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ECONOMIC TALKING POINTS

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Economic & Geopolitical Forecasts for 2018

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Brace yourself. This could be a year of culmination. Just about everywhere you look --- the financial markets, domestic politics or geopolitical environment --- it appears all have veered off on a course that cannot possibly be sustained another year.

For example, Treasury yields and inflation barely budged last year and remain radically out of synch with past trends given where we are in the U.S. business cycle. Meanwhile the stock market keeps defying gravity despite modest GDP growth and dismal productivity gains. Then there's the bizarre ascent of the Bitcoin and its digital currency cousins. They have no obvious intrinsic value and, arguably, show attributes more closely resembling a Ponzi scheme, only this time one cleverly based on a mathematical contrivance. Even so, it has managed to capture the interest of sophisticated investors as well as mom and pop savers who want a piece of the action. But if you ask many of these people how they evaluate the underlying worth of cryptocurrencies, one often get an explanation that elevates word salad to an art form.

And let's not forget the bizarre political dynamics in Washington, which may well reach a climax this year. There are ongoing investigations in Congress and at the Justice Department into Trump's relationship with Russia during the presidential

campaign and allegations that he obstructed justice once in the White House. We could be approaching a seminal moment in this political drama that may determine the longevity of the Trump Administration.

Lastly, business leaders, investors and policymakers will have to carefully navigate through a minefield of geopolitical hazards. Will North Korea's obsession to build nuclear-tipped ICBMs lead to a catastrophic war on the Korean Peninsula? Are we about to see tensions between Saudi Arabia and Iran boil over into a hot war and push oil prices toward triple digits? Will China's annexation of the South China Sea and the militarization of its islands interfere with vital maritime traffic and lead to a confrontation with the U.S?

How all these exogenous events play out this year could have a profound impact on where the global economy is headed.

Global Summary

There are lots of worrisome issues out there to be sure. But there is much to find on the bright side too. The world economy in 2018 is off to its best start in a decade. Most countries have now shaken off the slump brought on by the severe 2007- 2009 recession. The U.S, Europe and Japan will benefit from stronger domestic demand, a pick up in government spending and a boost in exports. Supporting all this activity will be a healthier banking system and, for much of 2018, a relatively accommodative monetary policy by the major central banks. <u>Global GDP is expected to expand 3.7% this year, the most in seven years, and that compares with 3.5% and 2.4% in 2017 and 2016, respectively.</u>

The pace of growth, however, will be greatest in the first half 2018, before it trails off in the final months of the year. Part of this deceleration will be a consequence of slightly higher market interest rates. Another factor is that while the world appears to be in a synchronous upswing, the major economies are in fact at different stages in their business cycle. Case in point: after 8½ straight years of growth the U.S. expansion is now the third longest ever (or since 1854). In contrast, the economies of Europe and Japan began to show signs of a genuine recovery only last year.

The resurgence among the industrial countries should increase demand for basic commodities and back-office service operations, all of which will revitalize the economies of emerging countries. <u>Leading the charge will be India, Indonesia, Vietnam and South Korea. Expect those economies to expand between 4% and 7%.</u>

<u>Russia and Brazil struggled with recession in 2015 and 2016, but they finally managed to squeak out minimal growth last year. We expect both economies will show slightly better activity this year, with each registering 2% to 2.3% growth</u>. It will be difficult to move much beyond those ranges due to the myriad of self-inflicted barriers, namely stifling government controls, graft and the poor allocation of resources.

One significant area of concern is China's economy. Top Communist Party officials are attempting a risky high wire balancing act by seeking to engineer a gentle slowdown to better balance its economy and reign in excess borrowing. Can China pull it off without hitting the brakes so hard that it inadvertently causes an abrupt slowdown in economic activity, or worse? (More on China's economic challenges further below.)

