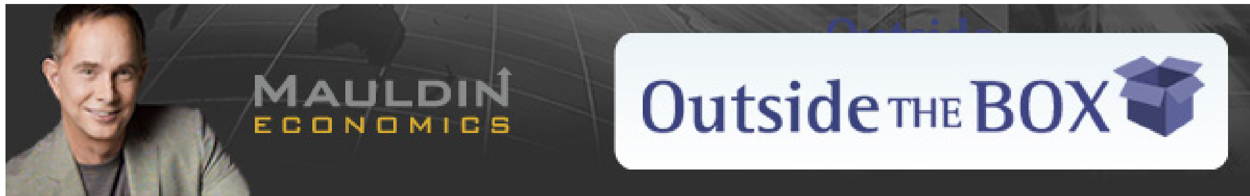

The Big Picture

JOHN MAULDIN | February 12, 2016

I've been a bit slow in bringing good friend Neil Howe's predictions for 2016 to your attention, but over the last couple weeks I have turned back to them more than once as Neil's take on the year ahead has begun to look very prescient indeed.

In this New Year's interview that Neil did with his firm, Saeculum Research, he wastes no time in telling us that he thinks expectations of several more Fed rate raises this year are "delusional," because "The global economy is in no condition to take this medicine. My very safe prediction is that the Fed will either stall or back down."

Bingo: after scaring the pants off everybody in the world last year with their hawkish talk of a persistently isolationist monetary policy, the Big Dogs of the FOMC have been yapping like toy fox terriers the past couple weeks, making sure everybody hears the message that "… we are closely monitoring global economic and financial developments and assessing their implications for the labor market and inflation, and for the balance of risks to the outlook" (Board of Governors Vice-Chairman Stanley Fischer, Feb. 1, 2016).

Neil doesn't stop there. He reminds us that the world geopolitical situation is deteriorating, particularly in the Middle East, and that the US presidential race is a complete crapshoot. At this point, the interviewer chirps in with "You sound a bit more downbeat than most." Well, says Neil,

> If I'm coming in beneath the consensus forecast, it's because – over the last decade – reality has been coming in beneath the consensus forecast….
>
> [T]here do arise periods lasting ten years or more when the consensus forecast can veer consistently too high or too low. And over the last decade, it has veered too high. Each year since about 2005, forecasters have been predicting a rise in corporate earnings, in GDP, in inflation, in interest rates—in basically all of the vital growth metrics – that is substantially higher than what subsequently occurred. And I'm talking about every forecaster: the IMF, World Bank, Fed, ECB, OECD, and CBO, along with surveys of business economists….
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> Systematic overshooting by international institutions is leading some observers to talk about "an in-built 'optimism bias.'"

Which leads the interviewer to quip, "I guess we can't call it the dismal science anymore," and to wonder at the reasons for the chronic boosterism.

“Oh, I know why it’s happening, says Neil,

> The world has fundamentally shifted over the last decade, especially since we’ve emerged from the Great Recession. We are seeing slower demographic growth, overleveraging, a productivity slowdown, institutional distrust, policy gridlock, and geopolitical drift. But the professional class has been very slow to understand what is going on, not just quantitatively but qualitatively in a new generational configuration that I call the Fourth Turning. They don’t accept the new normal. They keep insisting, just two or three years out there on the horizon, that the old normal will return – in GDP growth, in housing starts, in global trade.
>
> But it doesn’t return.

And with that, I think I’d better turn you over to Neil for the straight scoop on what is shaping up to be a watershed year. His message here is a very fundamental, very important one. I should also mention that in addition to his newsletters and research at his website, he is now available on the larger services at Hedgeye.com. He recently joined them as managing director to lead the investing research firm’s work in the demography sector. If you’d like to know how to access Neil and Hedgeye’s institutional research, you can email them at sales@hedgeye.com.

Oh, and for those of you who have registered for the upcoming Strategic Investment Conference, don’t forget that Neil will be with us. For the first time ever, he’ll be previewing his upcoming work, *The First Turning*. His book *The Fourth Turning*, published back in 1997, is familiar to many of my readers as one of the most significant books written in the past 25 years.

I was actually somewhat surprised that the conference sold out almost four months before it opens. I’ve never had that happen before. For those who didn’t jump on the registration bandwagon in time, we may possibly have a few slots open up, as there are always a few people who have to cancel at the last minute. You can go to the SIC 2016 website and register to be placed on our waiting list.)

Now, let’s take a look at Neil’s “Big Picture.”

Your thinking about fundamental shifts analyst,

John Mauldin, Editor
Outside the Box

The Big Picture

January 2016 Report

All signs point to 2016 being a momentous year on every front, from the shuddering global economy to the stormy upcoming election season. How will the world look by year's end? BP interviewed Saeculum Research Founder and President Neil Howe to get his take on what's ahead. (This is an expanded version of the interview we published as a Social Intelligence report on January 6, 2016.)

BP: Neil, 2016 sure began with some big headlines, didn't it?

NH: Yes, the year began with a bang—and not in a good way. Both the Dow and the S&P 500 suffered their worst 5-day and 10-day start to a year in history. With the market down roughly 8%, we are suddenly back to the "correction" lows of late last summer. China's Shanghai market entered free fall, with circuit breakers stopping trading on January 6 after only 29 minutes. Beijing had to intervene massively to keep the CNY from following suit. Meanwhile, most of the Sunni Arab nations abruptly broke off diplomatic relations with Iran. And North Korea successfully tested an H bomb, which—Dear Leader Kim Jong Un helpfully, if not quite accurately, reminded the media—"is capable of wiping out the whole territory of the U.S. all at once."

BP: Wow. "Bang" may be just the right word. Neil, could you give us a sense of what everybody is going to be talking about in 2016?

NH: In January, analysts always predict how the economy will perform over the coming year. Now is no different, especially with the big December announcement that the Federal Reserve is raising short-term interest rates by 25 basis points to between 0.25 and 0.5%. The Fed boldly suggests that interest rates may close in on 1.4% by the end of 2016 and 2.4% by the end of 2017. Spoiler alert: I think this is delusional. The global economy is in no condition to take this medicine. My very safe prediction is that the Fed will either stall or back down. And the risk of U.S. recession by the end of the year? It's higher than most are estimating: I'd say roughly 50-50.

Abroad, there are signs of progress in international relations, but the overall geopolitical outlook is dangerous. The Middle East has become a maelstrom. Europeans are voting for leaders who want to dismantle Europe. Putin seems to enjoy doing whatever he damn well wants to—while boasting off-the-chart popularity ratings at home. Meanwhile, Americans are left wondering why their country no longer plays a leadership role in world affairs.

These issues only raise the stakes for the upcoming elections. Not that Americans needed more reason to pay attention: Ever since the first slate of primary debates last summer, we haven't been able to take our eyeballs off this race. We have the prospect of seeing another Clinton in the White House, a highly polarized presidential campaign season, and—oh yeah—Donald Trump endlessly in the headlines.

