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ECONOMIC TALKING POINTS

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A Lamborghini Economy

Before I discuss May's robust job numbers as well as other recent upbeat economic reports, try doing this thought experiment first.

Let's say you were introduced to someone who drives a Lamborghini, owns a yacht and lives in a spacious beachfront home. Assuming this was all legally obtained, your first conclusion might be of a person who either inherited lots of money or was successful in business. At the very least, it's a pretty impressive life style and one likely to rouse perhaps a bit of envy.

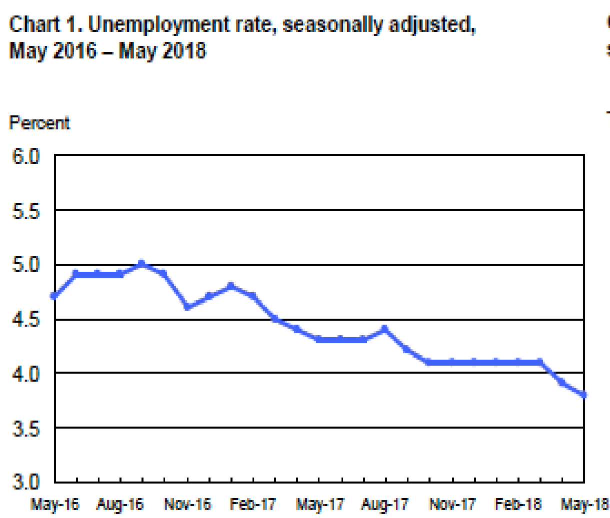
But what if I were to introduce one more fact and tell you the flashy car, boat and mansion were financed entirely on debt. Worse, that person's cash flow was so deeply negative, the only way to meet current and future obligations was to keep borrowing ever-larger sums of money. Chances are your view of this person would markedly change. All that display of wealth suddenly looks more illusory and that this individual's future seems terribly bleak. You wouldn't want any part of that lifestyle and there's certainly nothing to envy here.

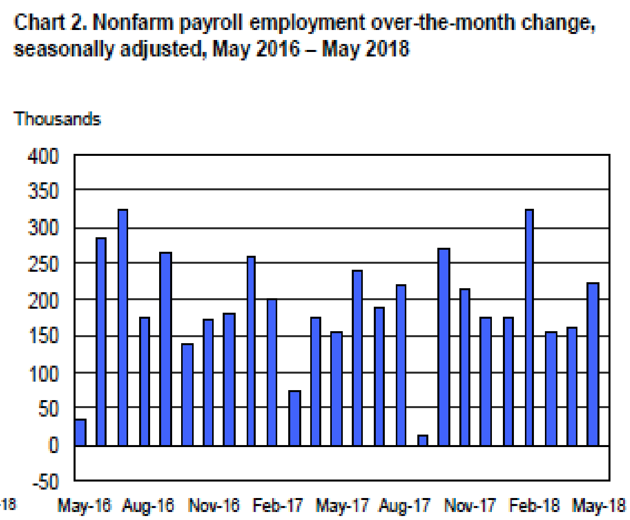
What does any of this have to do with the current state of the economy? Everything!

For the next several days and weeks we will hear political pundits and even economists rave about the hearty job market and the steadiness of this economic expansion. And on the surface there appears to be a lot to crow about. May's unemployment rate fell to 3.8%, the lowest in 18 years. And the broader measure of underemployment --- which includes Americans stuck with part time work but prefer full time, plus those too discouraged to look for jobs --- dropped to 7.6%, the smallest in 17 years.

Certainly the headline employment numbers looked pretty good. Total payrolls rose by 223,000 last month, and the government also updated figures for March and

April to show that 15,000 additional jobs were created than originally estimated. Moreover, the employment gains last month were widespread, especially for those in retail (up 31,100), construction (25,000), manufacturing (18,000), transportation and warehousing (18,7000).





