Black Swan Capital 2017 Forecast Issue

Summary Overview

Despite the optimism flowing into markets based on the US Presidential Election we believe there will be a disappointment phase for risk assets. We suspect growth through at least two quarters next year will disappoint expectations. Accordingly, we are expecting a correction lower in **stocks** and the **US dollar**. A correction higher in **bonds** (lower yields) and **gold**; with **oil** being a wild card, though we suspect if growth disappoints, corresponding demand for energy will be marked down as the year advances, especially since it seems already lower supply expectations from OPEC baked in the price, oil prices should also move lower with risk assets at least into the second quarter.

Why do we expect global growth to disappoint?

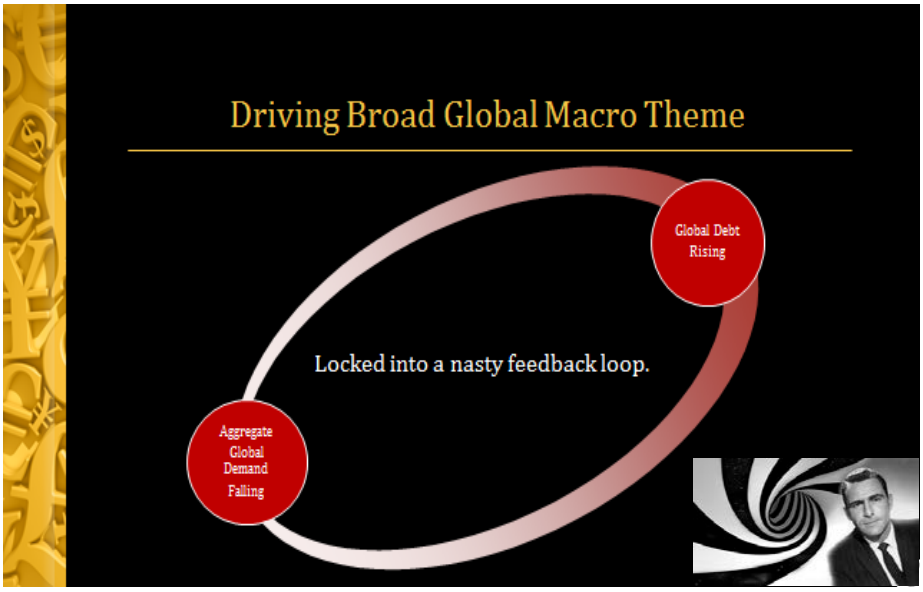
In a word—debt! It is the reason we believe the two key drivers of global growth—the United States and China—will likely disappoint in 2017.

> *Financial Times*: China's debt load has reached 255 per cent of GDP by the end of June, up from 141 per cent in 2008 [i.e. they ramped up credit to replace lost global demand because of the credit crunch, and the bad news is global aggregate demand is still relatively stagnant], and well above the 188 per cent for emerging markets, according to the Bank for International Settlements.

The same global macro feedback loop of the debt/demand/deflation trap is still the dominant driver.

Debt/Demand/Deflation Trap

New Abnormal



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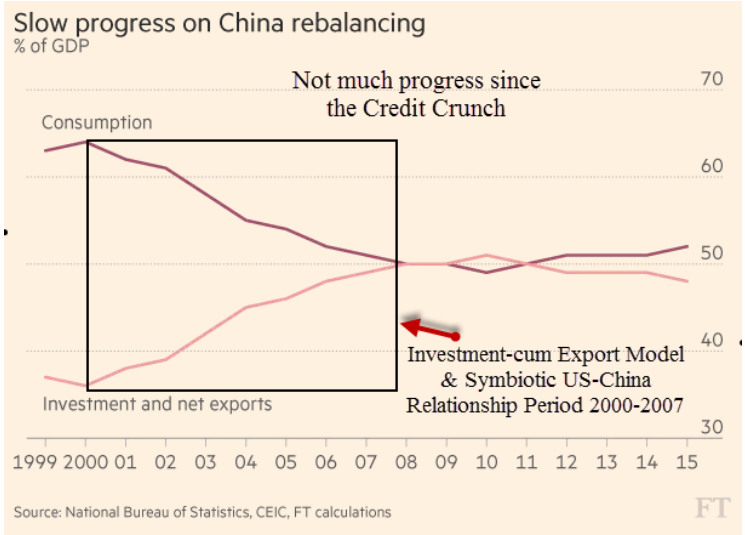
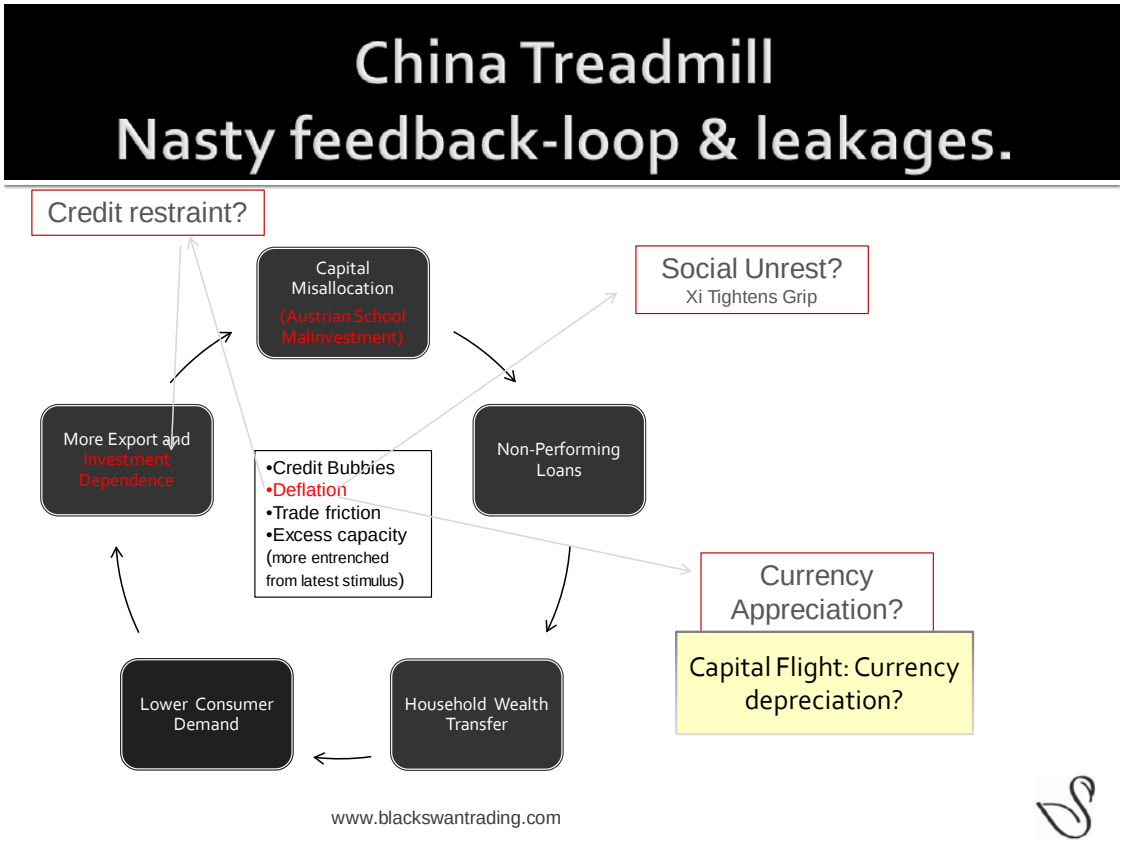
As global debt rises, it puts downward pressure on aggregate global demand regardless of monetary conditions. As you saw in the first graphic above, China's debt-to-GDP has ramped up quickly as a replacement for the decline in aggregate global demand.

China has talked a lot about rebalancing its economy, but the facts show little rebalancing has taken place since the credit crunch.



Without global rebalancing and the Chinese consumer becoming a bigger driver of growth, the chances for a Japanese style multi-decade stagnation rise. **The treadmill is still a vicious one for China.**



Capital flight from China and negative impact of rising cost of dollar denominated debt for Chinese borrowers is forcing China to use reserves to support its currency. Remember when everyone believed the yuan was "incredibly" undervalued against the dollar?

Based in what we are seeing, <u>it seems China will most likely muddle through in 2017 at best, and face a mini-financial crisis at worst</u> should the US not growth quickly enough to drive the demand for Chinese final goods.

US growth disappointment?

Turning back to the US growth outlook…as indicated, debt seems to be the 800-pound elephant in the room, though economists still tend to believe fiscal spending, creating more debt, is stimulative to the US economy. And this alone has many, neo-Keynesians and construction companies, excited about President-elect Trump's plans for $1 trillion in infrastructure spending in the US.

The reality is fiscal spending when debt is above 50% of gross domestic product (gdp) has a negative stimulator effect. And as you saw in the first chart, US debt-to-GDP is now up around 250 per cent! It is not to say we have reached the Crack-up Boom stage; but it is to say debt is a major drag on economic growth and social welfare.