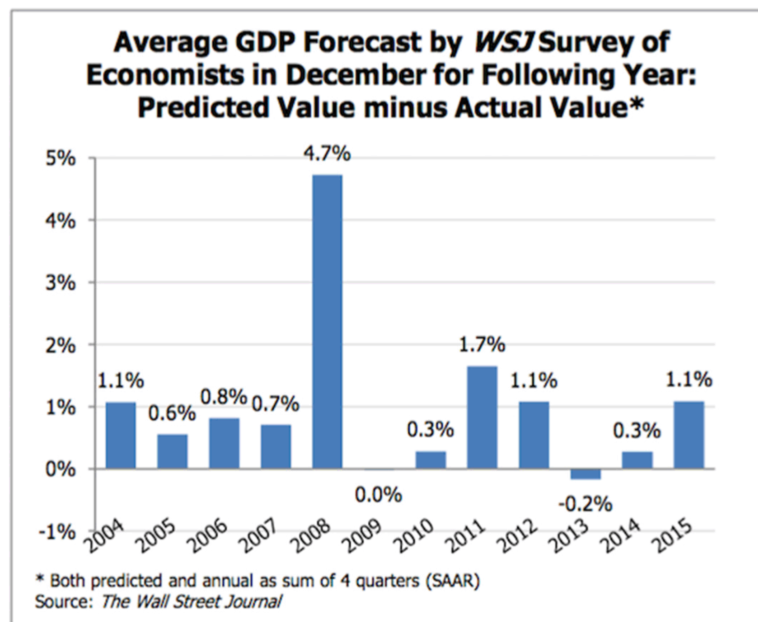
BP: OK, let's focus on the economy. You sound a bit more downbeat than most.

NH: If I'm coming in beneath the consensus forecast, it's because—over the last decade—reality has been coming in beneath the consensus forecast. And this is a new development. Much has been written about the abysmal track record of expert forecasters, whose performance is hard to distinguish statistically from a "blind" forecaster who simply chooses the historical average growth for each indicator. As the late economist Ezra Solomon once remarked, "The only function of economic forecasting is to make astrology look respectable." But even if most forecasts are pretty random, they are generally unbiased, meaning that they do not systematically err too high or too low over a long time span. The CBO recently confirmed this for its own forecasts going back to the 1970s.

That being said, there do arise periods lasting ten years or more when the consensus forecast can veer consistently too high to too low. And over the last decade, it has veered too high. Each year since about 2005, forecasters have been predicting a rise in corporate earnings, in GDP, in inflation, in interest rates—in basically all of the vital growth metrics—that is substantially higher than what subsequently occurred. And I'm talking about every forecaster: the IMF, World Bank, Fed, ECB, OECD, and CBO, along with surveys of business economists.

Does anyone recall that the IMF's first estimate (in 2010) for global growth by 2015 (+4.6%) was roughly *double* the likely final print for 2015. Or that the initial look-ahead Fed forecasts for U.S. GDP growth in 2011, 2012, and 2013 were at or over +4.0%? 4.0%! The actual average value over those years for the U.S. was +1.8%. For the EU and Japan, it was +0.6%. I mean, how wrong can you be?

Even if you look at GDP growth predictions made in January of the year in question, the Fed has been too high on average by well over one percentage point since 2005. *The Wall Street Journal's* survey of economists has erred in the same direction by exactly one percent. In 10 of the last 12 years, they overestimated, sometimes wildly. In 2 of the 10, they nailed it. In no year did they significantly underestimate.



Systematic overshooting by international institutions is leading [some observers to talk about "an inbuilt 'optimism bias.'"] The OECD, chastened by its overcarbonated numbers, [is soul-searching for solutions]. The Fed's [new chronic boosterism] is also coming under intense fire, with critics charging (accurately, I think) that the Fed is wagering its credibility on a high-risk expectation game: Forecast it, and they will come. Look, I get that a few institutions—[corporations forecasting earnings] or the White House forecasting employment, for example—will always initially overshoot. We all understand their incentives. But the economics profession as a whole?

BP: I guess we can't call it the dismal science anymore. Why do you think this is happening?

NH: Oh, I know why it's happening. The world has fundamentally shifted over the last decade, especially since we've emerged from the Great Recession. We are seeing slower demographic growth, overleveraging, a productivity slowdown, institutional distrust, policy gridlock, and geopolitical drift. But the professional class has been very slow to understand what is going on, not just quantitatively but qualitatively in a new generational configuration that I call the Fourth Turning. They don't accept the new normal. They keep insisting, just two or three years out there on the horizon, that the old normal will return—in GDP growth, in housing starts, in global trade.

But it doesn't return. So even while they grudgingly downgrade their near-term forecasts, they keep reassuring us that a better future is still out there if we just wait another year. Like a receding mirage, the good news always keeps glimmering on the horizon.

BP: It's been a decade now. Are these guys finally waking up?

NH: Interesting you asked. For the most part, I see most forecasters trying to stay on script. Once again, both here and abroad, they are predicting a "rebound" from 2015: Faster real growth, rising inflation, higher interest rates, and so on. Both Kiplinger and the IMF, for example, predict U.S. GDP growth [will hit 2.8% in 2016]—up from perhaps only 2.4% in the year that just ended.

But I also notice that the mood is a lot less giddy than it was at the end of 2013 and 2014. There's a new sobriety. Fewer forecasters are entering 2016 expecting any robust acceleration. Indeed, many have been busy downgrading their estimates. Most remarkable are the increasingly gloomy—indeed, dirge-like—2016 market forecasts issued by big banks like GS and by big asset managers like Morgan Stanley both before and after the holidays. [Citibank has downgraded the U.S. stock market] to "underweight." [Credit Suisse says] "rotate out of stocks." [JP Morgan has shifted] from buy on the dips to sell on the rallies. [RBS is bluntly telling clients] to "sell everything." We haven't witnessed this degree of institutional bearishness since the Crash of '08-09.

Now you could say these are signs that forecasters are waking up. Or that the forecasters are still too sanguine and that you should continue to discount accordingly. Which is a scary thought. But it seems to resonate well in a scary January.

BP: OK, so much for the other forecasters. I'd like you to explain why you think 2016 will be a dangerous year for the economy.

NH: It's because of what I would call a "quadruple whammy" of economic bad news.

Let me start with whammy number one: the clear deceleration over CY2015 in U.S. economic growth. We see this in GDP. Over the last three quarters, GDP growth has slowed from a healthy 3.9% in the spring, to 2.0% in the summer, to perhaps a mere 0.7% in the fall. This last estimate (from the Atlanta Fed's GDPNow, a cutting-edge Big Data algorithm whose star is clearly rising) itself shows a stunning deterioration in forward-looking evidence. On November 5, the GDPNow estimate for Q4 was +2.9%—and ever since, with almost all the new information negative, that estimate has been declining at about 3 bps per day.

We also see the deceleration in consumer spending. According to GDPNow, Q4 PCE spending grew at only 1.8%, slower (even) than it did in the "frozen" Q1. Just look at nominal retail sales, which barely budged (0.6% CAGR) over the last five months of 2015. For the entire year, they grew at the lowest rate (2.1%) since 2009. These figures combine both brick-and-mortar (which continues to struggle mightily, showing its embarrassment on Black Friday) with on-line (which continues to grow strongly and above trend).

Walmart just announced it is closing 269 stores globally (154 in the United States) to adjust to this shift and focus more resources on online retailing.