Even the closely watched gauge on wages ticked up in May. Average hourly earnings in the private sector rose 2.7% over the last 12 months, better than the 2.6% pace seen in April. (But let's not get too giddy about the latest pay hike. Keep in mind that in May 2009, when the economy was in the deepest, darkest depth of the Great Recession, average hourly earnings still rose at a 2.9% rate!!)

Besides the jobs report, the government released other positive news about the economy. There was the eye-opener on construction spending. It jumped 1.8% in April, the biggest monthly gain in more than two years! Fueling much if this activity was a surge in private construction spending, which climbed 2.8% (due mostly to a pick up in residential building).

Manufacturers also ramped up activity in May. The Institute for Supply Management's ISM index for manufacturing climbed to 58.7, compared with 57.3 the month before. Better still, new orders were arriving at an accelerated pace. One industry official in that survey commented "we are currently overselling our forecast and don't see an end to the upswing in business."

It all sounds so good. Now take a deep breath because there's one other sobering fact to consider. All these great stats on the economy tend to obscure the fact that behind much of this stimulus is a raging river of fiscal red ink. The $1.5 trillion tax cuts and the $1.3 trillion burst in government spending essentially locks the US to a path of trillion dollar budget deficits a year for the next ten years. In other words, the economy's performance looks impressive, but then so did that fellow with the Lamborghini.

The key point is you can make almost anyone and anything initially look good on the surface by relying excessively on debt—and that is precisely what is so disconcerting about this economy. Case in point: Despite all the strong economic numbers, the government still had to borrow a record $488 billion in the first quarter. And that's just the beginning.

Is this pattern unusual, even dangerous? You bet it is and here's why.

This business expansion is now the second longest ever. We've now completed nine straight years of growth. The only other time the US achieved a ninth year of economic expansion was in 2000. Back then, like now, the unemployment rate also hovered between 3.8% and 4%. But the fundamental difference is that the strong economy and low unemployment in 2000 generated a budget surplus of $236 billion! In fact, the government enjoyed several years of significant surpluses during that expansion. Those surpluses provided an opportunity to reduce the national debt and build a war chest to prepare for the next downturn.

In stark contrast, the ninth year of the current expansion --- again with identical unemployment levels as 2000--- is expected to produce a mammoth $804 billion deficit this year, followed by trillion dollar annual deficits as far as the eye can see, according to the CBO. So you can marvel all you want about the lovely stats on jobs, construction activity and manufacturing, but the underlying truth is that a healthy economy should not be generating a sea of red ink, especially at this late stage in the business cycle.

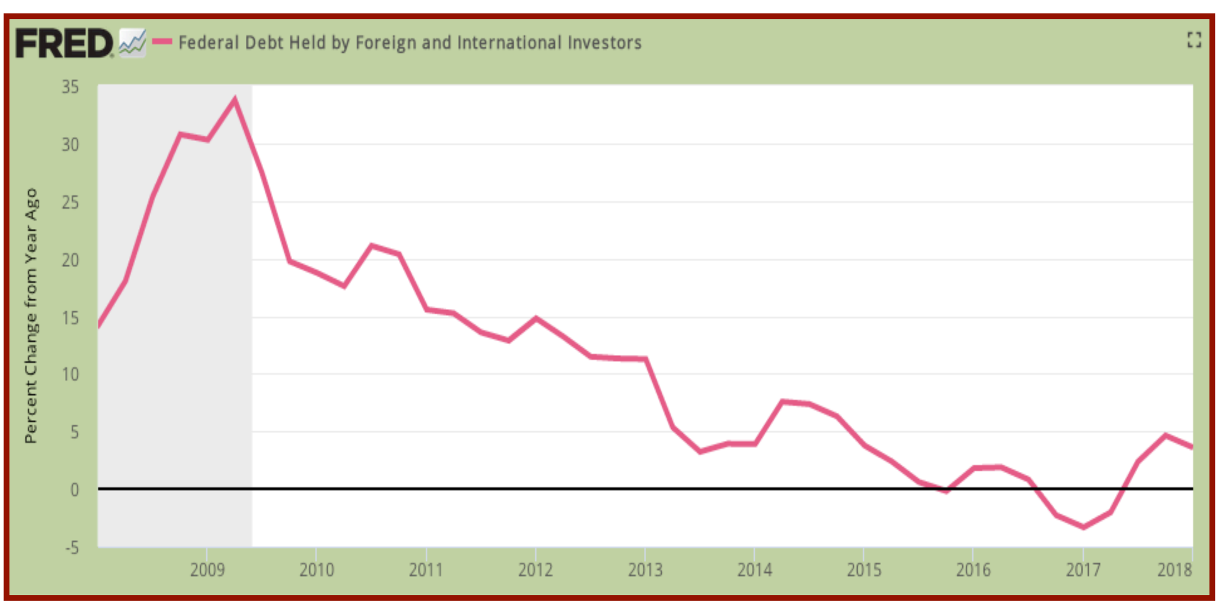
So the questions now pile up:

• How much longer can this economy expand when the level of government and even private debt keeps soaring at a time when short and long term rates are moving higher?

• How much longer will foreign investors keep buying the colossal volume of new U.S debt coming to market? (Hint: foreigners have already been scaling back. They now own about 43% of US government debt, down from 55% a decade ago.)

• How well can the economy perform at a time of rising protectionism when one out of every four dollars in GDP is linked to international trade?

Percent change from a year ago: Federal debt held by foreign and international investors



Sure, the macroeconomic data has been looking good and many analysts will myopically focus on that trend. But the argument we're making is that these solid numbers look increasingly illusory! The combination of unsustainably high levels of US debt, rising short and long term rates, the prospect of a full scale trade war, and the growing disenchantment among foreign investors with President Trump's politics and trade policies--- all suggest this aging expansion is approaching a turning point.

We have consequently raised our forecast for recession in 2019 to 50%, from 25% earlier this year. Expect the first symptoms of an economy that's losing steam to appear in the second half of this year through slower job growth, an erosion in consumer and business confidence, larger trade deficits, a material pick up in household delinquencies, higher inflation and an increase in the cost of capital.

When an economy reaches this late stage of the business cycle, it has to struggle harder when faced with serious headwinds. And from my point of view, the road ahead is looking increasing treacherous

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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	2.9	2.2	3.0	2.6	2.6	1.7	1.9	2.1	1.9
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	4.0	1.0	2.1	2.2	2.4	1.0	1.7	1.8	2.0
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.4	2.5	2.6	2.6	2.7	2.6	2.3	2.2
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.1	3.8	3.6	3.8	4.0	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	202	185	170	155	133	110	98	130
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.74	3.01	3.05	3.15	3.10	3.10	3.05	2.95
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

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	2.3	2.6	1.9
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.1	1.5
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.4	1.6
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.1	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	2.2	1.9
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.6	7.4	7.3
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.5	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.0	2.5	2.3
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	2.4
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.8	2.6
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.5	1.6	1.4
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.2	3.6	3.2

Economic & Geopolitical Events That Can Disrupt U.S. GDP Growth

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

PROBABILITY (%)	U.S.
60	White House implements new tariffs and triggers a trade war
45	President Trump departs before his first term expires
20	Federal Reserve raises interest rates too rapidly; Yield curve inverts
55	President Trump announces withdrawal from NAFTA
25	Yield curve inverts for an extended period of time
	FOREIGN
25	War on the Korean Peninsula
40	China mismanages efforts to deleverage; debt bubble bursts
50	U.S. - Chinese confrontation in the South China Sea
45	Saudi - Iran tensions escalate to direct military conflict: Oil prices surge
35	War erupts between Israel & Lebanon's Hezbollah
15	Brexit talks collapse and imperils global trade
30	Catastrophic act of terrorism involving WMDs