From Hoisington Research, Third Quarter Review and Outlook:

- If new fiscal measures are enacted, **debt-to-GDP ratios will be increased and will further depress growth, thereby causing interest rates to move lower, not higher.** In a highly incongruous development, governments will therefore be able to finance their new debt offerings at lower costs. While this may seem to be a good thing for the individual governments, the great majority of their constituents will be harmed. The higher debt will set off a chain reaction of unintended consequences. The 70-75% of the households that receive the bulk of their investment income from interest bearing accounts will have fewer funds for retirement. This, in turn, will cause older members of the workforce to work longer and save more, blocking job opportunities for new entrants into the labor force. Thus, fiscal decisions, which result in higher deficits, are likely to perpetuate and intensify our underlying economic problems.

- Impressive scholarly research has demonstrated that the government spending multiplier is in fact negative, meaning that a dollar of deficit spending slows economic output. The fundamental rationale is that the government has to withdraw funds, via taxes or borrowing, from the private sector, to spend their dollars.

- As an economy becomes more over-indebted, additional government spending slows growth even more due to "noninterest economic costs" such as misallocation of saving, reduced productive investment, weaker productivity growth and eventually a deterioration in demographics.

"The decentralization of power away from hubristic central planners is exactly what the world needs more of. The centralization of power is the source of the very risky environment we're in, not the decentralization."

Mark Spitznagel

And in a world or rising social discontent, we need to remember the waring as elucidated by Citron Zoakos, independent global strategist:

- **The only outcome of debt relief without revolutionary, entrepreneurial structural reforms in the markets for goods and services** (rather than in the labor market) will be the typical European class struggle. History has shown how dangerous this can be.

We believe President-elect Trump understands the game intuitively. But that is yet to be determined fully or articulated completely. However, his proposals effectively "get government out of the way" of the private sector (albeit the infrastructure spending proposals) by reducing both tax and regulatory burdens. And that prospect seems to have created lots of optimism. And here is where we believe the market (stocks and rates) is well ahead of itself. Policy takes time to get enacted. In addition, it takes a while for the benefits of legislation to flow through to the real economy.

Back to Hoisington's recent missive for some context:

- The Reagan tax cuts of the early 1980s are quite instructive on this point. That tax cut was far larger in relative terms than what is being proposed and since the federal debt was so much less than it is currently, the tax multiplier was more negative, approximating -3. Additionally, the Reagan tax cuts were being implemented while interest rates were falling sharply. Even with fiscal and monetary conditions working in tandem, the economy was very slow to respond. The Republicans lost control of the US Senate in the 1984 Congressional elections and their numbers in the House were reduced. Also, Fed Chairman Volcker was required to orchestrate a major decline in the dollar under the Plaza Accord of 1985 and interest rates did not reach their cyclical low until 1986.

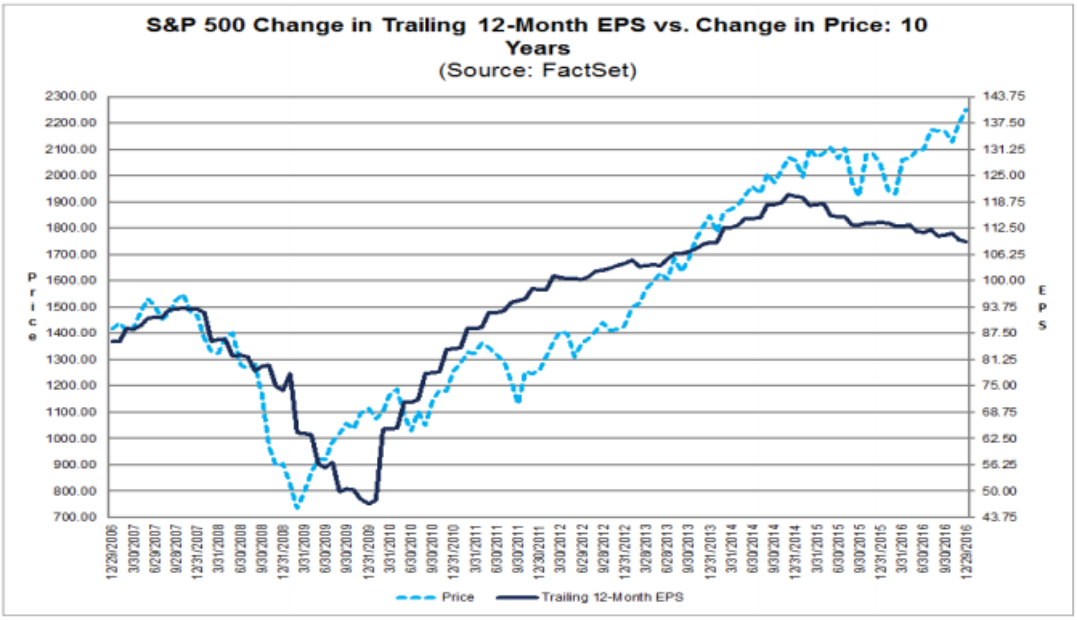
So, to re-emphasize, as explained above, there is good reason to believe even if President-elect Trump gets his agenda through Congress, said agenda will likely; 1) lack the stimulative impact of a similar set of policies President Reagan enacted; and 2) take time. And with the current rancor in the Congress (and the media), legislation itself will not be easy, as President-elect Trump is clearly going to be missing the usual "honeymoon period" that former newly elected Presidents have enjoyed.

In addition to the disappointment on time and extent of the Trump agenda, likely damping growth expectations for at least the first half of the year, and maybe beyond, it seems prices of stocks for running well ahead of earnings reality.

Rationales for a stock market correction?

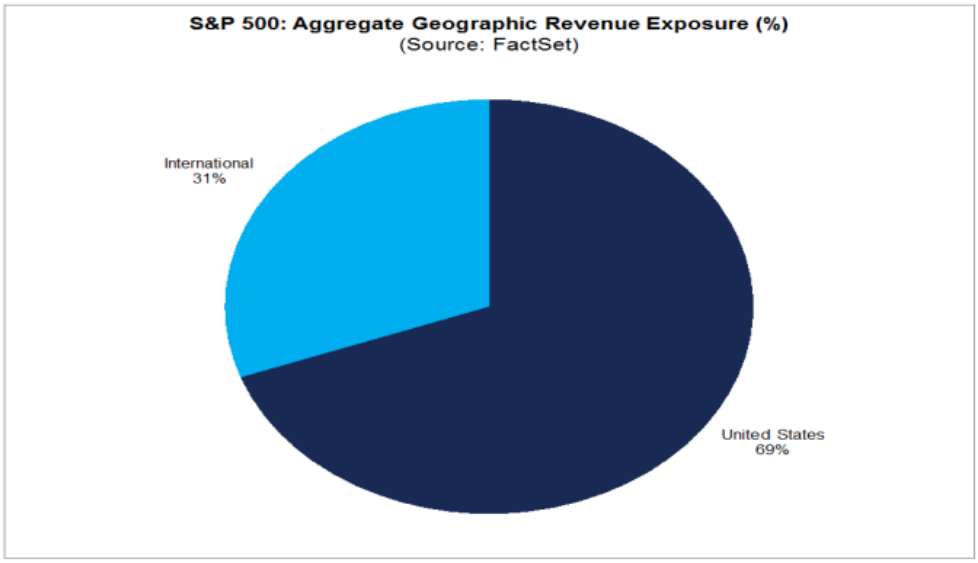
Already stock prices are well ahead of 12-month EPS expectations; these expectations will likely be lowered based on our assumptions above:

Trailing 12M P/E Ratio: Long-Term Averages



A whopping 31% of S&P 500 companies' earnings are exposed internationally; here is where the US dollar strength has quite a negative impact.

Geographic Revenue Exposure



And to give you an idea just how drastically stocks have outperformed bonds this year, and especially since the election, also suggests equities have quite a premium built into them:

Eurozone faces lots of political risks this year

And of course the outsized risk seems the potential for deterioration of the Eurozone.

This is an excerpt from a *Currency Currents* dated June 26, 2016 that summarizes why the regime will may unravel:

> The rationales for the UK leaving have been hashed over pretty well, especially now with the gift of hindsight. Despite seemingly the entire staff of the Financial Times still in denial, with commentary bordering on bitter, there is a clear broad rational for all of this; I return to a commentary from Citron Zoakos once again, from May 2016:
>
> > **In recent years, economists have debated fruitlessly over the importance or lack thereof of financial imbalances and excessive debt.** To no avail, they have sought answers to the question of what happens if these problems are not addressed by policymakers. Now we know: Voter insurgencies happen; revolts happen that topple the established policymaking elites.
>
> In short, the inability of authorities to deal with the credit crisis (not to suggest an easy task) and their decision to "save" the global financial system through massive injections of liquidity (at the expense of rising public debt) to save legacy (read: crony capital protected assets) and apply severe financial repression (zero and negative interest rates) has benefited owners of capital through the massive inflation of financial assets; yet those owners of labor (regular people who do real things for money—build stuff and serve) have wallowed with high unemployment, no return on savings, a decline of their largest asset (their home), and loss of real income. The UK lesson is a microcosm of this strident difference in world view between the elites and the average guy on the street (in every developed country it seems)—those in London (insert New York) love the EU (insert US Federal power); those serfs in the Northern England hinterlands (insert US fly-over country) do not.