What's still hot in retail? Travel and hotels (thanks, king dollar!); low-budget "experiences" like games and media; furnishings and home remodeling (a big bull trend we spotlighted two years ago); and health services, full stop. What's suffering in retail? Everything else, including autos, which has been on a great run but is now exhausted.

The problem is not that households don't have income to spend. They do. Slowing inflation plus unchanged pay growth has translated into a nice real income boost in 2015. The problem is that households are taking that extra income, due largely to falling energy prices, and they are saving it. Maybe they feel the bonanza will be short-lived. Maybe they are uncertain about the future. If Larry Summers were our economic czar (well, he nearly became our monetary czar), no doubt he would implement negative interest rates and try prying those extra dollars out of people's pockets. But he's not, and so here we are.

The cooling consumer would not be worrisome if industry and agriculture were picking up the slack. But that's clearly not happening. The Industrial Production Index has fallen 2% over the last 12 months, with especially steep drops in November and December. Energy has been hit the hardest: The same oil price decline that delights commuters in New York has slammed drillers in North Dakota and Texas. If the price stays in the $30 neighborhood, we can count on a dramatic growth in energy bankruptcies. Keep in mind: Many of these companies will see their forward hedge contracts expire in the spring.

Since the global crash in raw materials prices is across the board, U.S. revenue from all forms of mining has shrunk to about two-thirds of what it was 18 months ago. Falling prices are also hitting U.S. farmers: 2015 net income is down 50% from the glorious bounty harvests of 2013 and 2011. In 2016, we can expect a further drop. There's lots of hardship here.

Meanwhile, the U.S. manufacturing sector is wheezing. Its biggest single complaint is the high dollar, which chokes exports and devalues income from foreign subsidiaries. It's also suffering from a decline, both at home and abroad, in capex spending. According to the ISM PMI, U.S. manufacturers' new orders and production stopped growing since July and have been contracting since October. Census reports and Fed regional indexes tell basically the same story.

In short, the U.S. economy has experienced a dramatic deceleration since last spring. While it is still growing—and is in no immediate danger of recession—it may not be moving much above stall speed. More than all of its current growth is now fueled by modest growth in U.S. consumer spending. If personal savings rates fall and if no other dangers arise (a big "if," which I hope to come back to in a bit), GDP growth may pick up speed and the economy may have another mediocre year in 2016. If savings rates go up, perhaps in the presence of other dangers, my outlook is a lot less happy.

BP: What are the odds that oil could rebound to say $50 in 2016 and at least take the heat off U.S. producers?

NH: I see very low odds that will happen. As I explained in my Big Picture essay last year (see BP: "January 2015 Report"), the global demand and supply shifts that triggered the recent price decline cannot easily be reversed in a year or two. They will take many years to reverse, which is why we often talk about a long "supercycle" in energy prices. In 2016, the consumer behaviors leading to lower demand will be reinforced by dismal growth in global GDP. On the supply side, most producing nations (I'll throw in Texas here) have no choice but to max out on output even at basement prices—to pay creditors, quell political unrest, or shore up FX rates and FX reserves. Those who do have a choice (like Saudi Arabia and its Persian Gulf allies) have chosen for long-term strategic reasons to turn the valves all the way up and weld them there. Then there are the massive deep-water production sites in the Gulf of Mexico and Brazil just now coming on line for which the capex is already a sunk cost. And I haven't even mentioned the new supply from Iran or the Caspian Sea.

Let me cut to the chase: I don't think we'll see a reprieve. More likely, we may see oil coming down to $20 or lower for a while—which may actually help in the long run by forcing some producers to close down.

BP: You talk about faltering growth in farms and factories. But don't services now constitute the vast majority of U.S. value added? So long as services are strong, do we really need to worry about the thing-producers?

NH: Good question. I'd say first that the data are often misconstrued. According to the BEA, "goods production" (agriculture and industry) today comprise only 21% of GDP value added. But if we look only at the private sector, that share rises to 24%. What's more, a rising share of the other 76%—"services"—in effect comprise intermediate inputs to industrial companies. Just think of all the professional functions, from IT to legal to finance to PR, which used to be handled in-house by the industrials but are now outsourced. Estimates vary, but some believe a full adjustment for this "contracting-out" could push goods production up to about 33% of GDP value added.

And that's not all. These goods-producing industrials comprise an even greater share of large-scale marketplace transactions. They make up the majority of exports and imports between nations. They make up roughly half of the market cap of the DJIA or S&P 500, which means they dominate fixed-income and equity markets. And because so much of their output goes into capital goods, their health is a superb forward-looking indicator of where the economy is going. Five of the Conference Board's ten leading economic indicators specifically refer to manufacturing or construction.

A lot of services, especially personal services like cleaning and home care, are just this side of informal "household production," which has never been included in GDP. Largescale goods production stands at the other extreme. Its performance can make or break nations.

So let's lighten up here and give the industrials a little love.

BP: They certainly have my love. I'm thrilled I can buy gas extracted from preCambrian shale for the same price as bottled water. So you expect them to rebound quickly?

NH: Well, not exactly. I just wanted to stress that the industrials' current size and importance is larger than many seem to think. Over the long run, there's no question that their share in GDP is declining over time—and that they are now entering what could be a very difficult decade or two. Keep in mind that the bust in commodity prices, mining, energy, and manufacturing are not just U.S. trends. They are global trends; they're hurting Manchuria and Malaysia as much as Manitoba and Michigan. Many thing-making industries are going to require a serious structural reduction in global capacity in the years to come.

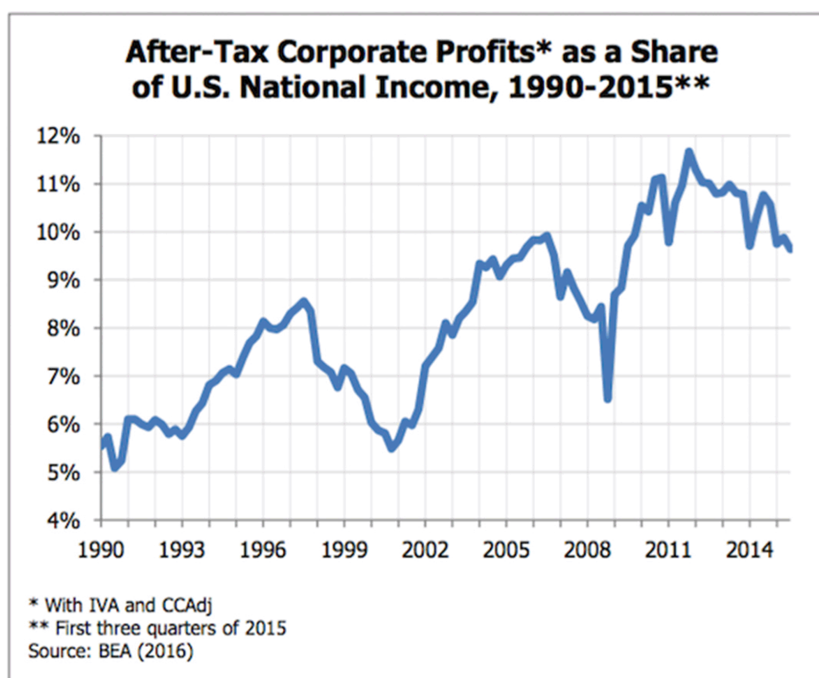
We recently published a report (see SI: "The Immaterial World") outlining the drivers behind this trend. They include the rise of the "sharing economy"—everything from Uber to Rent the Runway—which enables durables to be used much more intensively. There's the spread of urban living, which requires less personal housing and transportation per person. Ditto for the spread of extended family living (rising in both America and Europe). And then think about the ubiquitous presence of social media, enabling Millennials to define their social status by purchasing and showing off experiences rather than things. We're seeing a lot of changes, many of them generational.

