National Golf Course Owners Association
MCO 2017
June 21, 2017

The Economic & Geopolitical Outlook 2017 – 2018

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Brace yourself!
The world is about to change economically & geopolitically!

HERE’S WHAT WE KNOW:
• U.S. economic fundamentals are sound.
• Personal & corporate tax cuts are coming.
• Expect more spending on infrastructure & defense.
• Regulatory rollbacks are underway.
• Easier repatriation of foreign profits to the U.S.
• Foreign economies *finally* growing again. U.S. economy to benefit.
Consumer optimism near 15 yr. high

University of Michigan - Consumer Sentiment Index

Post-election

Business optimism:
Still very strong, but is it sustainable?

NFIB Small & Midsize Business Optimism Index

Post-election

Sources: University of Michigan; National Federation of Independent Business
HERE’S WHAT WE DON’T KNOW!

• Will investigations and lawsuits about Trump and his aids delay White House’s economic agenda?

• What kind of tax cuts will Congress pass & when?

• Could a “Border Adjustment Tax” be part of it?

• Is a trade war looming?

• How much infrastructure spending will we see and when?

• Which major geopolitical risks are likely to erupt — and how will President Trump react?
The U.S. Business Cycle: Three potential paths ahead...

**Scenario A (Trump’s tax & spending policy goal)**
GDP growth 3% - 4%

- Economy slips into recession
  - All out trade war
  - A crippled presidency
  - Major geopolitical eruption

**Scenario B**
Growth 2% to 3%
- Congress passes more modest fiscal plan.
- Geopolitical angst

**Scenario C**
Economy slips into recession
- All out trade war
- A crippled presidency
- Major geopolitical eruption

The Economic Outlook Group
The U.S. Business Cycle: Probable outcomes for the economy

$ Real GDP

Scenario A (Trump’s tax & spending policy goal)
GDP growth 3% - 4%

15%

Scenario B
Growth 2% to 3%
- Congress passes more modest fiscal plan.
- Geopolitical angst

60%

Scenario C
Economy slips into recession
- All out trade war
- A crippled presidency
- Major geopolitical eruption

25%

Economic cycle peaked Dec. 2007
Recession ends June 2009
2008 - 2009 recession

Trump era begins!
Consumers will be the main engine of growth in 2017 & 2018

- The job market remains strong.
- Wages to keep rising faster than inflation; improves purchasing power.
- Household wealth highest ever in both nominal & inflation-adjusted dollars.

HOWEVER, keep an eye on three issues that will impact future spending!

1. Growing concern about the bizarre political dynamics in Washington.
2. Major demographic changes underway; Millennials to replace baby boomers.
3. Rising geopolitical tensions (North Korea, Middle East, China, terrorism).

The Economic Outlook Group
Job creation is the ultimate report card on the economy: Employers just posted the highest number of job openings ever!

6.04 million Positions to fill: April 2017 (latest month)

- Construction: 203,000
- Manufacturing: 359,000
- Retail: 577,000
- Leisure & Hosp.: 847,000
- Health care: 1,013,000
E-Commerce has grown rapidly at the expense of department store sales.

The speed and comfort of online shopping appeals to more consumers (% change in sales, year over year).

Annual department store sales in decline.
Large U.S. retailers are closing hundreds of stores

Sources: Terry Lundgren, Macy’s CEO, The Economic Outlook Group

<table>
<thead>
<tr>
<th>Country</th>
<th>Space per Person (sq. ft.)</th>
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<td>Japan</td>
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<td>UK</td>
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Macy’s, JC Penney, Sears are shutting their doors in malls around the country

Who is moving in?

- Health care centers
- Fitness gyms
- Food/restaurants
- Education outlets

Sources: Terry Lundgren, Macy’s CEO, The Economic Outlook Group
After years of neglect, U.S. firms finally ramping up capital spending!

Pace of stock buybacks has decreased this year!
Pressure is building on firms to invest profits back into their operations.

Source: Bureau of Economic Analysis
Age of private fixed capital: Average age is 22.4 years, oldest in 60 years.
(Current-Cost Average Age as of yr. end 2015)

- Manufacturing facilities - 23.0 years old, surpassing the 1946 peak!
- Healthcare facilities (including hospitals) - 20.7 years, longest since 1949.
- Housing - 33.5 years, oldest since 1947.
- Lodging - 18.2 yrs, oldest in 53 years!
- Communications equipment - 6.0 years, oldest ever!

