring jobs back to America, "grave" might be an understatement.

On top of all these headwinds, what about the overall unrest in the world, or fall out from trade deals or a geopolitical event with unintended consequences? There is also the fact that much of the rally that we have experienced over the last nine years has been due to a monetary stimulus strategy by the central banks representing a bubble. The buildup of debt and other excesses that have been experienced during this time could catch up with the markets.

Similar to 2000, the US economy appears to be fine with low unemployment rates and optimism from the business community. But from 2000 to 2012, the S&P 500 lost money. Could we be in a similar situation? I have outlined some of our major concerns as to why a financial plan based on 6-8% growth projections could fail over the long term.

We believe an investment portfolio should have a combination of stocks, bonds, some investments with guarantees of principal, non-correlated assets, as well as investments that aren't dependent on a strong economy.

All indices are unmanaged and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges, or expenses. Past performance does not guarantee future results.

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[13] China Reduces Growth Forecast for 2017 to 6.5%. USA Today. Mike Snider March 6, 2017

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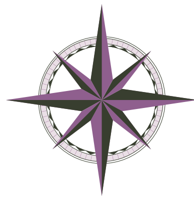

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