

The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

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Dear Client:

Washington, Dec. 2, 2016

The outlook for small businesses next year? Upbeat for many. Solid job and wage gains figure to continue to underpin consumer spending... the lifeblood of an extensive range of small companies.

SMALL BUSINESS

With the economy overall perking up a bit... More business sectors will feel a lift.

Among them: Retailers of all stripes. Construction, including home remodelers. Developers of software and apps. Business and professional services. Manufacturers of components for computers and other electronics. Recreation and tourism.

In for a revival: Firms serving the oil patch... the long-stagnating oil & gas drilling industry. Stabilizing oil prices and climbing rig counts will provide a rising tide for scores of companies, large and small. Firms in states with oil & gas activity... Texas, Okla., La., Ohio, Pa., W.Va., Ky. and Colo... stand to profit from stepped-up energy production.

Slower growth ahead, though, for restaurants, mainly due to higher wages being paid to chefs, servers and others. Also, falling costs of groceries are prompting more folks to eat at home.

Smalls that export or serve larger firms that do so will also lag. Exporters continue to face stiff winds in the form of slack markets in Europe, Asia and elsewhere, as well as the strong dollar, which makes U.S. goods pricier abroad.

Getting qualified workers will continue to be a tough task for employers, who find that they need to raise pay to hire skilled labor. Worker shortages abound across many lines of work, especially in construction, retail and food services.

But obtaining credit is becoming a bit easier as banks loosen terms for creditworthy firms. Moreover, delinquency rates are at a low level in light of improving financial conditions enjoyed by more small businesses.

Start-ups will find banks less generous, though they have other options, including a growing network of online lenders and other nonbank sources.

Sore points with smalls? Costly government regs are high on the list. Odds are the Trump administration will provide relief on some fronts. An eventual replacement for Obamacare is a good bet, sparing companies with at least 50 workers from providing health insurance or paying a penalty.

President Obama's proposed overtime pay rule is also probably history. The rule, requiring overtime pay for workers earning less than \$47,476 per year, was temporarily blocked by a federal judge in Texas, who may end up tossing it. As we've noted previously, Trump may hike the threshold for overtime pay, but not as drastically. He's also likely to nix automatic updates of the rate.

ECONOMIC FORECASTS

GDP growth

2.1% for '17, 2.4% for Q4 '16;
1.5% for full-year '16

Interest rates

10-year T-notes up to 2.7%
at the end of '17

Inflation

2.4% at the end of '17,
from 2% at the end of '16

Unemployment

Ending '17 at 4.6%,
from 4.9% now

Crude oil

Trading from \$50 to \$55/bbl.
in March

NEW

Small business job gains

For firms with fewer than 50 workers,
50,000 per month in '17

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**U.S.
ECONOMY**

The holiday shopping season is off to a healthy start. Early reports show that online sales of all sorts through Cyber Monday soared to a record level while in-store traffic slipped a bit, reflecting the growing shift to online shopping.

Consumers are more willing and eager to spend, as demonstrated by the recent increase in consumer confidence. The final quarter of this year will see consumer spending rise by 3%, and the momentum will carry over into 2017.

Tax cuts coming next year will put more money in shoppers' pockets.

Tax reforms that President-elect Trump and congressional GOPers aim to implement will likely lead many folks to pay down debts when they first start seeing the savings. But by 2018, they'll be spending some of the extra cash...a nice boost for the economy.

FINANCE

American corporations' hunger for dealmaking is growing again. The prospect of lower taxes and pared-back regulations that Trump is promising is making mergers and acquisitions that had been shelved in recent years appealing. Expect a surge of deals by mid-2017, after Trump's policies come into clearer focus.

A flood of cash from overseas could fuel tie-ups. U.S. companies are sitting on \$2.5 trillion in profits held abroad to avoid the IRS. Trump's plan to cut the tax rates on corporate profits could lure a lot of money home, giving dealmakers new firepower.

Sectors that figure to see mergers and acquisitions heat up: Pharmaceuticals. Regulators scotched some recent proposed tie-ups involving large drug makers.