Finally, don't forget demography. Aging societies with slow-growing workforces no longer require much capital-widening investment. After all, the existing plant and equipment can already handle all the new workers and the existing homes can already house all the new families. Getting local permits to build a new home is Italy is tough—but that's OK because Italy *really doesn't need* any new homes. Over time, the impact on durable goods and construction is massive. Consider further that in most high-income aging societies, working adults are taxed to support the consumption of the retired elderly, who in every society are the least likely to spend on things and the most likely to spend on services (starting with health care and personal care).

Let me stop there. Suffice it to say that increasingly we're all living in an immaterial world. And our economy will have to adjust.

BP: Fascinating. But let's return to 2016. What's the next whammy?

NH: The second bad sign is on the financial side. For the first time since the Great Recession, we are experiencing a substantial "earnings recession." We've had two consecutive quarters, Q2 and Q3, in which S&P 500 earnings have declined year over year. Q4 growth will almost certainly be negative as well—and, according to FactSet, company guidance suggests that even Q1 of 2016 will be negative. The BEA data for all corporate earnings show the same narrowing trend.



Profit margins are shrinking in part because of the high dollar and in part because of rising real worker compensation. CEOs would love to raise prices to keep their margins fat, but in today's deflationary environment they cannot. Naturally energy is showing the biggest profit squeeze, but over half of the other S&P 500 sectors are also showing negatives.

Earnings recessions are a classic late-stage indicator of an "aging" recovery. They are often (though not always) a prequel to the next full-blown recession. Their impact on the real economy is very direct. As a rule, companies handle declining profits by cutting back—on hiring, on R&D, on capex—anything at the margin no longer expected to add value. This pullback ultimately feeds forward into declining consumer demand. Arguably, we've already seen this dynamic underway during the second half of 2015.

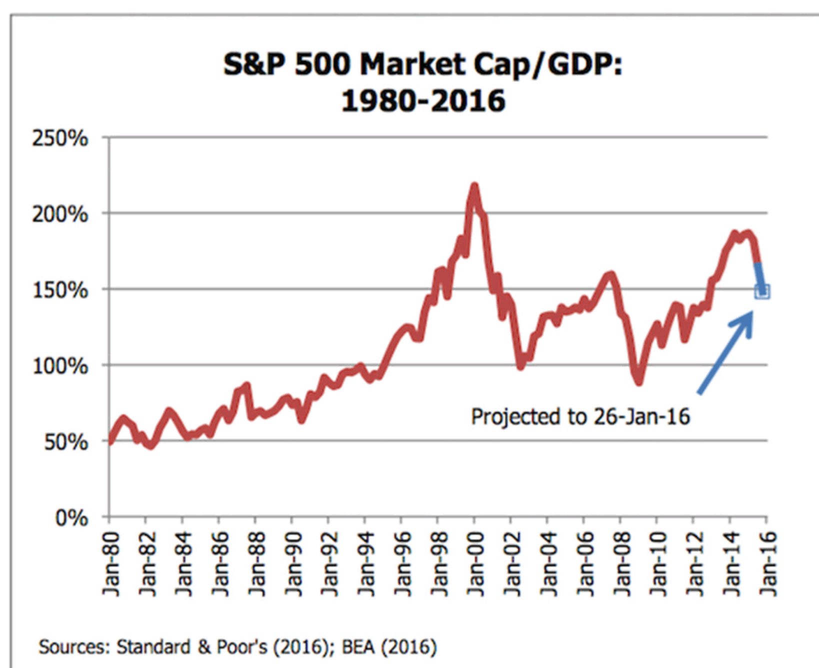
Yet this time around, there's another reason to regard this earnings recession as especially dangerous. For the last few years, we have been looking at very high valuations in U.S. equity markets. I don't want to go into all the different measures people use to measure equity valuations— like Shiller's CAPE, Tobin's Q, and so on. I just want to point out that most of them focus on three overlapping concepts: a smoothed ratio of price to earnings; a smoothed ratio of earnings to GDP; and the expected future of growth rate of GDP. Now here's my point. The two ratios are *both* far above their historical averages, and the low expected GDP growth rate (due to demographics) suggests, if anything, that the ratios should be beneath their historical averages. It's a sobering triad, pointing to nothing pleasant.

I don't want to get wonky or wade beyond my depth here. Let me just mention two analysts whose work on valuations I greatly admire, John Hussman and Ed Easterling. Their reports give me cover by allowing me to come across as an optimist.

So what do all these measures have to do with the earnings recession? It's this. Just knowing that the market is overvalued is of limited practical significance if the market can sometimes stay overvalued for years on end. What you really want is a leading indicator that tells when the market will break to the downside and correct. I think profit margins are such an indicator—not 100% foolproof, but highly suggestive. In every major postwar bear market, profit margins have declined together with P/E ratios and *have typically shown a clear declining trend before it became apparent* in the noisy P/E ups and downs.

BP: So does the current market downdraft marks the beginning of secular valuation correction?

NH: It may. Look, for example, at the ratio of S&P market cap to GDP, a very familiar valuation indicator. You can see that it plateaued at a lofty level throughout 2014 and started falling swiftly after Q1 of 2015. Today, I reckon it has already dropped by around 20% from its peak. The problem is it still has to drop another 30% just to reach its recent historical average. And of course it may in time overshoot.



Warren Buffett once described this indicator as "the best single measure of where valuations stand at any given moment." But there are obviously many others, and most of these are situated at roughly the same distance above their historical average.

BP: What's your prognosis for the market in 2016? And what impact will the market have on the real economy?

NH: I think 2016 will be a very dangerous year for equities. And I think the big banks already suspect as much, which is why they are doing something they hardly ever do: Warning their investors to cut their exposure. For several years, analysts have been puzzling over what Mohamed El-Erian calls the "decoupling" of market returns (which have been splendid) from real economic growth (which has repeatedly stumbled). In 2015, market returns ran out of steam. In 2016 and beyond, there is a growing fear that decoupling may turn around and rush back toward "recoupling"—implying large negative market returns.

In retrospect, we may put the turning point at the brief S&P 500 swoon of last August. Though prices recovered late in the year, other indicators showed the market turning steadily against risk—with the bond spread widening, the VIX rising, and the IPO count falling. By year's end, tech startups were struggling with downrounds and new "unicorns" were deemed an endangered species.

The forward link to the real economy is harder to assess. Though it is said that market crashes often do not cause recessions—those that don't are often fast crashes (like 1987) with no triggers in business income statements. What concerns me in 2016 is something a lot bigger than a flash crash. So yes, I think it could participate in a negative feedback loop with an economy that is already starting out the year in low gear.

