

CLUTINGER, WILLIAMS & VERHOYE, Inc.
REGISTERED INVESTMENT ADVISORS

Suite 3 – 6398 Del Cerro Blvd – San Diego, CA 92120

THOMAS H. CLUTINGER
LOUIS E. WILLIAMS JR. (1934-2008)
KARL E. VERHOYE (1931-1994)
SCOTT B. WILLIAMS, CFA, CFP
KENT STONE
THOMAS M. CLUTINGER

TELEPHONE: 619-326-0900

Economic and Market Outlook

March 31, 2017

(If Trump Can Deliver)

Section I. Enhancing the Engine of Economic Growth

Part A. The Promise

I've talked to dozens of big- and small-company
CEOs since the election, and I'm seeing
big improvement in animal spirits.
--Dave Cote
CEO of Honeywell

There is little doubt left that Dave Cote's statement represents the consensus for the majority of business leaders and investors.

Chart-1 (NFIB Small Business Optimism Index) shows a remarkable jump in Confidence, or as Dave Cotes says, "animal spirits."

Chart-2 (Are Small Businesses Planning to Hire?) illustrates that hiring plans are at the highest level since late 2006.

Additionally, Chart-3 (University of Michigan: Consumer Sentiment) conveys a similar pattern (i.e., greatest Confidence level since 2004).

Such shifts in Confidence can be powerful. Chart-4 (S&P 500) clearly shows the power of investor Confidence.

The Confidence at all levels has been heavily influenced by assumptions that the Trump Administration will make good on its promises to accelerate economic growth from the less-than-2% annual level since the end of the Great Recession (2007-09) to a rate north of the 3% annual historic rate.

The biggest risk to the President's success is the possibility of a "Trade War," says Douglas Holtz-Eakin, former Director of the Congressional Budget Office under

George W. Bush. He is also worried about President Trump's final Immigration stance, which may prove a "downer for growth."

We would add that the possible deportation of perhaps millions of undocumented workers--who are critical to farming, construction, and numerous service industries—could also dampen optimism about the level of economic growth. Even the uncertain status of H-1B applicants could be resolved unfavorably for technology companies that depend on such technical talents to maintain the U.S. dominant position in technological research.

In an article that appeared in *Fortune* (February 16, 2017), entitled "The Promise and Peril of the Trump Economy," the authors said:

The near future of the American economy will depend on which side of the scale predominates under Trump: free-business initiative or protectionist policies. Corporate tax cuts and regulatory relief will weigh heavily on the plus side. But an upheaval in trade would swamp all the potential gains from slashing regulations and taxes.

The *Fortune* article continued:

Many economists argue that a small pool of employable labor and an aging population, capped by low levels of immigration, have helped create a "new normal" that confines America to a plodding GDP growth rate of 2% or so. Trump isn't buying it. In the view of his economic team, the roadblock is a dearth of capital investment. They argue that Obama hobbled business with a host of expensive regulations in banking, energy, and manufacturing that forced CEOs into a defensive posture, in which they shunned risk taking and hoarded cash.

Whatever the reason, it's undeniable that capex [capital expenditure] in the U.S. has languished and that a healthy dose of new investment is absolutely essential to lifting America's growth trajectory. The crucial measure of capex, private nonresidential fixed investment, stalled in the third quarter of 2014. Since then, spending on new plants, labs, and research facilities has increased less than 0.5% a year, adjusted for inflation, creating a substantial drag on GDP.

Trump wants to jolt the U.S. economy back into action. He predicts a virtuous cycle in which his tax plan allows companies to raise their profits from new investments, driving them to boost spending. Then new machinery and tech breakthroughs will raise worker productivity and, hence, wages and employment. At the same time, lifting burdensome regulations should also recharge capex across the economy.

Part B. Three Key Economic Policy Questions

The *Fortune* article cited above summarized the core questions that will affect the final success or failure of the Trump administration's economic policies.

The concern about whether Trump can deliver is no small question since Congress has already begun raising cost issues.

The core questions summarized in the *Fortune* article are as follows:

1. **Will Trump go to BAT?**

One Republican tax-reform plan calls for a complicated new levy called the border adjustment tax. It could raise \$1 trillion to offset corporate tax cuts. But U.S. retailers hate it.