You can see the litany of Key Global Political events for 2017, defined by Brown Brothers Harriman, flow from Europe. The geopolitical risk for the zone is already high. This year may be the biggest test ever since the zone has been formed. Just imagine how the existing pressures for break-up will grow if the global economy doesn't rebound in 2017:

March	**Dutch General Elections** – The Liberal Party currently leads a coalition government with Labour, but Geert Wilders' Eurosceptic Freedom Party is poised to make large gains. **Hong Kong Chief Executive Election** – The 1200-member Election Committee chooses Hong Kong's next leader. Chief Executive C.Y. Leung has announced he won't be seeking a second term. **U.K. Triggers Article 50** – Prime Minister Theresa May has committed to the end of March as the deadline by which the U.K. will formally begin the process of leaving the EU.
April	**French Presidential Elections** – In the first round of the French presidential election, the far-right Marine Le Pen and the National Front face Republican Francois Fillon and a Socialist candidate, who will be chosen in a primary in January.
May	**G7 Summit** – Donald Trump attends his first G7 Summit as U.S. President in Sicily. **French Presidential Elections** – In the runoff or second round of the presidential election, French voters return again to the polls.
September	**German Federal Elections**** – Voters elect the members of Germany's parliament as Angela Merkel and the CDU hope that recent positive polling for the right-wing Alternatif fur Deutschland party is short-lived.
November	**19th National Congress of the Chinese Communist Party**** – Meeting once every five years, party delegates select the future leadership of China. At this meeting, 5 of the 7 member Politburo Standing Committee are expected to retire. **New Zealand General Elections** – After the sudden resignation of Prime Minister John Key, his successor Bill English looks to defend conservative control of the government.
December	**South Korean Presidential Election** – The impeachment of Park Geun-hye this December throws into question South Korea's presidential elections. If Park is banned from office, an election will occur much earlier than next December's date.

** Italian General Election – In the wake of Matteo Renzi's loss in Italy's constitutional referendum in December, snap elections may occur in H1 2017*
*** Exact dates have yet to be specified*

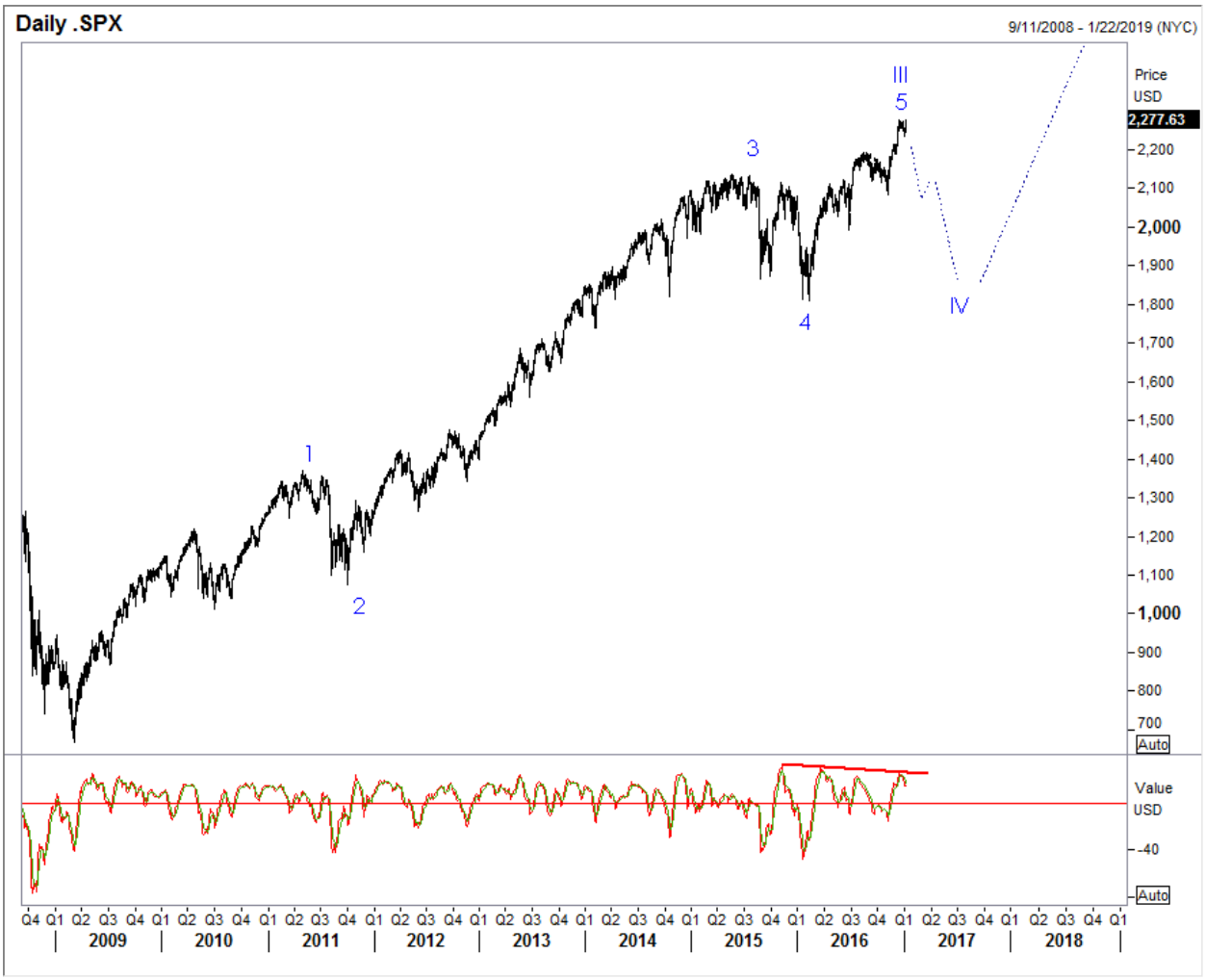
Despite the longer term and ongoing Eurozone risks, we are expecting rebound in the euro against US dollar during the first half of the year—and could see some relative money flow in stocks.

Why? Economic data of late has been surprisingly good; the German inflation data and PMI manufacturing data has been decent.

So, **we expect to see an expectations conversion flow**: from very high optimism in the US versus very low optimism in the Eurozone; i.e. currencies are a relative game. The relative improvement in Eurozone expectations vis-à-vis the United States could be the fuel to drive a surprisingly strong euro rally against the dollar. This also fits with our technical view a US dollar correction lower is overdue.

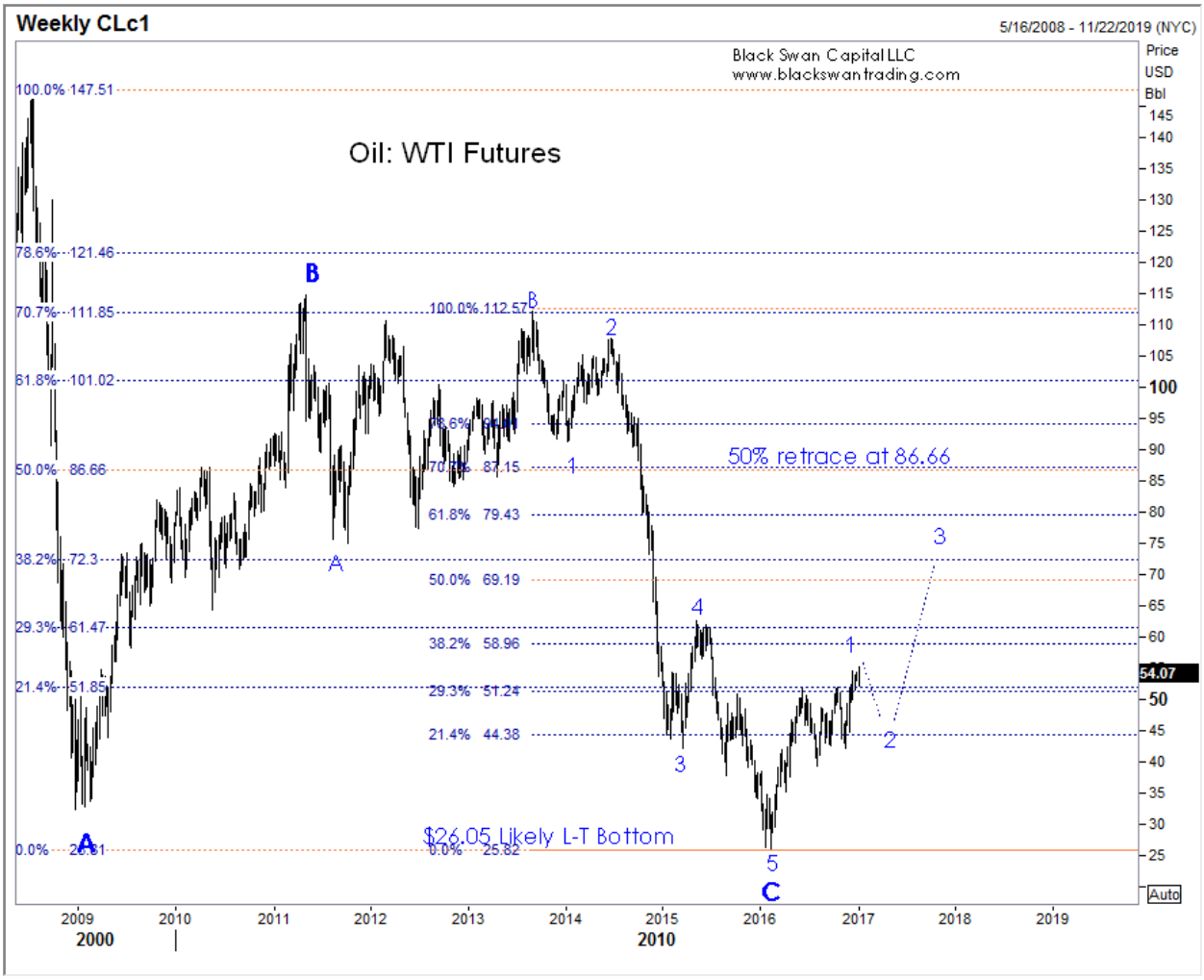
The technicals: Weekly wave view for key assets classes and major FX pairs