Age of government fixed assets: Average age is 24 years, oldest since 1925!

- Highways and streets - 28.4 years, oldest ever.
- National defense structures - 44.4 years old,
- Public transportation (airports and seaports) - 20.1 years

Source: Bureau of Economic Analysis,
Corporate spending to climb as Congress moves ahead with tax cuts. Expect outlays to increase most in 2018-2019.

Private fixed investment (residential & nonresidential) spending, after adjusting for inflation:
% percentage from previous year

Sources: Bureau of Economic Analysis; The Economic Outlook Group
Demand for housing is rising:
1. Thanks to improving economy, job market and demographics
2. Household formation accelerated Q1. Preference now is to own.
3. Mortgage rates remain near historical low levels.
4. Lenders relax on some mortgage requirements
5. But…there’s serious lack of inventory on new & existing homes.

Homebuilders still face numerous challenges
1. Too many burdensome regulations. (Regs account for 25% of homebuilder costs.)
2. Difficulty finding skilled labor. Could be made worse by immigration ban.
3. Lack of suitable and affordable land.

Sources: National Association of Home Builders, Trading Economics
Bi-partisan support for more government spending on infrastructure

% change annually in real federal expenditures and gross investment

Forecast

Sources: Bureau of Economic Analysis; The Economic Outlook Group
Sheikhs lose ground to Shale
Oil prices to hover $35 to $50 range the next three years

- OPEC/Non-OPEC extended accord to cut output. But expect compliance to erode.
- New technology has reduced break-even point for US shale producers.
- Shale oil extraction equipment and know-how will gradually spread globally.
- Shift away from reliance on fossil fuel is inexorable! Will curb demand for crude.
- More fuel efficient vehicles will also lessen the need for gasoline.
Total U.S. oil production

U.S. output the next two years will match Saudi Arabia and Russia!

Annual average output in crude; million barrels per day

FORECAST

Sources: EIA, The Economic Outlook Group
Biggest surprise: Inflation is actually slowing

Possible explanations:
- Modest wage increases
- Slipping energy prices
- More cautious consumer
- Firm dollar over past 12 months

Source: Bureau of Labor Statistics
Interest rates will slowly rise to levels that are still historically low.

Long-term rates (10 yr. Treasury) to peak at 3.60% end of 2019 with fed funds rate to hit neutral rate at 2.38%.

Sources: Federal Reserve, The Economic Outlook Group
Pres. Trump’s Tax Proposals

PERSONAL INCOME TAXES:
Lowers tax rates for all: Reduces brackets from 7 to 4 (0%, 10%, 25%, 35%) Eliminate the estate tax.

CORPORATE TAXES:
Corporate tax Rate drops from 35% to 15%. End most tax loopholes.

SPENDING INCREASES:
- Infrastructure (wants to spend about $1 trillion over 10 year period)
- Greater defense spending

Congressional Schedule

1. FOCUS ON REPLACING “OBAMACARE.”
   It passed House, but DOA in Senate.

2. COMPREHENSIVE TAX REFORM
   “Border Adjustment Tax” proposal
   Also DOA in Senate; Expect tax cuts

3. SLASH REGULATIONS:
   Process is underway.

4. INFRASTRUCTURE SPENDING:
   Bi-partisan support for modest program.

MOST LIKELY OUTCOME - Forget tax “reform”; tax cuts to pass 2018

C: Corporate  P: Personal
• C: Focus will be on cutting corporate taxes to the effective rate of 25% to 27%
• C: Fewer corporate loopholes closed.
• C: Tax holiday of 10% rate will repatriate $1 trillion (of $2.6 T) in US profits stashed overseas.
• C: Implement “Territorial Tax System.” Profits earned outside the U.S. will be tax free.