Key Economic Forecasts

- Actual
- Forecast

United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.8	2.4	3.2	3.0	2.5	1.9	2.5	2.6	2.8
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	3.6	2.4	3.1	2.6	2.4	2.2	3.1	2.9	2.7
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	1.7	1.8	2.0	2.1	2.3	2.4	2.4	2.5	2.7
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.0	4.2	3.8	3.8	3.9	4.2	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	194	128	230	190	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.45	2.55	2.85	3.10	3.35	3.38	3.40	3.40
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

US Economy

We see no signs the US business cycle is near its peak. Healthy consumer spending, a pick up in business investments, greater exports will together propel economic growth this year by 2.8%. The pace, however, will slow to 2.4% in 2019 as the economy faces headwinds from modestly higher interest rates and rising inflation. Yet there is enough momentum in the economy the next 24 months for this expansion to become the longest on record, beating the marathon 10 yr. upturn of the 1990s.

Consumers will continue to play their vital role for many reasons. Job and income security remains strong. The unemployment rate, already at a 17-yr low of 4.1%, will hover between 3.7% and 4% the first half of the year. In addition, household wealth has jumped to record levels whether you measure it in nominal dollars, inflation-adjusted dollars, or on a per capita basis. When Americans see their net worth increase, they typically spend more. How much more? We can expect to see an additional 3 cents to 6 cents being spent for each dollar increase in household wealth.

Wages have also been rising, though at a frustratingly slow rate. Average hourly earnings (year over year) has been stuck in the 2.3% to 2.7% range for much of last year. Yet even at these levels, Americans have seen their pay increase faster than inflation. Several other metrics that gauge employee pay, like disposable personal income and total employee compensation, also increased faster than CPI. Thus even with those modest increases in earnings, workers have been enjoying gains in purchasing power. We expect average hourly wages will pick up this year to a 3% pace, which will still be above the 2% rise we're forecasting for consumer prices.

However, there are forces at play that will alter the composition of spending this year.

Let's run by a few of them. Americans have supported this expansion for more than eight years, which raises the question of whether demand is close to being satiated. After all, how many more cell phones, autos, home electronic gadgets do households need after nearly a decade of shopping? This question takes on more relevance because consumers have financed much of these purchases by taking on more debt and saving less. The savings rate, for example, plummeted to 2.9% in November, the lowest in ten years. If households chose to replenish some of their savings and/or reduce indebtedness, we will see less discretionary spending in 2018.

Another important factor that should impact consumer outlays the next two years is demographics. Baby boomers have had a profound impact on the economy at every stage of their life cycle. It will be no different now that they are retiring. These boomers will be downsizing, selling off their possessions, moving into smaller homes and showing less interest in purchasing "stuff." What's especially noteworthy is that as the larger millennial generation takes center stage, they show no inclination to be big spenders. Large college debts, skepticism over the solvency of social security, higher health care costs and seeing first hand the painful consequences of the last financial crisis have left them with a set of values that discourages superfluous spending. The net effect of these major demographic changes is a shift away from simply buying more things, to a preference for spending on services, such as travel, fitness and seeking out new life experiences.

To be clear, we are not forecasting an abrupt pull back by consumers, especially since the latest tax cut does leave households with a little more disposable income this year. But neither do we expect Americans to significantly ramp up outlays. Our forecast calls for real personal consumption expenditures to increase by 2.6% in 2018, compared to an estimated 2.7% in 2017.

The biggest change in the contribution to GDP growth this year will come from the corporate side --- and it's about time. Up until recently, more than 85% of the earnings of S&P 500 companies went into buying back their own stocks and increasing dividends. That certainly delighted shareholders. But by investing so little into new plant and equipment, it hampered productivity growth and made it more difficult for US firms to compete in a tough global marketplace. The failure of so many firms to plow those profits into modernizing their production facilities has left many workers relying on antiquated machinery, computers and software.

That reality finally sank in last year. Companies started to ramp up capital spending again and we expect this trend will accelerate in 2018 given the latest overhaul in corporate taxes. Among the most important provisions in the legislation is the ability to fully expense capital investments in the first year, the transition to a territorial tax system, and new incentives to repatriate some of the $2.6 trillion in profits US companies have stashed overseas. As a result, we're projecting real nonresidential fixed investments to increase by 5.8% this year, compared to a drop of 0.6% in 2016 and an estimated 4.5% rise in 2017. The outlook for business spending in 2019, however, looks dimmer as firms confront a higher cost of capital and growing concern this business cycle will top out late that year or in 2020.