2. **What's the right way to finance an infrastructure building boom?**

Trump has advocated public-private partnerships, which aren't practical for many projects. The Democrats are pushing a \$1 trillion federal public-works campaign. A possible compromise: Use the tax windfall from repatriating stranded overseas profits of U.S. companies to fund the much-needed investment.

3. **Is Trump serious about starting a trade war?**

The President has threatened to impose tariffs on countries like Mexico and China if they don't lower barriers to U.S. exports. But odds are that a full-on breakout of protectionism would cause the value of the dollar to spike, shrink exports, and hobble growth.

Chart-5 (Shares of Federal Spending, 2017) shows the Budget Problems: First, where is the money to come from? Second, what will be the size of the Budget Deficit?

In an article written by Rick Newman, columnist for Yahoo Finance (March 2, 2017), entitled, "The Stratospheric Cost of Trump's Economic Plan," he writes:

The price tag is high, however, and as Trump's plan for the economy comes into focus, the big battle will be over where to get the money. Some experts think Trump's grand plan has *no hope of passage on Capitol Hill*, with the odds even stacked against a more modest version.

Here are the big programs Trump has proposed, with estimated costs and some handicapping on their odds of passing:

Tax reform. Trump called for "historic tax reform that will reduce the tax rate on our companies ... and massive tax relief for the middle class." There's no formal plan yet, but the blueprint Trump unveiled as a candidate would reduce federal revenue by *\$7 trillion over 10 years*, or \$700 billion per year, according to the nonpartisan Tax Policy Center. The federal government takes in about \$3.4 trillion in annual revenue, while spending about \$4 trillion. So Trump's plan would cut federal revenue by roughly 20%.

Boost defense spending. Trump aides say they want to boost the defense budget by 10%, which would be \$54 billion per year.

Infrastructure. Trump wants to spend a whopping \$1 trillion on roads, bridges and other public projects over a decade, with some of that funded by private investors and some by taxpayers. Here's the catch: Private funding only works for projects with tolls or other user fees that can generate a revenue stream, and many projects don't fit the profile. Plus, it's sometimes controversial when private investors profit from public assets such as roads. So it's likely at least some infrastructure spending will have to come from taxpayer funds. We'll lowball this figure at \$25 billion per year.

Repeal and replace Obamacare. The Affordable Care Act, aka Obamacare, actually *reduces federal deficits by at least \$14 billion per year*, partly through new taxes on high earners and some corporations. Trump doesn't

have a replacement plan yet, but if he repeals those taxes he'll add to deficits by the same amount.

Border wall. Cost: At least \$21 billion. Let's spread that over four years and round down to \$5 billion per year.

More spending on veterans, education vouchers for the poor and other things. Trump hasn't detailed how much more he wants to spend, so these costs are unknown.

Those few tax cuts and spending hikes would add something like \$800 billion to the national debt each year, on top of annual deficits of at least \$500 billion that are already in the cards. So in the best case, the annual deficit if Trump got his way would be \$1.3 trillion—close to the biggest deficit ever.

Budget hawks in Congress, both Democrat and Republican, want to find new revenue sources, such as taxes on imports and on foreign profits brought home (i.e., taxed at perhaps 10% rather than 35% to encourage repatriation).

They also wish to reduce spending in the non-defense discretionary category, seen in Chart-5 cited earlier, and most of them want \$1 cut for every \$1 added.

Since the non-defense discretionary category only amounts to \$561 billion total for the current year, between the prospective reduction in taxes and increased spending of about \$800 billion—*Houston, There Is a Problem!*

As it turns out, the Border Adjustment Tax-reform (i.e., called BAT), which Paul Ryan has put forward, is critical to all proposals for tax cutting and increased spending. The new source of revenue proposed by the Speaker of the House has many in both parties, as well as in industry, already in opposition. That opposition must be overcome or the promises of massive tax cuts, a huge infrastructure plan, and a stronger defense will, at least, partially disappoint.

Section II. Post-Election Market Rise—Trouble or Opportunity?

Part A. Giving Trump's Economic Policies a Chance

Less than five months into the post-election stock-market advance (two-plus months post-inauguration), and the financial press has been seized by doubt (i.e., fear that proclaims the market to be overvalued).

Moreover, this fear concerns the possibility of a Bear Market rather than that of a normal Correction. A Correction implies something that is 10% of a decline and happens, on average, once a year. It should also be pointed out that short-term Contractions of 3%-to-5% occur, on average, three times per year.