• P: Expect deeper personal tax cuts. Increase standard deduction.
• P: Gradual end (over 10 year period) to some itemized deductions.
• P: End the Alternative Minimum Tax (AMT)
• P: Keep estate tax in place, though threshold may be raised.
-- Infrastructure spending expected to increase $300 billion over 10 yrs ——not $1 trillion!
Forecast for U.S. GDP growth
Economic activity to accelerate. Odds of recession thru 2019 are 25%

Real growth by year (%)

Average annual growth rate since WW II

Sources: US Bureau of Economic Analysis, The Economic Outlook Group
### GDP Growth - Global Economy

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**Growth Leaders**
- India
- China
- Sub-Saharan Africa

**Moderate Growth**
- U.S.
- European Union
- Australia
- Canada

**In or Near Recession**
- Venezuela
- South Africa
- Brazil
- Ecuador
So...what could possibly go wrong?
ON WATCH:
Greatest risks confronting the U.S. economy

U.S.: White House in full-blown crisis - Trump gives up presidency (35%)
(1) Impeachment/resignation takes place during 1st term.
(2) Political turmoil hurts growth…until VP assumes presidency.
   Economy then rebounds 2019 as path clears for major fiscal stimulus

Trump finishes term amid continuing turmoil (65%)
(3) White House remains embroiled by numerous investigations
(4) Congress passes fiscal stimulus that falls short of expectations

Geopolitical eruptions (50%)
(1) North Korea
(2) South China Sea
(3) Saudi Arabia
(4) Russia
(5) Cyber warfare
(6) Terrorism
Assume impeachment/resignation scenario 2018
Economy abruptly slows next year, then rebounds as stability returns.

Real growth by year (%)

Average annual growth rate since WW II

Baseline forecast: 2.1 2.6 2.3

Sources: US Bureau of Economic Analysis, The Economic Outlook Group
Banning undocumented workers in the U.S. will hurt L&H industry:

- Nearly 10% of L&H employment consists of undocumented workers.
- Banning such workers will result in severe labor shortages and raise employment costs.
- Foreign anger at US immigration policies is reducing international bookings to the US.
- US could lose more than $15 billion in tourism revenues on 2017 and 2018.
- International travel to the US is No. 1 service export and No. 2. in total exports.

Sources: National Bureau of Economic Research, Tourism Economics
President Trump’s budget cancels funding for **Brand USA**, a government/private partnership program that encourages foreign tourists to visit the United States.

In the last four years, Brand USA’s promotions brought 4.3 million more visitors to the US, who spent an additional $13.6 billion and generated nearly $4 billion in federal, state and local revenues.

--- Oxford Economics
Geopolitical pot is boiling furiously!
EVERY FIRM NOW FACES EVENT RISK:
Exogenous shocks will be more frequent and more consequential!

How do geopolitical eruptions disrupt economic activity?

1. **Terrorists favor soft targets** - Shopping malls, theme parks, subways, airports have become preferred targets. These attacks can deeply affect consumer psychology, dampen household spending and hurt business revenues.

2. **Financial contagion** - The US more integrated than ever into the world financial system. A major geopolitical crisis can instantly destabilize capital markets, dry up liquidity, raise the cost of capital and restrict access to credit lines.

3. **Cyber warfare** - It’s the preferred weapon of choice by Russia, China and terrorists. Can destroy computer files, disrupt financial markets, shut down access to credit lines, hack into nuclear power plants and corrupt the U.S. electrical grid.

4. **Oil prices** - Geopolitical shocks are often transmitted through sharp swings in the cost of crude, especially if they originate in the Middle East.

5. **Global supply chain disruptions** - Two threats. (1) Any effort to interfere with maritime shipments endangers global economic growth. (2) Any effort to reprise protectionism could lead to a trade war and worldwide recession.
North Korea

IMMINENT THREAT: War in the Korean Peninsula could lead to global recession.
• Will soon be capable of launching nuclear-armed ICBMs at the US homeland.
• To raise cash, NK also sells nuclear weapons know-how and missile technology to other nations (Iran) and non-state actors (terrorist groups).

OPTIONS? Sending Dennis Rodman suggests there are few good options.
1. U.S. uses more cyber warfare tools to sabotage NK’s missiles at launch.
2. Shoot down NK’s missiles as they are launched.
3. Launch pre-emptive first strike to destroy NK’s nuclear military assets.
4. More pressure on China to block NK’s nuclear program. This strategy has been mostly ineffective so far. China’s president NEVER even met NK’s Kim Jong-un
Threat to Saudi Arabia and its monarchy to increase next 18 months!