S&P 500 Stocks [last 2277.63] - *ETF equivalent is SPY*: Note the divergence in momentum as prices make a new high? This could be a classic distribution top. A move back to 1,800 would be a normal place for a correction to carry based on wave theory.



US 30-year Bond Futures [last 151 ^28] – *ETF equivalent is TLT*: Expecting a rally back to 159 level on realization inflation isn't flowing through and growth expectations are a bit optimistic.

Oil Futures WTI [54.07] – *ETF equivalent USO*: Expecting a pull-back maybe to the low or mid-40's; then possible rally back toward $70. But, risk is to the downside given the supply/demand dynamics. Much longer term, the future for oil may be dim. Note this article which appeared in the latest issue of *International Economy* magazine.

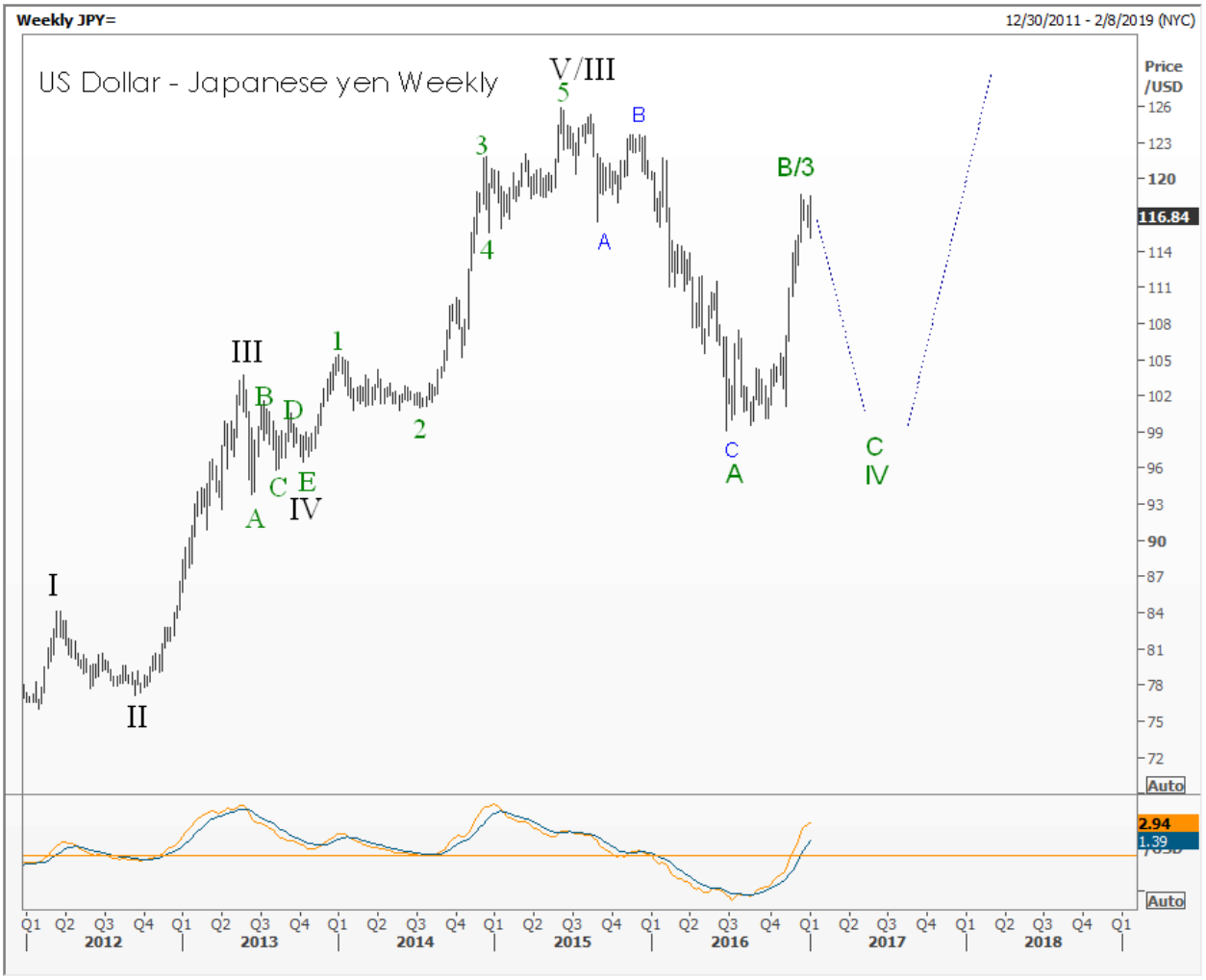


Gold Futures [54.07] – *ETF equivalent USO*: Looking for a rally during the first quarter of the year, back toward 1,300. This view is predicated on a US dollar correction. Longer term we are bearish gold; we have a target to 852; the next extension target is 714 which would test a key weekly swing low at 716 back in August 2009.

US Dollar Index [102.13] – ETF equivalent is UUP: Looking for a correction back toward 100-98; then another rally; eventually carrying to 110 on what could be a virtuous circle of money flow into the US, as discussed in this *Currency Currents* (Trump Virtuous Circle).