In terms of foreign trade, the expansion underway in Europe, Japan and many of the emerging countries should boost US exports in 2018. Our forecast calls for a 4.4% increase in real shipments of goods and service, which will exceed the 4% rise in imports. The subsequent reduction in the trade deficit will add to US GDP growth. Aside from stronger growth overseas, US exporters will also benefit from a stable dollar the first half of 2018, before the greenback weakens the second half as

investors speculate the European Central Bank and Bank of Japan will begin to transition away from their ultra accommodative monetary policy.

Housing

The housing market underwent a roller coaster ride last year. Both existing and new home sales had some shallow fluctuations the first eight months of the year, and then skyrocketed the next three (thru November). What accounted for the rebound in sales toward the end of last year and what does it say about 2018?

There is no question that demand is solid, with household formation picking up and those seeking a home appear more inclined to own rather than rent this time. Mortgage rates also remained close to their historical lows for most of the year, though they have been creeping up in the final months of 2017. That probably motivated more buyers to lock in their purchases. A third factor may have been greater confidence in the economic outlook. GDP growth expanded at a better than 3% annual clip in the second and third quarters, and the unemployment rate dropped to a near two decade low. Homebuilders also ramped up new construction of single-family homes, thus adding more supply of lots and houses.

These trends will not only continue into 2018, there's a strong chance the housing sector will surprise on the upside. Ironically, part of this upturn is due the passage of the tax cuts. Yes, it limits interest deductibility to the first $750,000 of a mortgage (instead of the previous $1 million) and places a $10,000 cap on what you can deduct from state and local (including property) taxes. The conventional thinking is these new limits will hurt home values in high tax states (New York, New Jersey, Connecticut and California).

But our assessment is that home values in these states will remain mostly flat. That's because tax liability is just one factor homebuyers take into consideration. The availability of high-paying jobs, strong regional economies, the quality of public school education, access to public transportation and quality health care also play a role in the home buying calculus.

That's not to say to the latest changes in tax law will have no impact on sales. Over all, it will likely stimulate more activity in the housing market. We expect there will some migration out of the high tax states (which should loosen up much needed inventory). At the same time, it will promote sales and raise home values in low tax states (Florida, Texas, Washington, Nevada). Our forecast for 2018 has existing home sales increase to 5.75 million units (versus an estimated 5.55 million in 2017), with new homes sales at 663,000 (vs. 608,000) and housing starts rising to 1.29 million units (vs. 1.22 million)

The Tax Cut & Jobs Act

The *Tax Cut & Jobs Act* Congress passed late last year will have only a minor impact on overall GDP growth. The primary reason for its negligible effect is that the timing of this legislation is all wrong. Typically, the purpose of such stimulus is to jump start an economy that is moribund and suffers from high unemployment. That's when cuts in tax rates have the greatest effect.

But this economy is in fundamentally sound shape. It has been growing for nearly nine consecutive years and actually picked up more speed in 2017 thanks to an

impressive foreign recovery. US joblessness is now at a 17-yr. low. Corporate earnings are at record levels, as are profit margins. The stock market routinely reaches new highs. Confidence levels with consumers, business leaders and investors remain elevated. Given all these positive developments, its hard to see how the tax cut could move the needle much toward faster, especially when the Federal Reserve is simultaneously raising short term rates another 75 to 100 basis points this year. In terms of aggregate GDP growth, we project the new tax law will add a mere 0.2% to US economic growth over the next two years.