And data analytics. Retailers facing shoppers' continued shift to e-commerce are eyeing firms that specialize in data to spot buying trends or manage inventories.

One casualty of rising interest rates: Mortgage refinancing. Refi applications have soared since rates on Treasury bonds jumped in the wake of the Nov. elections, with homeowners rushing to lock in refinance rates before they climb any higher. In six months, refi activity will be down by half, costing some loan officers their jobs.

Lenders will be looking to loosen their mortgage terms to keep some business as refinancing wanes...OK'ing lower loan-to-value ratios, charging fewer points, etc.

ENERGY

Don't put too much stock in OPEC's recent decision to cut oil production. For one thing, the cuts...intended to curb the world's excess crude supply...might be smaller than OPEC claims. Several member countries received exemptions and are likely to increase their own production, making OPEC's goal harder to reach. And it's unclear if suspended member Indonesia's output will count toward the cuts.

Oil prices will keep rising in the near term as markets digest the news.

But the long-run path for prices is unchanged: Gradually higher next year, with U.S. crude averaging between \$50 and \$55 per barrel over the course of 2017.

**GLOBAL
ECONOMY**

A looming threat to Canada's vast oil industry: Pending taxes on emissions of carbon dioxide for the province of Alberta's prolific oil sands miners. An emissions levy proposed by the national government could preempt a milder tax that Alberta's provincial government is mulling. Canadian producers will need prices to rise to about \$60 per barrel within the next five years to stay profitable after taxes. That's likely...prices are near \$50 now...but the tax bite still promises to be painful.

One upside for Canada's oil patch: Good odds for the Keystone XL pipeline, the proposed line to carry Canadian crude to the U.S., which Obama rejected. Trump is more disposed to approve the project, which would cut delivery costs.

Look for Mexico's economy to slow further in 2017, with growth of just 2% or less for Mexican GDP. The drop in the value of the peso sparked by Trump's win...and fears that the Trump White House will impose tariffs on imports from Mexico...has stoked inflation and is forcing the central bank to hike interest rates. In the event that Trump does slap tariffs on Mexican goods, look for the peso to lose 25% more of its value. The vast majority of Mexican exports end up north of the Rio Grande.



**FEDERAL
JOBS**

Trump's proposed hiring freeze? It'll reduce the federal workforce. But it won't lead to a smaller government or save dollars in the budget in the long run, as Presidents Reagan and Clinton discovered when they tried to keep similar campaign promises in earlier decades. Here's the problem:
You can't just cut jobs through attrition without scrapping programs.
If the programs keep running, agencies will turn to federal contractors to perform duties that staffers previously handled. Counting overhead and profit, contractors often cost more than the full-time staffers they are stepping in for. To succeed, Trump would have to extend the freeze to contractors...unlikely.
Trump's targets for elimination are small: The Education Dept. and EPA... Environmental Protection Agency...employing a sliver of the federal workforce. At the same time, he wants the Defense and Veterans Affairs Depts. to be exempt from personnel cuts, shielding thousands of staffers and private contractors.
Net: Shrinking the federal government is much easier said than done.

MEDICARE

The chances of overhauling Medicare are the best they've been in years. But the shifts some Republicans want to make still face rejection, even if Trump backs away from campaign promises and embraces the proposals.
On the table: Capping federal payments to the program and giving vouchers or a set amount so folks can buy traditional Medicare coverage or private insurance.
People at or near eligibility age would be grandfathered into the program, but that won't keep seniors and some lawmakers in both parties from fighting back.

**TRUMP'S
AGENDA**

Social issues won't rank high on Trump's to-do list during his presidency, despite his repeated overtures to "values voters" during the campaign. Tax reform, immigration, health care and other issues will crowd them out.
Still, some of Obama's social initiatives are good bets to be reversed.
To start, an executive order barring discrimination by federal contractors on the basis of gender identity or sexual orientation will be stricken by a Trump order.
And Education Dept. policy protecting transgender students in bathrooms? Probably dead. If the Supreme Court doesn't kill it, Trump is expected to.
Reproductive rights will be in the crosshairs, too. Don't be surprised if the Justice Dept. drops its defense of federal court challenges to guaranteed access to birth control under Obamacare. Trump will side with those with religious concerns.
Big changes in abortion policy aren't likely, especially early in Trump's term. But if he gets a chance to replace a liberal with a conservative on the Supreme Court, Republicans could make headway in reversing long-standing abortion rights laws.