BP: With so much up for grabs in our domestic economy, I guess the deciding factor may be what happens abroad.

NH: Wonderful segue. You've taken me straight to my third whammy, the global economy, which is slowing down on a massive scale.

If you look at 2016 from a comprehensive geographic perspective ("from China to Peru," to borrow from Samuel Johnson), you see a clear separation. There are few dire threats in the high-income world. None of the major affluent players are growing very fast, but then again neither are they expected to slow down much. Let's say Japan continues to eke along at 0.75%, the EU at 1.5%, and the U.S. at 2.5%. That's a good status quo ante for roughly half of global GDP. But now let's look at the other half, the developing half. Here we see ongoing deceleration. In 2015, the IMF estimates that the developing economies grew at 4.0%—the slowest since the Great Recession year of 2009 and less than half the rate they enjoyed in 2007, just before that downturn. In 2016, I think their performance will deteriorate further.

At the epicenter of this slowdown is China, whose high growth rate only a few years ago (running over 10% per year) enabled it to generate, singlehandedly, perhaps a quarter of the annual growth in global production. Everyone agrees that China's growth rate is now falling, but no one can agree on how much. While the official numbers put Chinese GDP growth last year at just under 7%, most outside analysts are frustrated by the regime's irregular accounting methods and figure it's doctoring the numbers to hit official targets.

Leland Miller at China Beige Book says the real growth rate may be around 4.5%. Citigroup chief economist Willem Buiter suggests the true growth rate is probably closer to 4.0% and could be as low as 2.2%. Imports and exports (in USD) declined every month last year. The Caixin Manufacturing PMI shows contraction in 6 of the last 7 months, while producer prices have been tumbling for over three years.

There are many reasons why China is now in trouble. Its industrial and real estate sectors racked up vast amounts of debt over the past decade, leading to excess production and capacity that is hard to unwind. Its overvalued currency is squeezing its export businesses, but any deliberate attempt to devalue would be like disarming a bomb, incurring the risk of sudden capital flight. Meanwhile, just as rural areas are running dry on new young adults to send to the cities, China is undergoing rapid demographic aging. Just this year and next, its working-age population has stopped growing and has now started a gradual decline. Basically, China has outgrown one growth paradigm and hasn't yet figured out how to move to another.

So much for the causes of China's woes. Let's look at the effects. Most importantly, China's slowdown shrinks an important source of rising demand that has helped keep global economies running over the past decade. Europe, for example, exports furs, fashions, and sport cars to feed China's insatiable demand for brand-name luxuries. That is taking a hit. The U.S. and South Korea export films and smartphones to feed China's mania for media and cool IT. That is also taking a hit.

The collapse of China's infrastructure boom is a significant driver of falling global energy demand and a huge driver of falling global commodities demand. In 2014, incredibly, China constituted roughly half of the global demand for most major metals, from iron, copper, and nickel to all those once-treasured "rare earth metals" whose prices have since tanked.

China has been an economic juggernaut over the past quarter century. It has lifted more people out of utter destitution into at least modest affluence than any nation in history. But now its boom is coming to an end, after producing "ghost cities" without residents and "ghost bullet trains" without riders. As China changes its course, so must much of the rest of the world.

BP: Which countries are getting hit hardest?

NH: Here's how to think of it: If your country is dependent on exporting oil or commodities, or if you are close to China (which presumably means you trade a lot with China), it is likely you are feeling pain. Sadly, this rule of thumb covers the great majority of the developing economies.

The energy price collapse has obviously slashed income to most of the Middle East and to Russia and its Central Asian CIS allies. The energy and commodity declines together are dragging down nearly every nation in sub-Saharan Africa, many of which export little other than oil, gems, precious metals, and base metal ores. Ironically, most of the vast mining operations in Angola, Zambia, and the Congo were originally funded by China. The price declines are also a hardship for Latin America, a region already reeling from a catastrophic failure of political leadership (in Venezuela, Brazil, and Argentina). The IMF estimates the Latin American GDP, as a whole, actually shrank last year.

Among the regional Asian economies suffering from falling trade with China, let me mention Indonesia, Malaysia, and Mongolia. There are even some regional high-income economies who are struggling to adjust: Taiwan, Singapore, South Korea, and (to a lesser degree) Australia and New Zealand.

BP: This sounds uniformly bleak. There must be some blue sky out there.

NH: Yes, there are important exceptions. Look for economies that aren't blessed with energy and commodities and aren't hugely dependent on China. Check out India and the Philippines, two large economies which (using unbiased national accounting) are probably growing faster than China right now. They hardly skipped a beat last year. Vietnam and Thailand are also doing well, largely because they are not affluent enough to have been swept into China's industrial supply chain yet.

Canada and Mexico, both significant energy and commodity exporters, are both doing better than they deserve. And for one reason: Their border with the United States, an economy whose relative strength thus far keeps them moving forward.

BP: OK, I understand that 2015 was a tough year for the developing world. But aren't all the plunging raw material prices past us now? Shouldn't these economies begin growing again this year?

NH: I'm afraid not. Adjusting to the new export prices faced by most of these countries—and to the large deterioration in the terms of trade they imply—takes time. It's not something business and political leaders like to do before they really have to. So they usually find ways to delay. It's human nature.

They buy forward contracts to hedge against the price decline, and then pray the price goes back up again (when they know it probably won't). They wait until they need to roll over their loans and hope the bank or foreign fund will want to reinvest (when they knew they will probably be refused). They spend down from FX reserves to keep their currency from falling. They beg for international agency loans. They ask for delays on stateto-state payments. They ask domestic banks not to act on nonperforming loans. There are so many ways to put off the day of reckoning.

Some leaders do act with resolution to get through the adjustment right away. This usually means a large and sudden currency depreciation—and brutal hardships for most citizens. Russian President Vladimir Putin chose this path about a year ago when most analysts figured his economy faced almost certain ruin in the wake of plunging oil prices and Western trade and investment sanctions. Real wages in Russia have fallen by 11%. Retirees are demonstrating in city squares. But remarkably, Putin's fast action worked. He may have saved his economy in the near term, even if he still faces intractable dilemmas in the longer term.

But the typical course of action is to delay and defer. As a result, the inevitable decisions around the world to defund companies, lay off workers, cut back production, pull out investments, and devalue currencies are made piecemeal over many months. It's like watching snow settle. What's more, adjustment moves in one country are likely to trigger further moves in another. One devaluation causes another "competitive" devaluation; one spooked foreign investor may persuade others to follow suit. Over time, these small movements may ultimately build up to a crisis point, when suddenly everyone sees where things are heading and everyone wants to get out the door first. Then it's like watching an avalanche fall.

We saw this happen in 1997. It could easily happen again in 2016.

BP: The financial media have been dumping on the '97 parallel. They say today is different.

NH: Yes, today is different. Today is worse. Look, I've heard their arguments: They say that East Asia today is more committed to floating exchange rates, has more FX reserves, and has a smaller share of dollar-denominated debt. But everyone goes off the float in a crisis, no one ever has enough FX reserves, and the dollar-denominated share is almost impossible to measure. What we do know is that total debt is higher (per GDP).