Infrastructure

The White House is expected to unveil a 10-year, $1 trillion infrastructure project early in the new year. After decades of neglect (mostly due to sequestration limits and tight state and local budgets), there is now bi-partisan agreement in Washington that such investments are desperately needed. The average age of the government's fixed assets (e.g., highways, national defense structures, airports, seaports, and water pumps and pipes) is now 24 years, the oldest since 1925. There are on average 650 water main breaks each day. Such incidents disrupt the movement of people and goods and impairs productivity. Of even greater concern is that 56,000 bridges in the US are deemed structurally deficient. Their very integrity is in question. Yet 185 million cars and trucks travel over these frail bridges daily.

While there is unanimity on the need for such expenditures, the thorny question is who will pay for them? Deficit hawks in Congress argue the government's borrowing limit is already maxed out. The tax cuts just passed, along with interest payments, is expected to widen the national debt by another $1.5 trillion to $2 trillion over the decade. Moreover, given current federal spending obligations, we could see annual budget deficits reach the trillion dollar mark as early as FY 2019.

As a result, GOP leaders seem intent to first focus on cutting entitlement spending, with the savings being used for seed money on infrastructure. But Democrats vigorously oppose this approach. Another source of funding might come from the repatriation of earnings that US corporations have stored overseas.
Our projection is that in the end, the White House and Congress will provide about $100 billion in seed money over the decade, along with tax credits to encourage private sector participation to help repair and replace the nation's aging infrastructure.

Inflation

There has been much head scratching in the economics profession on why consumer prices have remained tame so late in the business cycle. Historically, the companion to economic growth has been higher inflation. But that relationship appears to have broken down. Moreover this unusual combination of healthy growth with minimal pricing pressure is not uniquely an American phenomenon. Europe and Japan have experienced similar trends.

So why has the behavior of prices been so out of lockstep with the past? Are there transitory factors that kept inflation pressure under wraps, or are deeper structural issues at work here? There is considerable evidence it's more the latter.

The two primary forces that altered the dynamics that shape inflation have been technology and globalization. To begin with, half the world's population ---3.8

billion people --- now has access to the Internet and that has unleashed powerful disinflationary forces. The ability of these consumers, wholesalers and even manufacturers to compare prices and order goods online have forced sellers to be competitive. And it makes no difference whether the products being sold are toasters or Cad/Cams.

Other factors have helped constrain inflation, such as stable energy prices (we'll have more to say on this later) and fewer collective bargaining agreements. Both American and foreign companies are also acquiring new technologies to improve operational efficiencies and reduce production costs so they can price their products competitively and still protect profit margins.

Finally, the US is now more integrated into the global economy than ever before. American companies in virtually every industry rely on an international supply chain network that is designed to provide the best quality products at the most practical cost.

These are all transformative changes that was best summed up by Nobel Laureate Bob Mundell: "The only closed economy now is the world economy."

In the absence of any major geopolitical eruption, such as war or a severe supply shock, we see headline consumer price inflation inching up to 2.3% the end this year, and 2.7% in the final quarter of 2019.

With inflation to remain tame, the Fed is expected to raise short-term rates no more than three times this year, followed by two final increases in 2019. Since the economy is expected to lose some steam next year, and more markedly in 2020, our forecast calls for this interest rate cycle to end in 2019, with fed funds topping off at an unprecedented low of 2.63% for this cycle and 3.40% for the 10 yr. Treasury note.

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017	End 2018	End 2019
Crude oil per barrel	46	78	95	107	111	111	58	38	49	67	48	44
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.00	2.31	2.47	2.35	2.30

Oil Prices

The outlook for energy prices also looks good from a consumer standpoint. WTI oil ended last year just above $60, with Brent posting an additional six dollar premium. Many analysts have projected prices will hover between the $55 to $70 bbl. the next two years. But we don't see support lasting at these levels.

Our forecast is for oil prices to glide down to a range of $40 to $55 bbl. this year and next. There are several reasons why crude will be headed lower.

First, the joint agreement in late 2016 between OPEC and key non-OPEC producers, like Russia, to curb production by 1.8 million barrels did make a dent at reducing the glut in oil supply. But while this agreement has been extended to the end of 2018,

compliance is expected to erode the next 12 to 24 months as US oil companies succeed in grabbing market share away from Saudi Arabia, Russia and other major exporters of crude, thus depriving them of much needed revenue. The US is currently exporting a record 2 million barrels a day --- and that is expected to climb further.