- Iran-supported Houthis are launching missiles into S.A.
- AQ and ISIS are sending in suicide bombers.
- Iran’s Revolutionary Guards finance terrorist attacks against Saudi oil fields and Bahrain, home of the US Navy’s 5th Fleet.

The Economic Outlook Group
Threat to Saudi Arabia and its monarchy to increase next 18 months!

- Iran-supported Houthis are launching missiles into S.A.
- AQ and ISIS are sending in suicide bombers.
- Iran’s Revolutionary Guards finance terrorist attacks against Saudi oil fields and Bahrain, home of the US Navy’s 5th Fleet.

Major Saudi oil and gas fields
CHINA: Hybrid model of communism & capitalism has run its course!

Communist party leadership is deathly afraid of a business cycle --- and will do anything!! to avoid a downturn.

- Economic growth has relied for years on rising government spending and easy loans.
- Grave misallocation of capital. (Result: stuck with empty office buildings, “zombie factories”)
- Nonperforming loans keep climbing. Capital fleeing the country.
- Chinese workers are losing confidence in Communist Party’s management of the economy.
- Economic reforms (shift away from industry/exports -- to consumption / services) are delayed.
- Economy is not on solid footing! FINANCIAL CRISIS MAY BE A MATTER OF TIME.
- CP seeks to distract from country’s economies woes by stoking nationalism.

Sources: National Bureau of Statistics of China, The Economic Outlook Group
SOUTH CHINA SEA: Crucial supply chain routes

- 55% of world’s merchant fleet tonnage pass here
- 32% of all oil shipments
- 65% of all natural gas shipments.
- Country dependence on energy supplies thru SCS:
  - South Korea 65%
  - Japan 57%
  - Taiwan 60%
  - China 80%
Yes, Russia annexed Crimea, meddles in Syria, backs Iran, intervenes in democratic elections and generates fake news. **But don’t exaggerate its influence in the world.**

- Russia has been in recession the last two years!
- Distribution of wealth most unequal in the world; Russian anger bubbling up.
- It has failed to diversify away from oil; Energy provides 70% of all export revenues.
- Its population is shrinking, leaving an older demographic and fewer ethnic Russians.
- Russia is so corrupt, it is simply incapable of restructuring its economy!

**Result:** “**Russia doesn’t want war, it only wants the fruits of war**.”  
Winston Churchill (1946)
“Either you know you’ve been hacked --- or don’t yet realize it!”

CYBER WARFARE:

- It has become the weapon of choice for Russia, China & North Korea. They can damage military systems, financial markets, communication networks, nuclear power plants, ATMs, electrical grids, and influence elections….without firing a single shot!

- Average time it takes to **identify** a breach = 201 days

- Average time it takes to **contain** the breach = 70 days

- Average **cost** of a single data breach = $4 million (29% increase since 2013)

Source: IBM Security - Data Breach Study 2016
Global Fatalities and Injuries from Terrorist Attacks

Terrorists favor soft targets - Shopping malls, theme parks, subways, airports have become preferred venues. These attacks can deeply affect consumer psychology, dampen household spending and hurt business revenues.

Sources: Global Terrorism Database, The Economic Outlook Group
Every company has exposure to event risk!
How to prepare for upcoming shocks?

1. Undertake “rigorous” stress tests.

   Conduct “what if” scenarios: Introduce adverse hypothetical scenarios — events that can potentially disrupt business activity, limit access to credit, interrupt communications, and hamper your ability to satisfy your clients.

2. Dedicate a risk management team to engage in geopolitical forecasting.

   This team would monitor fast-changing geopolitical and economic events — especially where your assets, production facilities and supply chains are most at risk. The group should not only identify global hot spots — but prepare scenarios and probabilities on how events may evolve in the months and years ahead.


   Remember, clients seek reliable service…or they’ll walk!

   Prepare in advance a governance plan that can be implemented quickly to mitigate the harmful fallout from an external shock. Your firm’s reputation is at risk.

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Summary Conclusions

• The economy continues to expand in 2017-18, but major risks loom ahead.
  ✓ US GDP to grow 2.0% - 3% average next two years
  ✓ US to remain the bright spot in the global economy
  ✓ Inflation and interest rates are marching higher
  ✓ US dollar to get stronger in FX markets

• But given the many risks ahead, contingency planning is imperative!