Here's why the situation is worse today than it was just before 1997. Back then, both the world and emerging markets were growing considerably faster than they are today— which means that most countries were one or two or even three percentage points of growth further from recession that they are today. The outlook was glorious. Today, not. Back then, major central banks around the world still had plenty of room to lower rates, which many of them used. Today, not. Back then, U.S. equity markets overall were fairly valued, which reduced the possibility of contagion. Today, not. Back then, the vulnerability was limited to one region. Today, it is spread among emerging markets all over the world. Indeed, the first big sovereign debt default this time could be Brazil or South Africa or Venezuela or Ukraine or Egypt or wherever. (I'm just reading off some of today's higher CDS spreads.)

Back then, our main concern was foreign investors withdrawing their assets from emerging markets. Today, precisely because the IMF persuaded so many countries to get rid of capital controls, a new concern is outflows triggered by domestic residents pushing their funds abroad. The IMF has since backtracked on its earlier disapproval (it now soothingly refers to "capital flow management"), and over the last year a growing number of emerging markets are reimposing capital controls as inflows dwindle and outflows speed up. We may be nearer to the tipping point than many think: In 2015, there was a net-net capital outflow from all emerging markets for the first time since 1998.

And then there's China. In 1997, China was an inert bystander, with few financial ties to the rest of the world. Today, China is a slowly collapsing supernova, with such massive external trade and financial activity that even a slight change in its rate of decline will have large repercussions both regionally and globally. Without a doubt, China is the single biggest reason why what goes down for emerging markets in 2016 could be worse than in 1997.

BP: I should have known: Once again, it's all up to China! So what will happen in China in 2016?

NH: Here's the problem China faces. Because of the CNY's de-facto peg to the USD, the dollar's rapid rise—by about 25% (trade-weighted average) over the last two years— has dragged China's currency up with it. What's more, two years ago many analysts *already* believed that the CNY was overvalued. And now that China's economy is slowing down and the PBOC is reluctantly allowing to CNY to ratchet down, the pushing and shoving to get to the exit is beginning to overwhelm the authorities' power to control capital outflows.

We're not just talking about carry traders wanting out. We're talking about the Chinese people wanting out. The elite have already dug their own exit tunnels—a fact attested to by the huge recent influx of Chinese cash into European businesses and into Canadian and Californian real estate. More will follow. Since last summer, the PBOC has spent roughly $100 billion in FX reserves each month trying to keep the CNY up. But the hemorrhage is slowly widening even as the CNY slowly falls.

Clearly the dam will burst open long before the PBOC gets to the bottom of its $3.3 trillion war chest, which really isn't that large relative to potential investor flow. Consider that each adult Chinese citizen can *legally* send $50,000 per year abroad. If just one Chinese household in twenty were to exchange the legal maximum from CNY to USD today, PBOC's *entire kitty* would be empty by sundown. China's government itself is to blame to setting up this situation. In recent years they've helped keep the CNY up by running the perfect roach motel: Investment can get in, but can't get out (except with special permission). As a result, most Chinese families and firms have never been able to diversify their portfolios by investing abroad, creating an enormous pent-up demand for foreign assets.

Xi Jinping and the PBOC don't have many good options, and they don't have much time to choose from among them.

BP: What are their options?

NH: Their first (and worst) option would be to stay the current course, losing reserves and credibility at a growing rate while failing to stop the currency decline. Before the year is out, they will have to enact a major devaluation anyway and do it from a position of weakness. Their second option would be a resolute defense of the CNY near its current level with much stricter capital controls and jacked-up interest rates. But capital will still seep out—and to prevent higher interest rates from killing the economy, they would have to switch entirely to fiscal stimulus. I just think it's too late for this. Their third option would be to bite the bullet up front and enact a large devaluation (40% or more) that the PBOC is certain it could defend and then accompany that by further relaxing of capital controls. It is the best option, but since it requires boldness and political courage it is probably not the one Beijing will choose.

In a brilliant interview I highly recommend, strategic trader Mark Hart summarizes both the problem and the options. His bottom line is this: We are very likely to see a large CNY devaluation in 2016—regardless of whether China's leadership does this preemptively or whether they are dragged to it unwillingly. And that devaluation will come with real risks. Global markets may sink and cause investors to flee other emerging markets. Other economies (especially in Southeast Asia) may retaliate with their own devaluations, threatening "currency wars." Global leaders will react with heated and nationalist finger pointing. To avoid losing face, leaders in Beijing may blame others (the Fed, the EU, Shinzo Abe) for forcing them into this decision. It won't be a pretty picture.

BP: OK, I think I get your global take. I recall you saying earlier that the economy faces a quadruple whammy. What's the fourth?

NH: It's the Fed—or, more specifically, the FOMC's 12-member "dot plot" intention to hike interest rates. If the Fed goes ahead as planned, it will exacerbate nearly every problem I've mentioned. Domestically, it will raise hurdle rates and dampen borrowing and investment activity. Globally, it will accelerate the carry-trade reversal, suck domestic savings out of emerging markets, and put added stress on the developing economies at a moment of vulnerability.

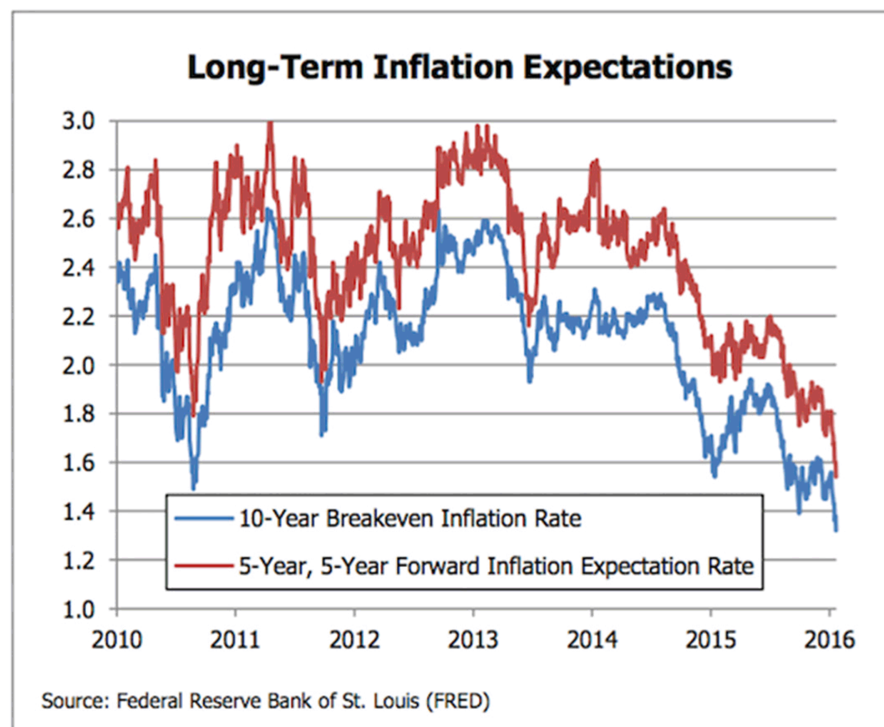
BP: Wow. So why is the Fed doing this?