Moreover, the technology behind hydraulic fracking and horizontal drilling has gotten so sophisticated, it keeps lowering the break-even point, which for the Permian and Eagle Ford Basins is now around $40 to $45. We expect total oil production this year to exceed 10 million barrels a day and approach 11 million next year, with 75% of that coming from shale. At this pace, the US will be pumping as much as Saudi Arabia.

But let's not stop here. The science, technology and engineering know-how behind fracking will soon spread beyond US shores. Some countries have resisted its use because of environmental concerns and fears it may also trigger earthquakes. Others, however, believe technological improvements have substantially reduced both those risks. The result: We are seeing countries in Latin America, Asia and Sub-Saharan Africa view fracking in a more benign light and have begun negotiations with major US producers to tap oil and gas reserves in their regions. Such projects will ultimately add more supply to global inventories.

At the same time, there is an inexorable shift by individual and corporate consumers around the world to reduce their dependence on fossil fuel. Companies in the US and Europe have taken the lead to rely more on solar, wind, biofuel, hydro, and battery to generate the energy they need. That will reduce future demand for crude. For all these reasons, we see oil prices slide down to the $40 to $55 bbl. range the next two years.

One final point about energy. The question we often get on this topic is whether oil prices will ever shoot up to triple digits again? Are those days gone forever?

In terms of pure market fundamentals, our answer is yes. With the dissemination of the shale technology to other countries plus gains made by the private sector to tap alternate sources of energy, the days of $100 per bbl. for crude is over. The only circumstance which could thrust oil toward that price point again would be a geopolitical shock that placed Saudi Arabia, its monarchy and oil infrastructure at grave risk. How likely is such an event? Given the heightened tensions in the Persian Gulf, it's a scenario that cannot be viewed as remote. We have assigned a 30% chance of a hot war breaking out between Iran and Saudi Arabia in the next 12 to 24 months.

US dollar

The US currency will fluctuate within a narrow range the first two quarters of the year. Its minimal net move can be attributed to two conflicting forces. Favoring the dollar is the widening interest rate differential between the US and the other major economies. The Federal Reserve is expected to raise short term rates another three times this year, while the European Central Bank and the Bank of Japan are nowhere near ready to tighten monetary policy. At the same time, the dollar will face downward pressure as the economies of Europe and Japan continue to improve, prompting investors to take advantage of the more reasonable valuations of real and financial assets outside the US.

The second half of the year, however, will be more problematic for the dollar. US economic activity is expected to ease, which will raise fresh concerns about the longevity of this business cycle. In addition, the November midterm election is likely to see the Democrats win back one or both houses of Congress, which would introduce new uncertainty about future economic policy. Adding further downward pressure on the dollar will be the anticipated decision by the ECB and BOJ to finally jettison their highly accommodative monetary policy in 2019. <u>Our forecast calls for the dollar to slide another 5% against its major trading partners by the end of the year, and an exchange rate of 1.22 against the euro and 111 versus the yen.</u>

International outlook

Europe's expansion will pick up more speed this year (except for the UK) as it benefits from stronger economic activity in the US and Asia. After years of several lost dawns, the recovery that began in earnest last year shows signs of achieving a virtuous cycle, where growth leads to more jobs, greater household spending and thus more business investments. Aiding this process will be stable to lower oil prices, a healthier private banking system, and still a highly accommodative European Central Bank. We should see the first hints of the ECB preparing to taper its bond purchases late this year.