In our opinion at this time, such Corrections/Contractions provide extra opportunities to add to or acquire new investments for the longer-term.

We believe Corrections and shorter Contractions are opportunities because of our view that the market's rise since 2009 is part of a Secular Bull Market. Such markets are long-lived (15-20 years) and are driven by more than just political factors.

whether they are favorable or unfavorable to the accompanying Secular Economic Cycle. (To review the driving forces of Secular trends, look again at our quarterly reports over the past couple of years discussing this subject.)

We will discuss the subject of market valuation later in this report, but for now, it is important to say the current economic and market environment does not deserve the word *fear*, but does deserve the word *opportunity*.

However, what we see and hear in the financial media is not the normal concern or discomfort of a possible Correction of 10%, but, as we said above, fear of a Bear Market, whose average decline is 35%.

Clearly, such a decline deserves attention, but not based on the current simplistic reasons that we keep making new highs or that the rise has gone on too long.

Yes, Bear Markets of a Cyclical nature can interrupt the much longer trend of a Secular Bull Market (see [Chart 11](#) [Secular Trends]), but the key word, *Cyclical*, refers to a negative business cycle (i.e., a Cyclical Recession usually is caused by excessive inventories).

Since a Cyclical Bear Market results from a faltering economy, before we begin to worry to the point of fear, we should examine the health of the economy, which determines the environment for Corporate Earnings. A faltering economy accompanied by faltering Earnings spells Bear Market.

But is the economy faltering? While our answer is decidedly No, we will present the evidence a little further into the report.

Yes, change is afoot. Is it possible that Trump's economic policies disappoint? Of course, the answer is yes, but until whatever programs impact the economy for better or worse, it is unwarranted to assume that a Recession is nearby nor, thus, its precursor, the birth of a Cyclical Bear Market.

We simply cannot let the discomfort from change lead to poor investment decisions.

Howard Marks, co-founder of Oaktree Capital Management, who is known in the investment community for his insights into both the economy and security markets, holds as one of his precepts: *"Most great investments begin in discomfort."*

In April of 2014, Marks wrote more extensively on the subject when he said:

When I first went to work at Citibank in 1968, they had a slogan that "scared money never wins." **It's important to play judiciously, to have more successes than failures, and to make more on your successes than you lose on your failures. But it's crippling to have to avoid all failures, and insisting on doing so can't be a winning strategy. It may guarantee you against losses, but it's likely to guarantee you against gains as well.** Here's some helpful wisdom on the subject from Wayne Gretzky, considered by many to be the greatest hockey player who ever lived: **"You miss 100% of the shots you don't take."**

Additionally, Marks said:

Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss. ... No, the solution can't lie in rigid tactics, publically available formulas or loss-eliminating rules ... or in complete risk avoidance.

We will see who wins: Trump's spending plans or the budget-hawks of both political parties who brought us the failed austerity budgets that crippled the Obama administration's efforts to accelerate economic growth.

We have said above and in prior reports that we are in a Secular Economic and Stock-Market advance. This means that we believe that Trump's proposals would provide incremental growth, but by no means are they the most critical factor to the economic growth we see coming from the onset of a long period of exponential technical advances.

In giving Trump's economic programs a chance, we start by recognizing the following points:

1. The economy is already improving in the U.S., Europe, and China.
2. U.S. Corporate income has been rebounding from a slump in late 2015 into early 2016.
3. A gradual approach by the Federal Reserve in raising interest rates is the stated policy.
4. Inflation remains low.
5. Trump's plan favors tax-code and government-regulation reductions.
6. Trump's plan favors profit-repatriation through a lower-tax incentive.
7. Finally, Trump's plan has proposed a \$54 billion (i.e., 10%) increase to defense spending and a \$1 trillion increase to infrastructure spending.

The first four points recognized above concern the favorable economic backdrop in which the last three economically favorable proposals take the stage.

As investors, of course, we owe to ourselves the patience to wait for and then evaluate incoming data before making conclusions about President Trump's impact on the economy.

Furthermore, in giving the proposed economic plans a chance, we are, or should be, comforted knowing that much of his proposals are parallel to those presented by John Maynard Keynes in the 1930s. Keynes is still considered one of the greatest economists of the twentieth century.