• A White House under siege due to numerous investigations.
• War with North Korea
• Confrontation over South China Sea disrupts maritime traffic.
• Destabilization of Saudi Arabia; oil prices surge
• Outbreak of terrorism in the West
Turmoil in the UK: Theresa May’s future as PM? BREXIT talks? Terrorism fears? = will suppress UK growth

- Contentious negotiations now begins on the future relationship between UK and the EU.
- EU is furious they are losing the second largest economy in Europe.
- EU’s objective: Make sure no other nation views BREXIT as a “success” for the UK.
- UK’s objective: Seek hard break from EU obligations…but win free trade with Europe
- UK’s economy starting to struggle: higher inflation, low real wages, business exodus
- Terrorist attacks on soft targets could impact UK consumer behavior and tourism.
EUROPE: “Das ist unmöglich!”
EU has suffered a relentless series of blows the last 6 years.

“It’s been one bloody thing after another…”

- Sovereign debt crises in Greece, Italy, Spain, Portugal and Cyprus
- Loss of trade with Russia due to sanctions for grabbing Crimea.
- Potential strains from absorbing millions of refugees from the Middle East.
- Surge in terrorist strikes in Europe unnerve consumers and businesses.
- UK votes to leave the EU (BREXIT). Painful exit talks are anticipated.
- Stunned by Trump’s presidency. “U.S. trade & foreign policy gone rogue!”
Now the Good News: After a lost decade, Europe’s economic outlook brightens.

- Eurozone economy *finally* getting some traction. Why?
  --> ECB has kept interest rates at historic low levels.
  --> Euro’s value has fallen which helps exporters and attracts foreign tourism.
  --> Cheap energy prices
  --> Pro-EU election victories in Austria, Netherlands and France stems political risk
  --> EU nations unite more closely as doubts rise over U.S. commitment and policies.

→ *REAL WILD CARDS?* Italy, Greece, Brexit, terrorism and Russia.
Dollar surged after the Nov. election --- but has since returned to pre-November value.

U.S. Dollar Index, measured against its six major trading partners:

Key Foreign Exchange Rate Forecasts (year average)

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<td>Brazil’s real per US dollar</td>
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<td>Chinese yuan per dollar</td>
<td>6.64</td>
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U.S. Housing Starts - single family homes

Annual totals, in thousands

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<tr>
<td>2017</td>
<td>818</td>
<td>4.7%</td>
</tr>
<tr>
<td>2018</td>
<td>855</td>
<td>4.5%</td>
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Sources: Census, The Economic Outlook Group
Demography makes the market!

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<tbody>
<tr>
<td>Experiences</td>
<td>Great Depression, WWI and WWII, Korean War</td>
<td>Cold War, Civil Rights, Nuclear Weapons, Rice Crisis</td>
<td>Energy crisis, Downsize, Watergate, Single parents</td>
<td>Computer age, AIDS, China’s emerges, Jobs go offshore</td>
<td>Terrorist attacks, Great Recession, Housing bust</td>
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<td>Space Exploration, GI Bill, Housing boom</td>
<td>Housing boom, Cuban Missile Crisis</td>
<td>Home sales surge, Bank 1-stop shop</td>
<td>Excessive debt / bankruptcies, Health care insurance</td>
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<td>Globalization, Record college debt, SS solvency worries</td>
<td>Banking re-reg., Digital age</td>
</tr>
</tbody>
</table>

• **Retiring baby boomers**
  --> They are downsizing, selling off possessions, moving into smaller homes.
  --> Interest income has plummeted.
  --> No meaningful increase in social security’s annual cost-of-living adjustment (COLA.)
  --> Result: More selective about spending: Willing to focus more on fitness and travel.

• **Millennials have a different set of values than past cohorts of similar age.**
  --> Many are heavily burdened with college debt.
  --> Doubt the solvency of SS.
  --> Exposed to an unprecedented series of domestic and international shocks.
  --> Not big spenders. Less interest in causal dining or fancy cars.
  --> Result: More inclined toward experiential spending, instead of purchasing “stuff.”