That's not to say it's perfectly clear sailing for the region. Among the risks ahead are a breakdown in Brexit talks, the civil conflict in Spain as Catalonia seeks independence, upcoming elections in Italy where its Five-Star anti-establishment party is gaining popularity, and the rising influence of far right parties in Germany, Hungary, Austria and Poland. <u>All these risks, of course, bear close monitoring. We're projecting real GDP growth in the Eurozone to reach 2.4% this year, and then slow to 1.7% in 2019.</u>

Japan's economy finally showed some traction last year. It has grown for seven straight quarters, the longest stretch in a decade. Consumer and business confidence have picked up and the recent national election gave PM Shinzo Abe a strong mandate to pursue much needed structural reforms. <u>We expect Japan's economy to grow slightly faster this year, expanding 1.9% as it continues to benefit from record low rates, a pick up in consumer outlays, greater government spending, and a jump in exports.</u> The biggest upside surprise, though, could come from greater household expenditures. Since the government plans to raise the sales tax from 8% to 10% in 2019, shoppers are likely to advance purchases to this year. We therefore see the economy squeak by with just 0.9% growth next year. But Japan also faces several downside risks. Chief among them is the outbreak of a war on the Korean Peninsula, a military confrontation with China in the South China Sea, and worries of an abrupt slowdown in Chinese economic activity.

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.4	2.8	2.4
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.3	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.8	1.4	1.0	1.4
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.9	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.2	2.7	2.5
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.8	7.5	7.5
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.3	6.2
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	0.9	2.3	2.8
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.0	2.1	2.0	2.5
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.7	2.8	3.0
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.4	2.1	2.0
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.5	3.7	3.9

NAFTA & Brexit

The termination of NAFTA and the possibility of a hard Brexit are certainly two risks that could disrupt trade flows and damage the world economy. President Trump may demand trade fairness and reciprocity in his NAFTA talks, which is perfectly understandable. But terminating NAFTA outright makes absolutely no economic sense given the intricate supply chain network with Canada and Mexico that many US firms rely on. Ultimately cooler heads will prevail and recognize that this is not a zero sum game where U.S. manufacturing competes with Canadian and Mexican manufacturing. The modern day reality is that all have benefit greatly by participating in a formal North American manufacturing relationship.

Far more complicated are the ongoing Brexit negotiations. While some progress has been made on the UK's financial obligations to the EU and the legal rights of EU citizens living in the UK, many hellishly tough issues remain. Among them involve the trade and border links between Ireland and Northern Ireland, the UK's withdrawal from EU's customs and trade pact, and the length of the transition period when Britain fully separates from the EU. As a result, we see the UK's economy struggling this year as British and foreign firms put on hold any major capital spending project until there is greater clarity on what Britain's economic relationship will be with the EU. Our forecast calls for the UK to grow about 1% this year and 1.4% in 2019.

Emerging Countries

Faster growth in the OECD countries along with a stable to slightly weaker dollar will revive demand for commodities, basic manufacturing and back office service operations in the emerging economies. Brazil, Indonesia, Malaysia, Vietnam and sub-Saharan will be the biggest beneficiaries. All told, we see real GDP growth in the emerging market sector increasing 5.5% this year, compared 4.8% in 2017. The one outlier will be India. Its economy was briefly tripped up last year by PM Narendra Modi's somewhat overzealous changes to the economy, such as the surprise elimination of high cash bills and the introduction of a goods and services tax. But economic activity will be back in full swing this year with faster growth and hotter inflation. Projections are for the India's economy to expand by 7.5% this year

<u>and next (compared to 6.8% in 2017), exceeding the pace of its chief Asian rival, China.</u>

At the other end of the extreme are two key countries that will suffer economically this year: Venezuela and Turkey. The former defines what an economic basket case looks like. Venezuela's fortunes plummeted from being Latin America's richest country to the most desperate. Its autocratic leader, Nicholas Maduro, is literally destroying the economy by blindly pursuing the same destructive interventionist policies of his predecessor, Hugo Chavez. Maduro's actions have not only caused the country to default on its financial obligations, but also brought on chronic food shortages. <u>The country is destined to experience its fifth straight year of recession in 2018, with the economy contracting another 5%.</u> At the same time inflation is expected to climb nearly 2,000%, essentially making its currency, the bolivar, worthless. The country's finances are in such horrific state that the government recently announced plans to form its own digital currency (the "petra"), one that will be backed by its oil and gas reserves. Frankly, we doubt Maduro will be able to pull off such a feat.