As we said in our December 2016 report, entitled Return to Keynesian Ideas:

Trump's economic policies, as outlined to date, resemble those of Keynes, who argued that government spending could boost the economic growth by increasing aggregate demand and that such spending would prompt other people to spend, in turn creating a virtuous cycle. Spend enough government cash, and you could put all of society's unused resources to work. To Keynes, deficit spending ultimately generated sufficient revenues for government to recapture its original spending investment.

Clearly, President Trump's attitude towards deficits as an investment is not new.

Part B. Are Stocks Expensive?—Really?

“There is no shortage of pundits, advisers, analysts, strategists or alarmists who warn that stocks are overvalued and that a sizable setback could occur at any time,” so said Charles Lieberman, writing for Bloomberg (March 2, 2017).

Lieberman continued:

It has been widely noted that stock indexes such as the S&P 500 have risen almost 250 percent from the lows of March 2009, that they have set record highs, and that they have increased for eight consecutive years. If these facts don't suggest stocks are expensive, what could? Yet none of these facts speak to whether stocks are expensive or cheap; they only show that stocks are more expensive than they were in 2009. The facts cited above provide no suitable benchmark to judge the market.

What follows is a series or number of perspectives all pointing in the same direction—namely, that the Price-Earnings multiple (i.e., P/E Ratio) as used as a key metric to judge valuations is simplistic and frequently just plain wrong.

As a preamble to our discussion of the P/E Ratio, take a look at Chart-6 (History of U.S. Bear & Bull Markets Since 1926). This Chart tells us at least two facts:

First— The average Bull Market period lasted 8.9 years, with an average cumulative total return of 490%.

Comment—The current expansion just turned 8 years old and has increased returns approximately 247%.

Second—The duration of advances in history has ranged between 2.5 years to 15.1 years. The gain for the S&P 500 during these advances has ranged between 75.6% and 935%.

Comment—The current advance is not unusual, and its valuation cannot be judged on either its length or return.

Turning to the “key metric” commonly used to judge stock valuations—the P/E Ratio—we also find that it is not a sound benchmark on which to base judgments.

The following presents a number of perspectives on the P/E Ratio's soundness.

To begin, Chart-7 (S&P 500 Trailing 12-Month P/E Ratio: 1954-Present) shows the current P/E Ratio at 22.1, which means that the S&P 500 Index is priced at 22.1 times the Earnings on a trailing 12-month, or 4-quarter, basis.

If we use the trailing Earnings as an estimate of four quarters ending in March of 2017 (i.e., a number we will not actually have for another month or so), then the trailing P/E Ratio drops to 19.5 times.

At a level of 19.5, the only thing we can say about its usefulness is that the current level is above the 16.56 level shown as the historical average going back to

1954. Of course, with no further usefulness, we can also say that the current level is above the historical average going back to 1871 according to the data collected.

Comment—We have consistently argued that comparing today's level with historical levels is nearly meaningless as a guide to over- or under-evaluation judgments. Why? Because an average of a mix of high and low multiples drawn from profoundly different economic environments is too simplistic.

First Perspective

There are many critical variables that define a period's P/E Ratio. They include such factors as differences in economic growth rates, inflation, rising or falling interest rates, differing periods of income-tax rates (i.e., increasing or reducing), differing periods of corporate profit behavior, and, of course, differing aspects such as war and geopolitics.

For illustration purpose, take just two variables that are strongly linked to differences in the P/E Ratio through time: inflation and interest rates.

The evidence is that periods with high inflation and high interest rates are connected to periods of low P/E Ratios, or multiples, and that low inflation and low interest rates, such as now, are connected to high P/E Ratios.

Chart-8 (S&P 500 Average PE, 1871 to Present) directly compares the average level of the P/E Ratio as inflation progresses from lower levels to those that are higher.

Comment—Note that, since 1871, when the inflation environment has been as low as today (i.e., 2% to 3%, and until very recently 1% to 2%), the P/E Ratio has exceeded 18 times.

Second Perspective

Since the P/E Ratio is a function of both Price and Earnings, the resultant P/E can be high in one period because P rises more than E rises, for example, or high because E actually falls. In other words, it may be crucial to understand different periods of even the same or a similar Ratio because the two periods could be remarkably different in circumstances.