NH: Some in the Fed say it's hiking rates because the U.S. employment situation is basically fixed. But if we look at the working-age employment-to-population ratio, we are clearly a long way from a hot labor market—so that reason seems, at the very least, incomplete. Others say it's hiking rates because market valuations are excessive ("bubbly," as the Brits might say). I agree, but are they willing to slow down the global economy to correct these valuations? I haven't heard anyone gutsy enough to say that.

Still others say that a "small" hike won't hurt much. Sure, but by the same token it won't help much either. The whole point of the Fed's "forward guidance" in its December hike was to put a stake in the ground and commit itself to a "half-throttle" plan of future hikes, amounting to nearly 30 bps per quarter over the next three years. That's pretty big. I don't think the Fed intended to make much ado about nothing.

In truth, I don't think it's entirely clear why the Fed is doing this. Most likely, it's playing an expectations game—hoping that its plans will make the consumers and businesses *believe* the economy is speeding up and thus be more willing to buy and invest. The Fed also feels powerless with ZIRP and is terrified that it may eventually hit the next recession with interest rates still stuck at zero. And then there's the fact that the Fed tends to echo the opinions of bankers, and bankers (perhaps irrationally) really don't like low interest rates.

The fact remains, however, that the only legitimate reason to embark on such a major shift in monetary policy is to ward off the threat of inflation. Only no such threat exists. Look at the CPI, PCE deflator, M2, and price of gold—nothing there. Look ahead at market expectations for inflation five and ten years into the future—nothing there either. I cannot recall another episode in history (except maybe back during the gold-standard Coolidge and Hoover presidencies) in which the Fed has hiked interest rates in the face of decelerating GDP growth, falling inflation expectations, and a global slowdown. I don't think it will turn out well.



BP: So what's going to happen?

NH: One thing I can say with confidence is that this full string of rate hikes will never happen. The Fed will postpone, cancel, or reverse them—in all likelihood, well before the end of 2016. And it will do so in a belated response to global market declines, disappointing economic news, or an emerging markets crisis, possibly involving China. After just the first two weeks of January, the Fed Funds futures market is already signaling a rapid decline in the share of traders who believe the FOMC will go ahead as planned. Some are talking about a perverse "Yellen call." Rather than support you if the price drops, this Fed will hold you down if the price goes up.

If for whatever reason the Fed does not back down early in 2016, we are likely to see tell-tale signs of the inevitable in a flattening yield curve. The Fed may already be concerned about the failure of its December announcement to push up long-term interest rates. And if it's not, it soon will be. One thing is for sure: A narrowing NIM will get all those gung-ho bankers to scratch their heads and say, what the hell were we thinking?

Investment analyst (and prolific author) John Mauldin recently offered an open bet with any takers—that the Fed Funds rate will go back to zero before it ever reaches two percent. His open bet understandably went viral. A stronger version of the bet would be that we will see QE4 before the rate ever goes above *one* percent.

BP: How will the Fed's rate-hike effort affect the global economy?

NH: The Fed hike is predicated on the assumption that the United States can prosper and accelerate while the rest of the world slows down. The more the Fed hikes, the more it drives a wedge between our prospects and theirs. While in theory you can say this ought to be possible, given the relatively modest impact of trade on the U.S. economy, history says it rarely happens. Most of the time, the U.S. and the rest of the world expand and contract together—probably because of linkages through financial markets, geopolitical events, and just contagious animal spirits.

In recent years the Fed has become more isolationist in its outlook, perhaps following the White House, Congress, and the American public in a retreat from globalism. Back in 2014, Raghuram Rajan, Bank of India Governor (and former University of Chicago professor), told the Fed that it ought to take the world more into consideration when making policy decisions. His outburst wasn't kindly received by Chairman Ben Bernanke. Late last year, both the IMF and the World Bank suggested to the Fed that now is probably *not* a good time to hike rates. The Fed did not respond. I have no problem with the Fed saying, hey, our first responsibility is to serve the U.S. economy. But what the Fed fails to understand is the message that your economy and our economies are connected. We all tend to rise or fall together. At least keep us in mind.

So that's my fourth whammy. It's obvious to most Americans that rising interest rates and a rising dollar will force our own economy to swim upstream. What's less obvious is that these same trends—when global demand is weak—are painful for the rest of the world as well. And sooner or later that rebounds on us. Fun fact: From 2014 to 2015, the dollar value of global GDP actually declined. Historically, this doesn't happen often. But when it does, it typically sets up a global recession year—like 1983 and 2009. If you're a poor country, it means that hard-currency liquidity is disappearing. If you're American, it means no one else can afford what we sell. Either way, it's not a good sign.

BP: So of course I have to ask you: Does all this add up to a U.S. recession in 2016 or not?

NH: As Yoda would say, "The dark side clouds everything. Impossible to see the future is." If you ask *The Wall Street Journal*'s panel of 60 economists, their current answer (taking the average) is that the probability of a recession in the next year is 17%. This is the highest average they've given since the question was first asked two years ago. But clearly it suggests a possibility, not a probability.

Now if I were just looking at the U.S. economy in isolation, I would probably offer a similar figure, maybe 25%. While the momentum going into Q1 is weak, there's still enough growth in core employment, income, and sales (especially in services) to safely bet against a serious downturn starting before the end of the year. But if I look more broadly at the economy, and take into account the impact of financial markets, the global economy, and the Fed, then my outlook darkens. I'd say the probability is more like 50%. And if we look forward through 2017, then I'd choose a higher number still.

BP: I'll take that as a qualified yes. Will we see an inverted yield curve before the next recession?

NH: Unlikely. People sometimes clutch at straws and say we can't have a recession without an inverted yield curve. But of course we can. We had many of them before World War II, and Japan has had several recessions over the past twenty years even while its short-term rate has been stuck around zero.

Is it possible? Well, I do see one scenario where it could happen. Let's say the hawks prevail in the FOMC and the Fed goes ahead with some of its hikes in 2016, pushing the Fed Funds to, say, 0.75% by August. Soon after the last hike, a global currency and financial crisis hits at just the moment when sovereign wealth funds around the world (think: Saudis, Chinese, Nigerians, Singaporeans, and so on) stop selling their assets, largely Treasuries. Let's imagine that they are running dry—and maybe that their abrupt illiquidity helps trigger the crisis.

So suddenly a massive tide of assets sales—which up until then was helping to boost long-term yields—comes to an end. Meanwhile, of course, every global trader looking for a safe haven is trying to buy them. We could easily see 10-year yield fall to 0.6% or 0.5%, basically to rates we associate with the German 10-year Bund. (Recall that in late 2008 we saw the 10-year fall 190 bps in 7 weeks.) Bam, there's your inverted yield curve.

I'm not saying it's likely, mainly because I think the Fed will back down. But it's possible.

BP: This seems like a good jumping-off point for geopolitics. What are the major global themes going into 2016?

NH: It's easy to look around the world and see signs of promise. In East Asia, China is trying to wage a peace offensive with its neighbors. All told, we're like to hear fewer alarm bells going off around the South China Sea. In the Middle East, the big news is that IBPS is on the retreat. They're losing territorial control in the north and east to the Kurds and Iraqis. After vicious back-and-forth fighting in recent weeks, ISIS appears to be losing the key city of Ramadi. In Russia, Putin's efforts to turn Ukraine into "new Russia" have stalled, and the regional conflict has reached a stalemate—which itself is cause for celebration.