Turkey's economic challenges, while certainly not as severe as Venezuela, are also getting more serious. True, it did register an impressive 11% increase in GDP growth the third quarter compared to the same period a year ago --- and that may seem impressive. But keep in mind GDP growth in the year ago quarter actually contracted by 0.8%, which takes some shine off the latest headline number.

Growth this year, however, looks more problematic. Turkey's widening current account deficit, deepening foreign indebtedness, surging inflation rate and ailing currency will cast a dark shadow over the economy. Making matters worse is the increasing authoritarian rule of President Recep Tayyip Erdogan, which will likely trigger more social unrest and scare off foreign investors. <u>In addition to its domestic turmoil, Turkey is also being wracked by terrorism and the geopolitical upheaval in Syria and Iran. Our forecast calls for economic growth to slow from an estimated 6.5% in 2017 to about 2% this year.</u>

China

The single biggest cloud hanging over the global economy this year is China. No country has tried as hard or been as successful at avoiding a recession the last several decades. By boosting government spending and allowing the nation's debt to balloon, the country has managed to remain unscathed from the 1997 Asian crisis, the 2000 dot.com crash, and the global 2007 – 2009 Great Recession. Chinese leaders have long been committed to preventing an economic downturn——at any cost! The reason? A recession would not only threaten jobs and possibly foment social unrest, it could undermine confidence in the leadership of the Communist Party and even question the regime's legitimacy.

But if history has taught us any lesson, it is that no country, regardless of its political system (capitalism or communism) can repeal the business cycle. Even the most aggressive command economies, like Russia, Cuba and Venezuela have suffered recessions. Yet China's Communist Party leadership has managed to keep the economy out of trouble. It has accomplished this by using three principal tools: ramping up government expenditures, opening the credit faucet and manipulating its currency. But the by product is that China must now grapple with excess

industrial capacity, zombie factories, a massive debt bubble, rising defaults and bankruptcies, an over supply of housing and waves of capital outflows.

The bottom line is China's economy is not on solid footing. To thwart the day of reckoning, President Xi Jinping is now pursuing a two-prong strategy. The first is to scale back credit creation, especially by the country's shadow banking system. But this is an extremely delicate task because any restrictions on lending could also backfire and precipitate an economic crisis.

His second policy objective is to restructure the economy so it is less dependent on exports and government subsidized building projects, and rely more on domestic consumer demand. The problem is such a transition takes time, which is something the country doesn't have much of. Chinese workers will not be able to boost spending anytime soon to offset reductions in government investments. The reason? Since there is no official social safety net program in place to rely on for retirement, people tend to save much of their income.

After taking these factors into consideration, we have assigned a 40% risk that China's debt bubble will burst the next 12 to 24 months. If that happens, there could significant aftershocks in the global economy. At this juncture, however, our baseline forecast calls is for the economy to grow 6.3% (based on official calculations) this year, down from 6.8% in 2017.

Economic & Geopolitical Events That Can Disrupt U.S. GDP Growth: Their Probability of Occurrence

Any scenario above 50% will be incorporated in our baseline economic forecasts for 2018 and 2019.

PROBABILITY (%)	U.S.
35	President Trump departs before his first term expires
25	NAFTA talks fail and cause a trade war
20	Federal Reserve raises interest rates too rapidly; Yield curve inverts
30	Bitcoin price crashes; sell-off spreads to broader equity markets
25	U.S. inflation accelerates faster than expected
	FOREIGN
45	War on the Korean Peninsula
40	China mismanages efforts to deleverage; debt bubble bursts
25	U.S. - Chinese confrontation in the South China Sea
25	Iran's domestic turmoil boils over to civil war: cost of crude climbs
35	Saudi - Iran tensions escalate to direct military conflict: Oil prices surge
20	War erupts between Israel & Lebanon's Hezbollah
15	Brexit talks collapse and imperils global trade
30	Catastrophic act of terrorism involving WMDs

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