The Labor Dept.'s pro-worker push will grind to a halt under Trump as some Obama-era measures are modified or scrapped and enforcement withers.
Ripe for revision: Electronic reporting of workplace injury and illness data. Rules that boost wage-and-hour violations by companies that misclassify workers. Limits on silica exposure...firms may get more leeway in how they protect workers.

Look for less-aggressive enforcement of workplace discrimination rules by the Equal Employment Opportunity Comm. during a Republican administration.
One goal: Softening or eliminating salary reporting requirements for firms with 100 or more workers. Employers fought Obama's push for the information, saying the requirement was costly, cumbersome and unlikely to lead to pay equity.
EEOC's final rule on wellness programs may also come under Trump's ax.
And the commission may scale back workplace rules that protect gays.
Under Obama, discriminating against an employee because of sexual orientation or gender identity violates civil rights. That approach won't fly with a GOP-led panel.



TECH &
TELECOM

The feds are poised to step up surveillance of computers and networks, enabled by a judicial rule change that allows greater access to computers and other electronic devices. Initiated by the Justice Dept., the new authority paves the way for government operatives to probe computer networks in far-off places as well as get into devices that mask locations, inhibiting police searches.

Security concerns will trump privacy as the feds look to bolster defenses against terrorists and other nefarious actors...both domestic and foreign. But security experts say the surveillance efforts could weaken overall online security by creating holes in security firewalls that could later give hackers new entryways.

Look for regulators to eliminate or ease a flurry of telecom rules under a pro-business Republican head of the Federal Communications Comm. The new chief, to be appointed by Trump, is sure to favor a light regulatory touch that will include easing installation regs, eliminating web provider privacy rules and green-lighting some preferential data treatment, or “fast lanes,” for web traffic.

Among the beneficiaries: AT&T, Verizon, Comcast, Time Warner Cable and other telecom firms that are sure to see less red tape for networks and services. Facebook, Netflix and Google, on the other hand, are in for less favorable policies because a hands-off approach gives telecoms more leeway to control web traffic.

Businesses are ramping up efforts to profit from the Internet of Things, the growing computer-connected network of devices, machines, cars and more.

But cashing in won't be easy for vendors such as Verizon, AT&T, Nokia and Intel. Coming up with a business plan keeps telecom providers up at night. Why? Many of the planned services rely on dirt cheap wireless data connections that sell for far less money than the broadband data plans used in smartphones.

New partnerships will help companies monetize the expanding network. The electric utility Southern Company, for example, is working with AT&T to sell services. Coming tie-ins with large data businesses will also add value.

FOREIGN
AFFAIRS

As many U.S. companies eye business opportunities in Cuba... They'll pressure Trump to keep the door open to rebuilding relations with the island nation. Standing to gain the most: Telecom and pharmaceutical firms as well as airlines, hotels and other tourism-related interests. Agribusiness, too.

Trump is sure to take a hard-line stance toward the Cuban regime, pressuring it to release political prisoners in exchange for more trade with the U.S.

One major sticking point: Settling financial claims by U.S. businesses and Cuban exiles whose property was seized during the Cuban revolution.

However, changes brought about under Obama will remain: Cuban nationals living in the U.S. will still be free to send remittances to Cuba. Americans can keep on traveling to Cuba for research and educational purposes. And it will still be OK for Cuba to buy certain goods on credit in lieu of cash.

But the U.S. embargo on Cuban trade won't be lifted anytime soon. Most Republicans in Congress, especially in the House, are steadfastly opposed.

Yours very truly,


THE KIPLINGER WASHINGTON EDITORS

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