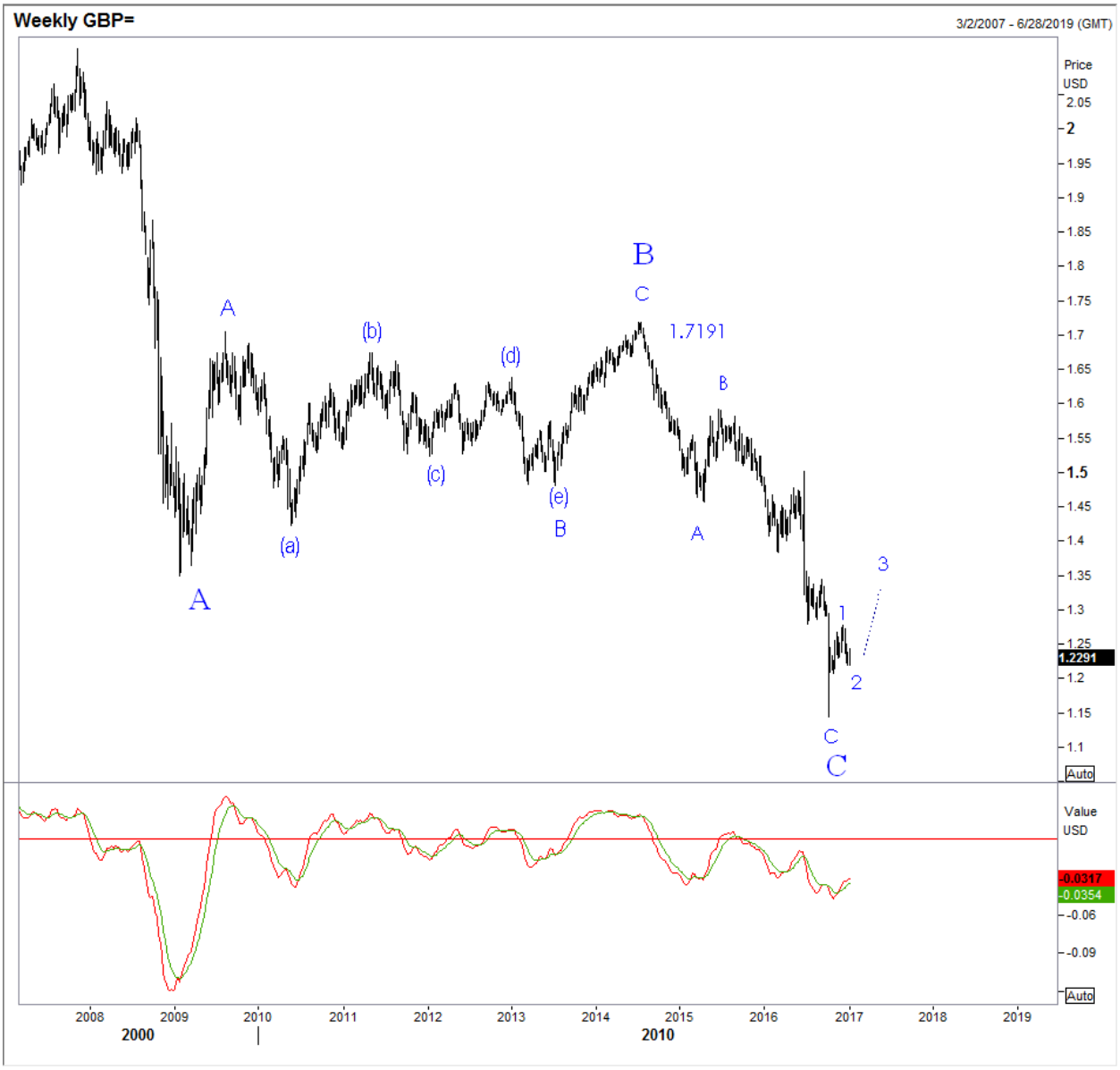
Major Forex Pairs

USD/JPY Weekly [last 116.84] – ETF equivalent FXY: Lots of alternatives, but expecting a major correction (or new trend) lower on US dollar weakness and safe haven flow early in 2017.

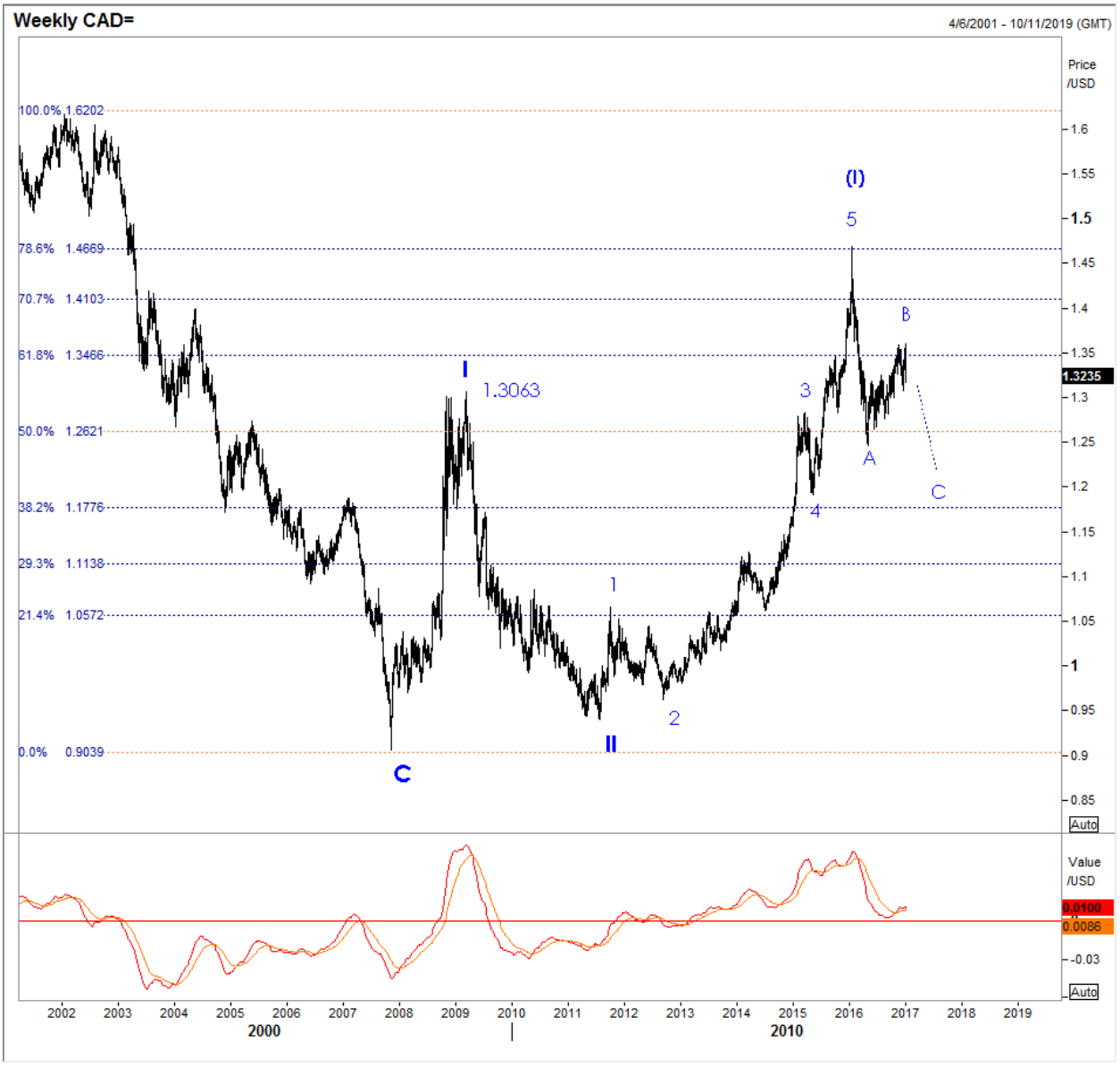


EUR/USD Weekly [last 1.0547]- ETF equivalent FXE: Eventually looking for a move to 0.9600 level; obviously if the Eurozone becomes unhinged, all bets are off.

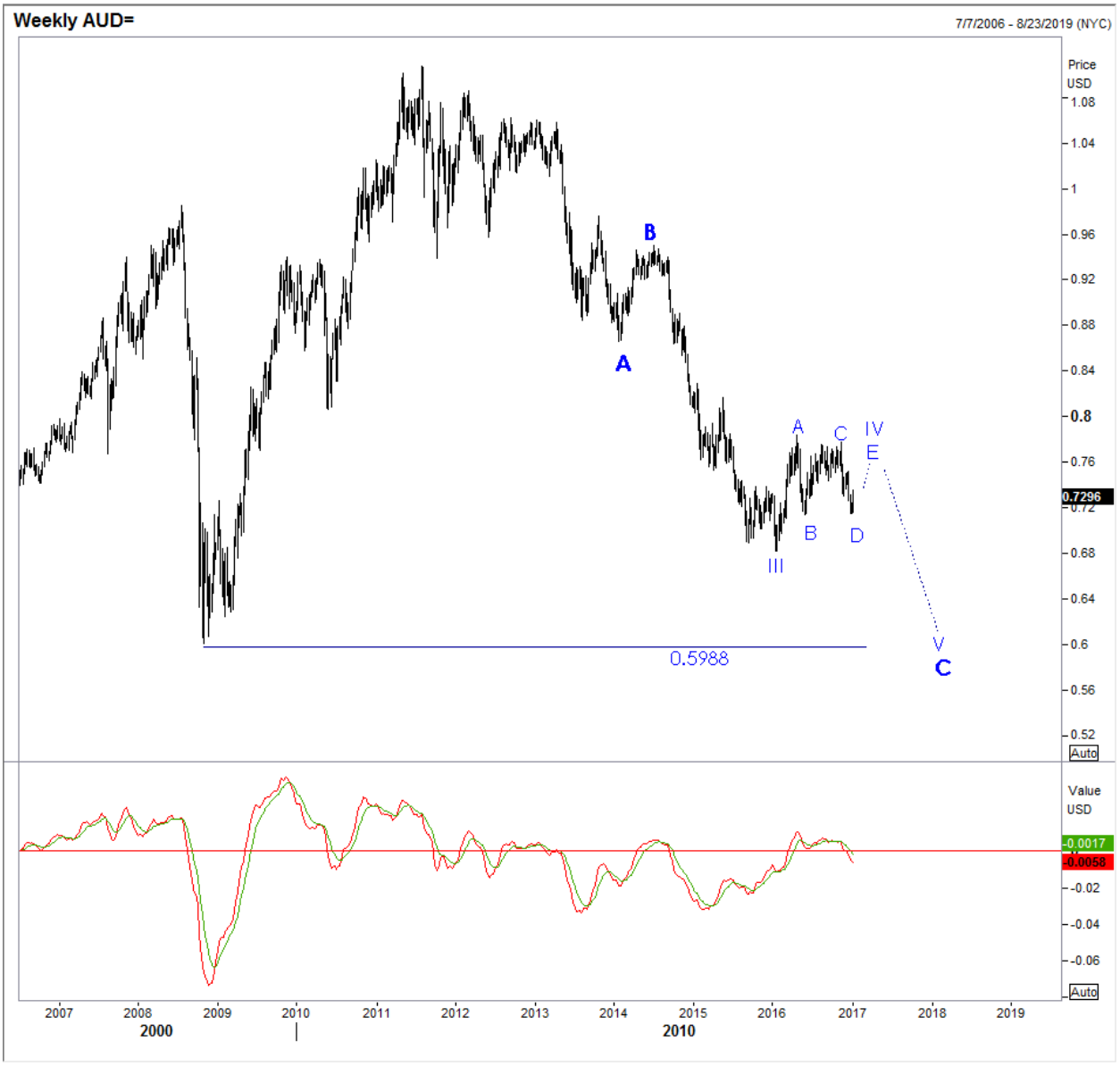
GBP/USD Weekly [1.2294] – ETF equivalent FXB: We suspect the bottom is in place—the Brexit spike low back on 10/7/16 at 1.1450—now correcting lower in Wave 2. Expecting a strong rally to resume soon in Wave 3, on expectations the UK economy will continue to positively surprise relative to European competitors and possibly the US.