Comment—Thus, what we are saying is that historic comparisons should not be made at all, except in comparing like periods—comparing like periods of factors such as inflation, interest rates, earnings growth, tax differences, etc.

Third Perspective

In Chart-9 (Average Company Lifespan on S&P 500 Index [in Years]), we see still another problem in relying on comparisons between current and historic data. Note that *Lifespan* in the Chart means how long a company has been included in the Index (the company may have existed before and/or after its inclusion in the S&P 500 Index).

The Chart is focused on showing the fluctuating but overall trend of having companies included for shorter and shorter periods of time.

Also note that this Chart shows that, in 1960, companies included in the S&P 500 average had been there an average of 60 years. By 1998, the average lifespan, or time of inclusion, in the Index had fallen to under-25 years, while today it has fallen further, to under-20 years.

Obviously, this creates a problem. How can we compare today's S&P 500 Index with its history when the makeup of the Index is becoming less and less stable?

If we look at today's composition compared to even that of 1990, let alone 1960, we find a remarkable change in what companies representing what sectors are included.

It makes a difference since P/E Ratios of some sectors are inherently higher or lower than other sectors because of greater growth, greater expectation of growth, greater profit margins, etc.

For example, in 1990, the Energy sector of the S&P 500 Index accounted for 13.4%, but today, only 6.6%; yet the Technology sector accounted for 6.3% in 1990, against 21.5% today.

In fact, the top-three-of-ten sectors that made up the S&P Index of 500 companies in 1990 were Industrial, Energy, and Consumer Staples. Today, the top-three-of-ten are Information Technology, Financial, and Healthcare.

Comment—We conclude, as obvious, that an average P/E Ratio of 2017 should not be compared to that of 1990, or 1960, or 1871. Changes in the make-up of the Index make unsound the drawing of a conclusion based simply on historical comparison, such as, "We should avoid the stock market now because valuations are high." We say, high in relation to what?

Fourth Perspective

As seen in Chart-10 (Corporate Profits after Taxes/GDP), corporate profit's share of GDP has risen dramatically since the mid-1980s and has, in fact, returned to levels that existed immediately after WWII.

Comment—Perhaps higher P/E Ratios are deserved at this time because corporate profits have captured a larger share of GDP, and their share of GDP appears to be turning up following a mild downturn after reaching new highs since WWII.

Fifth Perspective

Today's P/E Ratio stands at 19.5 on a trailing basis, or, as the *Wall Street Journal* reported on February 27, 2017, it stands at 18.1 on a forward-estimate basis.

This final (for now) perspective on the merit or lack of merit in using an unadjusted P/E Ratio as the measure backing judgments of under- and over-valuation raises another issue related to the construction of the P/E Ratio. There is a dramatic

Earnings problem with the Energy Sector. We already said that the Energy Sector currently accounts for 6.6% of the S&P500.

Chart-12 (The Value of Energy) presents the problem. Note that, although improved from well over 50, the P/E Ratio for the Energy Sector is still nearly a multiple of 30 times (due to low Earnings expectations). The *Wall Street Journal* pointed out that if one excludes the Energy Sector's 30 multiple, the S&P 500's multiple would drop from 18.1, on a forward basis, to 16.6.

Comment—The examples, or perspectives, offered above make our case that all Ratios, when compared to history, only become useful, if at all, when adjusted to take into account differing circumstances. Otherwise, whether a P/E Ratio is above or below average, the average itself is meaningless. In other words, draw judgments as to the value of any particular P/E Ratio at your own risk.

As we have said in numerous of our quarterly Economic and Market Outlook Reports, confidence in one's judgment about valuation (i.e., answering whether the market is likely to continue rising or whether it is near or nearing a period of trouble) should come from other than simplistic comparisons to historic averages.

An article entitled, "Asset Market as Banks," published in *Philosophical Economics* (February 27, 2017), perhaps stated our view best:

We shouldn't be focusing on valuation. We should be focusing instead on factors and forces that actually do cause panics, that actually do break the networks of confidence that hold markets together. We should be focusing on conditions and developments in the real economy, in the corporate sector, in the banking system, in the credit markets, and so on, looking for imbalances and vulnerabilities that, when they unwind and unravel, will sour the moods of investors, bring their fears and anxieties to the surface, and cause them to question the sustainability of prevailing prices, regardless of the valuations at which the process happens to begin.