USD/CAD Weekly [1.3235] – ETF equivalent FXC: Looking for a move back toward 1.200 in 2017…however, confidence here is moderate given the ongoing tight relationship between CAD and oil.

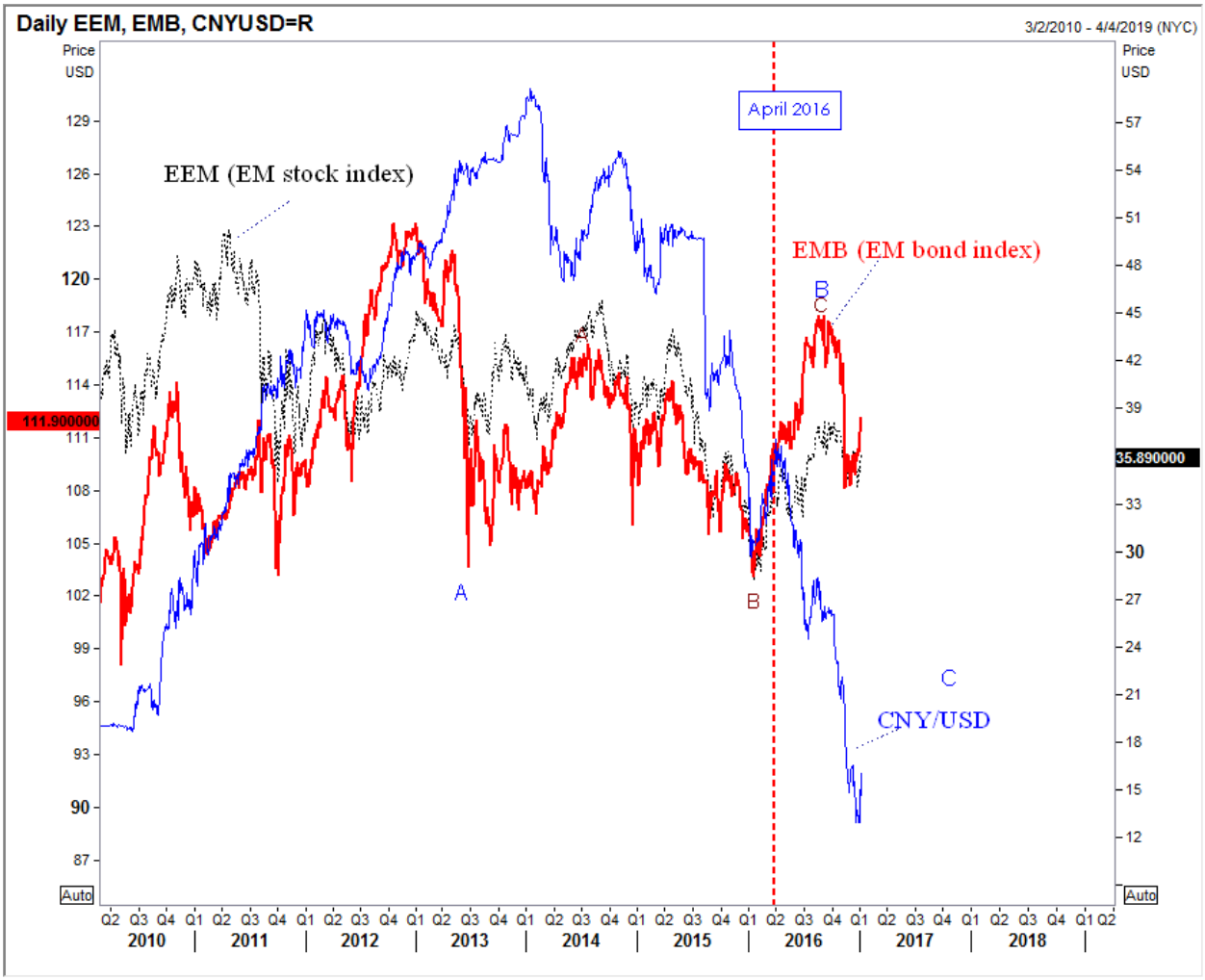


AUD/USD Weekly [last 0.7296] – ETF equivalent FXA: Looking for another minor rally on US dollar weakness—back toward 0.7600--then a sharp push lower into the mid- to low-60 cent level.



Other Charts of Interest

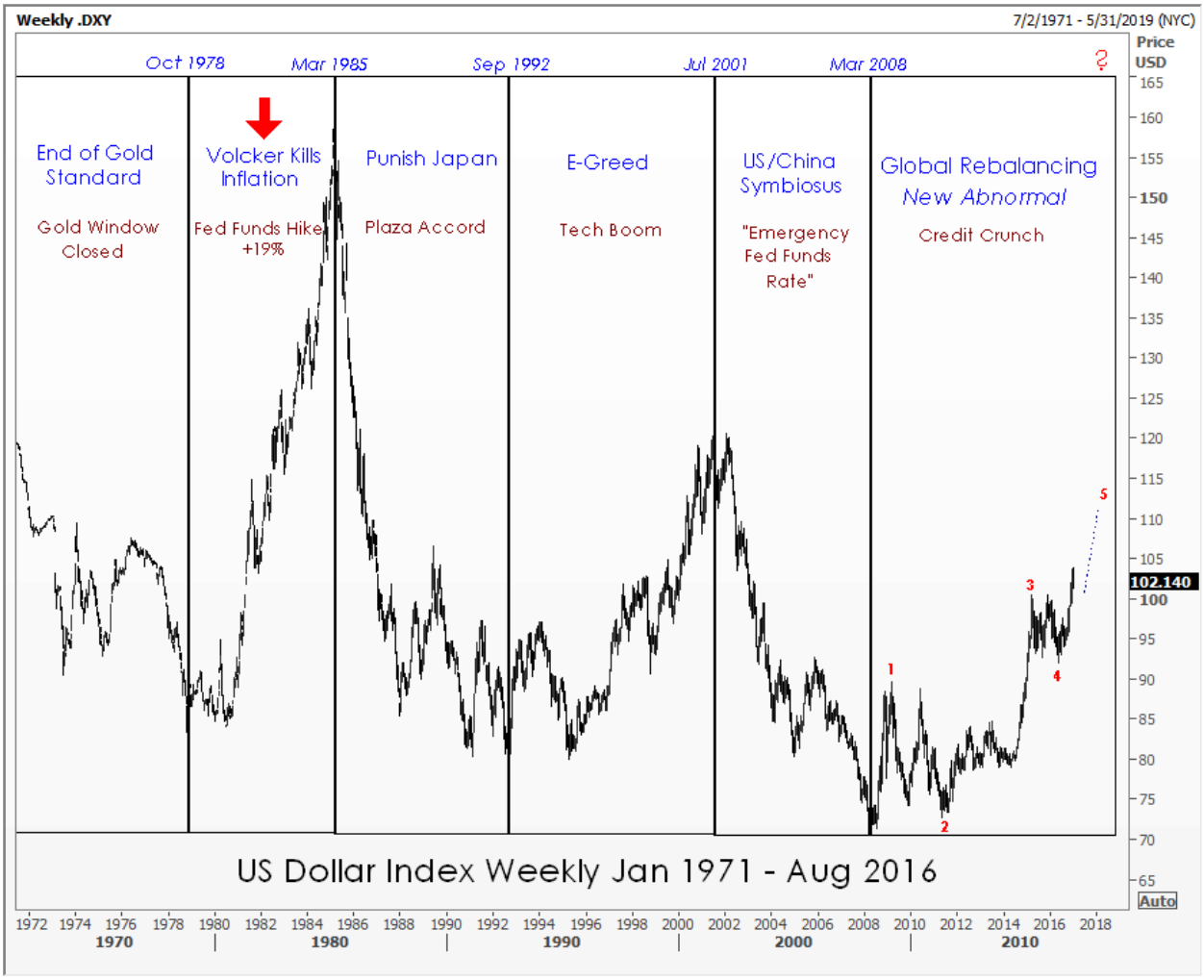
Emerging Market Stocks vs. Emerging Market Bonds vs. Chinese yuan-US dollar: The plunge in the yuan is likely to add even more trade pressure on the emerging markets already exposed to rising cost of US dollar credit and stagnant global demand for commodities. Our [view on Emerging Markets has not changed since this outlook in Currency Currents](#) from 9/29/16, "EM Capital Structure Trap."



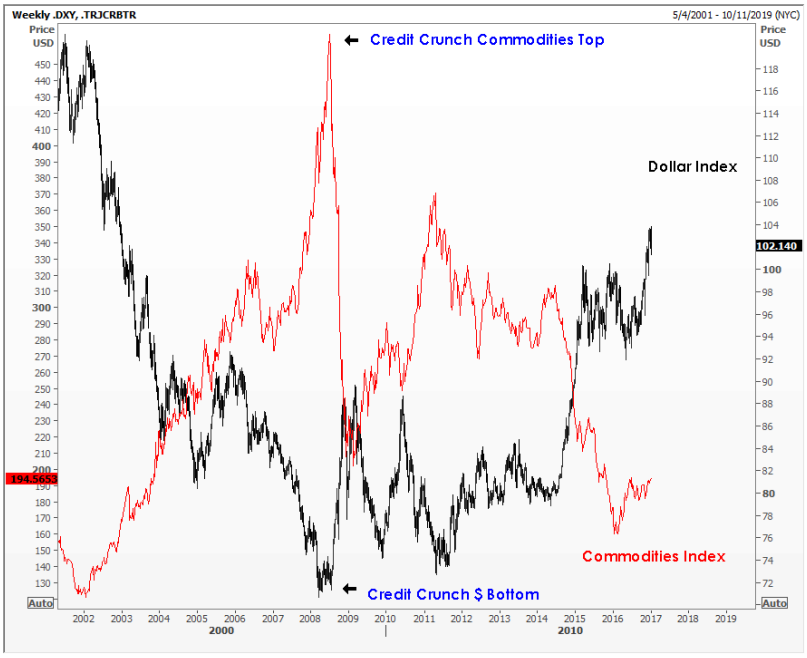
Chinese Stocks vs. Chinese yuan-US dollar: The decline in the currency hasn't seemed to help the market so far. But both are likely artificial reflections of reality i.e. manipulated to a large degree.

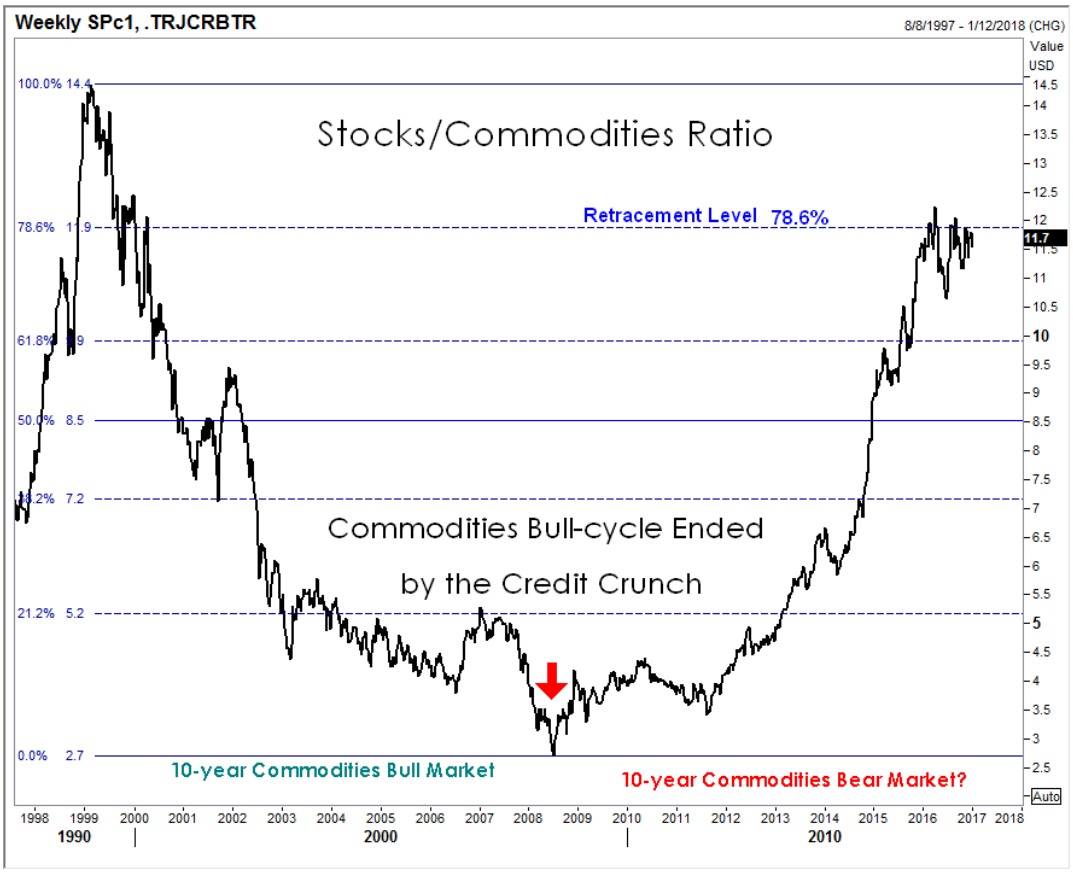
US Benchmark 30-year interest rates: Still no breakout from the 28-year downtrend…

US Dollar Era's – Rally into 2018 and then another commodities bull market (next page)?



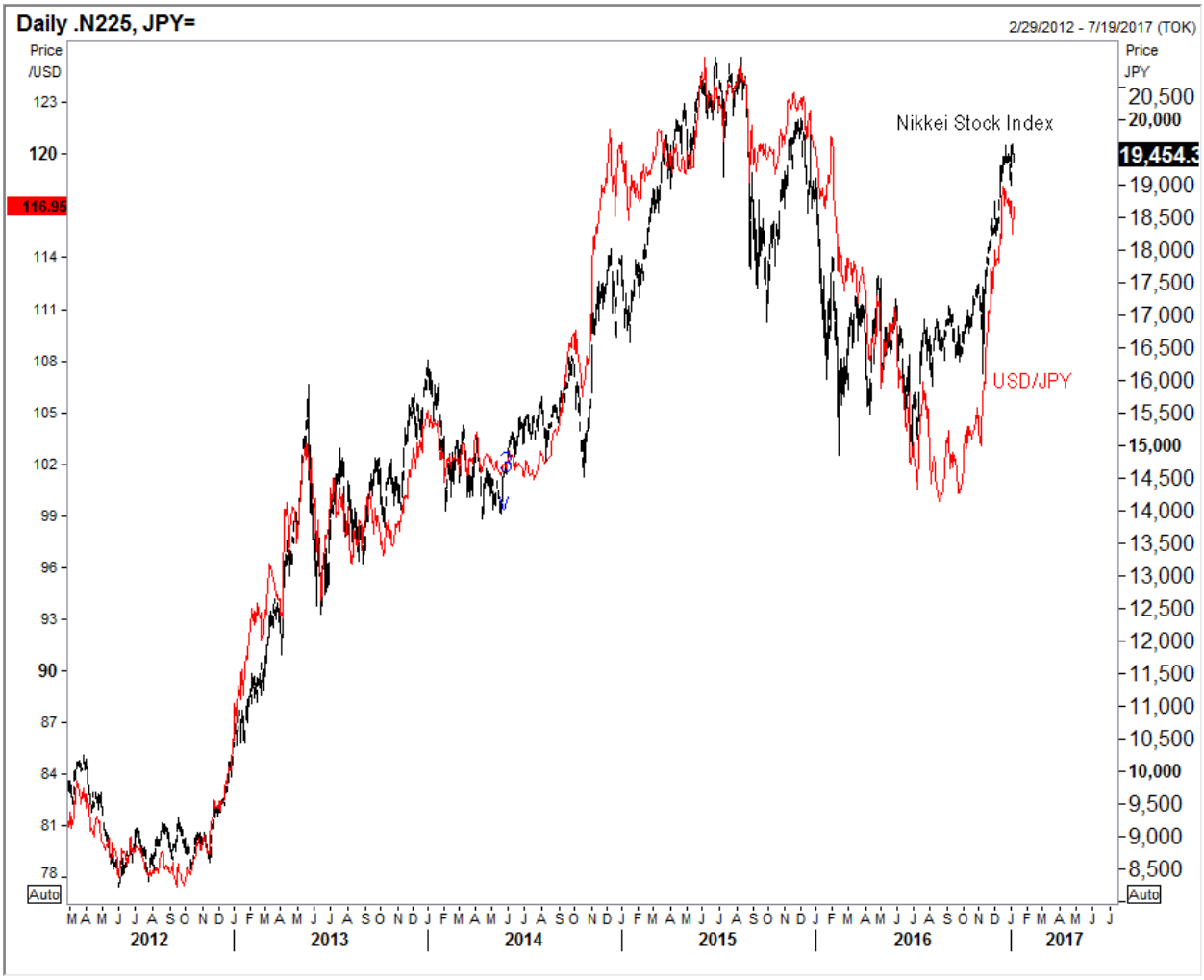
US dollar index vs. Commodities index: The ongoing negative correlation in play. 2018 sell the dollar and buy commodities?