Chart-13 (Bear Markets) highlights the fact that Recessions should matter to all investors. This, in turn, means that those aspects of the economy that are markers pointing to Recession are to be considered seriously, because they are critical to forming sound judgments.

In the ten Bear Markets since 1926 (i.e., Bear Market defined as a 20% or greater decline), eight declines were directly connected to developing Recessions. Of the two not connected, one was the result of the Cuban Missile Crisis, and the other a result of a structural market failure connected to Program Trading.

In the Section that follows, we turn our attention to those factors critical to the health of the economy.

Section II. Measuring the State of the Economy

In assessing the status, or soundness, of the economy, we have come to find that the following indicators, or tools, collectively provide for a concluding judgment:

1. The Civilian Unemployment Rate—including the Weekly Unemployment Claims and Continuing Claims.
2. All Employees: Total Nonfarm Payrolls ÷ Civilian Labor Force.
3. Real Retail and Food Service Sales.
4. Industrial Production.
5. Real Personal Income Excluding Current Transfer Payments.
6. 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity.
7. Smoothed U.S. Recession Probabilities Determined by the Federal Reserve.

Before our review of each of the seven tools begins, it is important to know that any final judgment to begin a sell program is made from a preponderance of the data. That means, first, that four of the seven indicators must have turned negative at the same time, AND, second, that the 40-Week Moving Average of the S&P 500 Index is greater than the current week. We note that, at present, the indicators are nowhere near meeting these conditions.

The first two tools, or indicators, are related to analyzing the status of the Labor Sector of the economy. Labor is a most sensitive Sector to even seemingly minor changes in the economy.

We will first look at a “predictor of the predictor,” which can be too early and, thus, its usefulness is questioned by some.

Thus, we begin with Chart-14 (Continued Claims [Insured Unemployment]) and its companion, Table-I (Unemployment Claims as a Recession Indicator). Taken together, these spot economic trouble in the Labor Sector, on average, 11-to-12 months ahead. Unfortunately, the lead has been as much as 20-to-22 months, depending on whether you examine Unemployment Claims on an Initial or Continuing basis. Chart-14 shows Continuing Claims, but it could have just as easily been Initial Claims. Table I shows the closeness of the relationship.

As it turns out, Chart-14 and Table-I are good forecasters of Chart-15 (Civilian Unemployment Rate) and Table-II (Unemployment Turns Higher) since an average lead time for Claims is followed by the shorter lead of 3.45 months by the actual Unemployment Rate.

Comment—Chart-14 and Table-II, taken together, are actually more useful to predicting the stock market's downward turn. Why? Because the stock market is itself a leading economic indicator.

In his classic investment book called, *Stocks for the Long Run*, (McGraw-Hill 2002, 3rd edition), Jeremy J. Siegel points out that, almost without exception, the stock market tops out prior to business-cycle peaks, and bottoms before business-cycles hit their low point.

We summarize the following points that Siegel makes:

1. Out of 47 Recessions since 1802, 43 of them (9 out of 10) have been preceded (or accompanied) by declines in the stock market.
2. The average lead time between a market top and a business cycle peak (i.e., beginning of Recession) is 5.7 months.
3. The average lead time between a market bottom and a business cycle trough is 4.8 months.

Since the long lead-time of Unemployment Claims to Recession, shown in Chart-14 and its companion Table-I (average 11 months), is more than the lead time of a stock market peak to Recession (Siegel's determination = average 5.7 months), there is a sizable warning (11 months less 5.7 months = 5.3 additional months) given by Unemployment Claims that a Bear Market may be nearing.

Such a supplemental forecast by Claims is useful, but the final call for Recession, as we said earlier, needs the turning negative of four of the seven indicators given at the beginning of this Section.

It is also useful to know that the stock market's decline may foretell a Recession and, in fact, may be the start of a Bear Market, but there are so many normal Contractions (typically, 10% once a year, and 3%-to-5% three times a year), that the decline must only be considered normal (i.e., short-term) until four of the seven economic indicators say sell, AND the market's decline is sufficient to cause the trend of the 40-week Moving Average to rise above the current price.

Our conclusion for the first indicator—Civilian Unemployment Rate (Chart-15)—is that it is currently positive.

We took extra time for this indicator than will be given to the remaining six because its predictive value in forecasting Recessions is 96.74%. Time was also given to the supplemental tools of Unemployment Claims and the stock market itself because they both set off warnings to pay close attention to the seven tools.