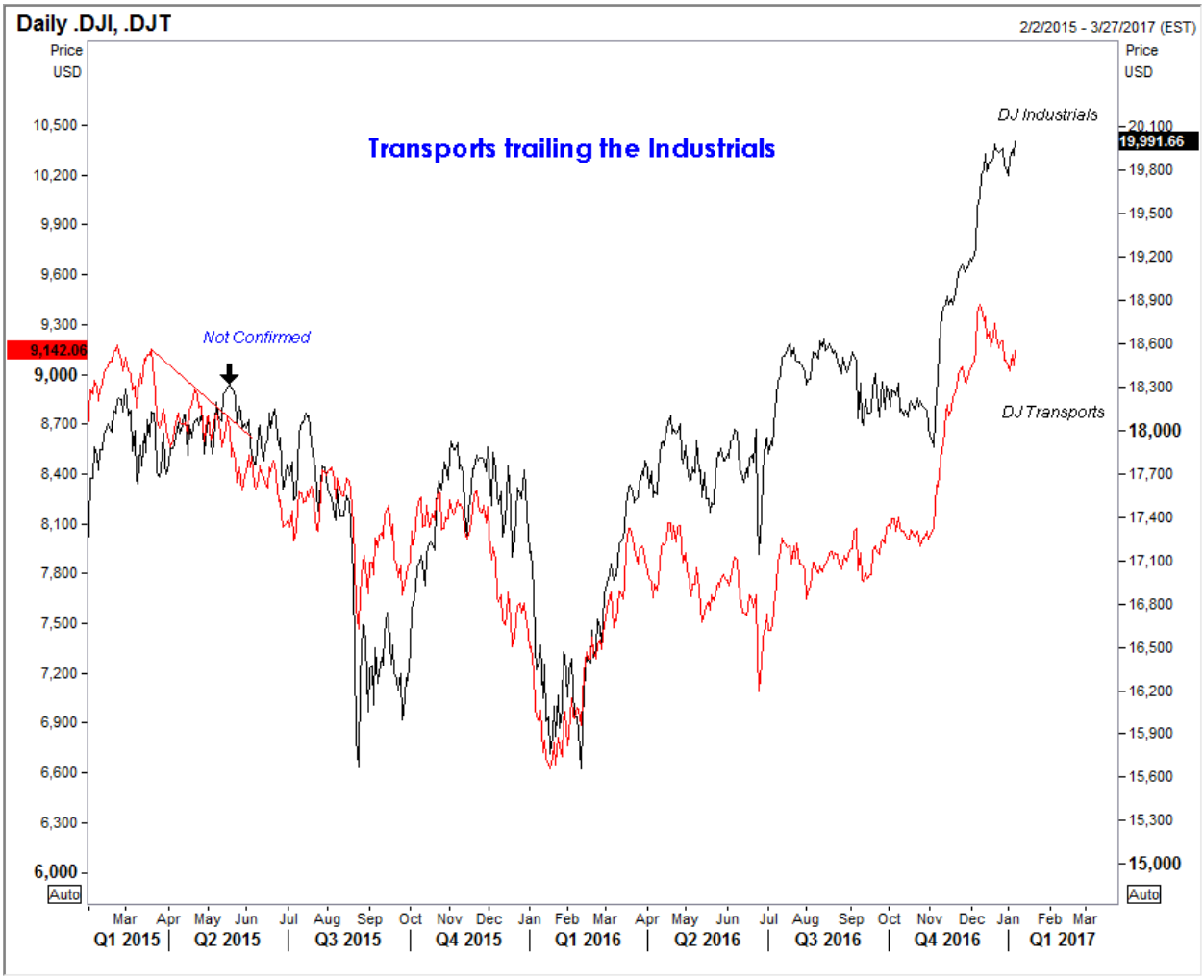


Commodities performance summary 2016: Nat gas the winner!

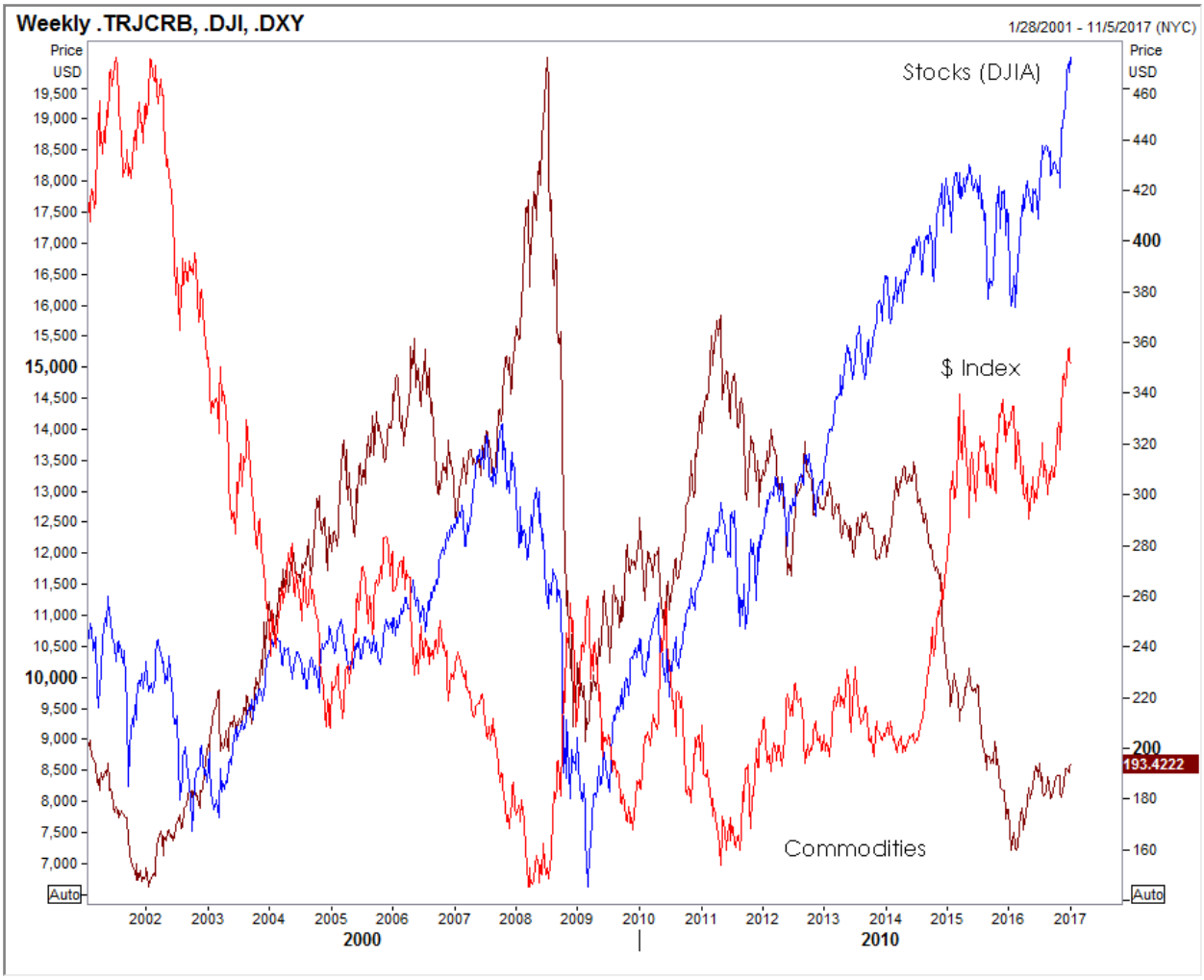
USD/JPY versus Nikkei 225 Index: The positive correlation remains intact



Dow Transports vs. Dow Industrials Index: Transports trailing. Industrials high not confirmed yet.



Stocks vs. $ Index vs. Commodities: One of these asset classes is doing its own thing; two are now kind of the same…



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