A short review of the remaining six indicators follows.

Chart-16 (All Employees: Total Nonfarm Payrolls/Civilian Labor Force) once again examines an aspect of the Labor component of our economy. In this case, when Year-over-Year data cause the graph to fall below zero, the risk of a Recession

becomes high and is so counted as one negative out of the four of seven used to make our concluding judgment of impending Recession. The current level is not below zero.

Conclusion—the second indicator is currently positive.

Chart-17 (Real Retail and Food Services Sales) confirms that consumers are spending. Furthermore, it is our opinion, based on analyses of the many sub-sectors of Consumer Consumption and of the Consumer's improved financial well-being, that Retail Sales are in the process of acceleration.

Conclusion—the third indicator is currently positive.

Chart-18 (Industrial Production Index) shows that, despite the negative pressure on Production coming from the Energy industry, total Industrial Production is no longer a drag on the economy. We fully expect to see positive contribution in the months ahead.

Conclusion—the fourth indicator is currently positive.

Chart-19 (Real Personal Income Excluding Current Transfer Receipts) remains well above a negative point. In fact, we expect Income acceleration now that the Labor market has grown closer to full employment levels.

Conclusion—the fifth indicator is currently positive.

Consider Chart-20 (10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity), together with Chart-21 (Yield Curve [10-Year Yield Minus 1-Year Yield] and U.S. Recessions) and Table III (Inverted Yield Curve [10 Yr Minus 1-Yr] and Recessions [1956-Present])—all show something in history that is nothing short of profound: There has never been a Recession without a previous Inverted Yield Curve (i.e., the shorter-term yield rises above longer-term yield—for further explanation, see our December 2016 Report, p. 5). Table III shows the average lead time of an Inverted Yield Curve to Recessions as 14 months. Such a long lead-time makes a Yield Inversion a clear warning that a Bear Market is also likely, and comes before the Recession, as Siegel's study would predict. In fairness, this indicator cannot be used alone, for even though no Recession has occurred without a prior Yield Inversion, there have been a few Inversions without a Recession. But, as one indicator among seven, it is vital.

Conclusion—the sixth indicator is currently positive.

Chart-22 (Smoothed U.S. Recession Probabilities) shows the Fed's conclusion concerning the probability of Recession three-to-six months ahead. In this Chart, we have drawn a line near 20%, which becomes the start of Recessions. It is the point near which the NBER (National Bureau of Economic Research) declares the official beginning of a Recession.

Conclusion—the seventh indicator is currently positive.

Summary of the Seven Indicators—7 Positive, 0 Negative

Chart-23 (Consumer Price Index for All Urban Consumers: All Items) is included to reflect the fact that Inflation is rising due to accelerated economic growth; and such rising Inflation will continue to add pressure to the Federal Reserve to drive Interest Rates up. Furthermore, note in Chart-24 (10-Year Treasury Constant Maturity Rate) that rates are already rising on their own. Fed action is about to push rates up, moderately faster.

Section III. The Risk to Chance

We have argued throughout this Report to give President Trump’s economic agenda a chance. We have supported such a position in part because the ideas are grounded in economic principles that have worked before—the ideas are similar to those utilized by John Maynard Keynes during The Great Depression (for more on this, see our December 2016 Report).

More recently (March 9, 2017), Paul Krugman, who won the Nobel Prize for Economics in 2008 (not a fan of President Trump), actually agreed with key aspects of Trump’s economic plan for tax modification, when Krugman said, “The plan is actually not too bad.” He continued, “Even some Democratic-leaning economists support a shift towards a destination-based cash flow tax.” However, Krugman did predict that neither President Trump nor Congress is likely to exercise sufficient leadership to pass even a majority of the proposals.

We will know soon enough but the risk to the chance that Trump’s proposals will be legislated into life remains in doubt, in large part due to the constant presence of distraction. Like many, though, we remain hopeful for a reasonable outcome because, like Dave Cote of Honeywell, we, too, see a big improvement in “animal spirits.”

At this early date, President Trump’s economic goals remain but a range of possible outcomes. Until events unfold, and their effects begin to be measured, we must remain watchful.

Scott B. Williams, CFA, CFP

Thomas H. Clutinger

Kent Stone

Thomas M. Clutinger