So examining the three big trouble spots around the globe, yes, we see some good signs. Our biggest concerns a year ago seem a bit less urgent now.

BP: That's certainly good news. What, if anything, should we be worrying about?

NH: Well, first you worry that you may be wrong. ISIS, for example, remains a real threat. They continue to gain territory in the west against the Assad loyalists. They're gaining strength in Libya. And Europol says they're actively planning larger Paris-scale attacks in 2016. And though we usually talk about a geopolitical crisis causing an economic crisis, you also worry about the reverse. What would happen, for example, if China underwent a major devaluation? No doubt nationalist passions would heat up in that region. What if Russia faces further privations due to falling oil prices? Would that make Putin friendlier? To quote John Wayne, "not hardly."

But let me point quickly to two particular threats in the Mideast which have grown more serious in the past couple of months. They are long-term threats which may or may not cause us problems in 2016. But they are big.

The first threat is clear evidence from Iran that Khamenei's regime has not the slightest intention of liberalizing or turning westward now that its $100+ billion is officially being "unfrozen" as we speak. Of course, many in the West hoped otherwise.

But now the regime is testing ballistic missiles, jailing dissenters, disallowing nearly all the reform candidates in the upcoming (February) parliamentary election, and cozying up to Russia and China. Speaking to Chairman Xi last week during his visit to Tehran, Khamenei announced that he "never trusted the West" and wants to strengthen ties with Beijing. Iran is spending blood and treasure on several fronts—in Syria, Iraq, Yemen, and terrorist networks throughout the Mideast. It's no mystery where much of that new money is going.

The second threat is the mirror image of the first: Saudi Arabia, under the untested leadership of King Salman and son, is burning its bridges with Iran and galvanizing a new sense of unity among Sunni Arab nations. The Saudis recently organized a 34-nation "anti-terror" coalition to which Iran was pointedly not invited. A couple of weeks ago, they found a convenient pretext to lead all the Arab Gulf states to break diplomatic relations with Tehran. Military ties with Egypt are strengthening, and the Saudis are eagerly trying to pull Turkey into their alliance. They are doubling down on their costly war in Yemen. They feel let down and left on their own by President Obama on the Iran deal, and now they're trying to take history back into their own hands.

In short, threats are escalating and sides are polarizing around an ancient sectarian divide, while the world's referee-superpower remains largely AWOL. Sure, there are other powers in play here—Turkey, Kurdistan, Russia, Israel—but they just make the whole situation more fluid and unpredictable. So if you want to know what the biggest new geopolitical danger is going into 2016, this is it. We're not just talking about terrorism. We're talking about the no-longer-remote possibility of state-versus-state conflict.

BP: OK, I guess we have something to worry about here, after all. Let's move across the pond. What about Europe?

NH: I think this could be relatively prosperous year for the EU. Yes, it remains economically troubled, with EZ unemployment still above 10 percent. And yes, Europe still faces stubborn deflationary pressure and can't seem to get its banks to start lending again. But the Eurozone now boasts a favorable combination of extremely low (indeed, negative) interest rates, a cheap currency, and growing fiscal stimulus. Its major worry is falling import demand in East Asia. Barring really bad news there, the EU may do better in 2016 than it did in 2015.

If I were investing in equities in 2016, this would be my global region of choice. The valuations are favorable. So is the near-term outlook.

My big concern about Europe is political. The ongoing migrant crisis is causing walls and fences to go up all over Central Europe. The popularity of nationalist slogans and direct-action plebiscites is rising. Support is growing for extreme right-wing and left-wing Eurosceptic parties who threaten to break up the Union—or who are at least indifferent to its fate. In France, Marine Le Pen's National Front party led the pack in December's first round of national elections. In Poland, right-wing Law and Justice Party candidate Beata Szydlo was swept into office in November. Even young voters are climbing on board. (See CW: "A Rising Generation of Eurosceptics.") Whether in Hungary, Poland, France, or Scandinavia, you see rising attraction to these leaders and to these parties.

Although David Cameron can wait until the end of 2017 to stage his Brexit referendum, he apparently wants to do it this summer. If he goes ahead, it will be a great opportunity to take the pulse of European public opinion.

BP: Let's move to the upcoming elections here at home. Just how do Americans feel about government and politics in general?

NH: Not good at all. In fact, we may be reaching a breaking point. American citizens so distrust the establishment that a growing number want to take a wrecking ball of the whole thing. Even many Democrats admit a fondness for the Donald's careless nihilism. According to a November Pew report, more than half of Americans think that "ordinary people" would do a better job than elected officials at solving the country's problems. And fully 59 percent of the public believes that government needs sweeping reform—a jump up from just 39 percent in 1997.

Not only that, but America has grown more polarized than ever. People are more ensconced in their partisan views today than in years past. I even get the sense that, increasingly, the losing side of a national election regards itself as an oppressed people having no recourse aside from obstruction, emigration, or rebellion. That really worries me, because it's only going to get worse—to the point that it not only impedes our ability to govern and formulate policy, but could trigger some sort of active resistance or succession movement. The historical precedent is there.

BP: That sounds serious.

NH: Indeed. But the show must go on, and we can only hope that a candidate will emerge out of a process that no one likes who can galvanize a clear majority of voters, not just those on one side of the aisle.

BP: Who do you see getting the nomination from each party?

NH: On the Democratic side, I think it's clear: It's going to be Hillary Clinton.

I agree the popularity of Bernie Sanders has been a real surprise. Here's this littleknown, self-proclaimed "socialist" drawing enormous crowds and stirring great excitement on the left-wing "single payer" side of the party. And especially among Millennial Democrats. According to a McClatchy-Marist poll, left-leaning 18to 29-year-olds would prefer to see Sanders in office over Clinton by a margin of 23 percentage points. Like Trump on the other side, Sanders illustrates the highly polarized mood of today's electorate.

But Clinton possesses a simply insuperable lead among rural, blue-collar, and minority Democrats. If she gets into trouble in Iowa and New Hampshire, her Southern "firewall" will save her. What's more, she can count on the overwhelming support of the superdelegates (basically, establishment politicians) at the convention. They constitute 15% of the delegates. They are her ace in the hole.

BP: OK, what about the GOP side?

NH: I really don't have a clue. Like many other onlookers, I find it humbling how often I have to change my opinion.

Right now, for what it's worth, I see two scenarios.

The first is that Trump starts to broaden his voter base beyond his core supporters —older, less affluent, non-college Americans. Let's imagine also that he gathers further (grudging) support from the GOP establishment. Maybe, like Bob Dole, the old pols soften and come to regard him as a "deal maker." Others may invoke the memory of Ronald Reagan, another "amateur" with a gift for politically incorrect hyperbole and for connecting with working-class Democrats. In this scenario, Trump wins on the first ballot.

The second is that we reach the convention and find that no candidate has an absolute majority. So no one wins on the first ballot. That's when the fun begins and all hell breaks loose. The only consensus likely to emerge will be around the candidate who is most likely to win in November—and this will suddenly thrust the moderates back into center stage. If Rubio is second to Trump in delegates, he will be the obvious choice. Others like Christie, Kasich, and Fiorina are possible, but Rubio will beat them out as both the most electable and most "conservative" option.

If I had to guess, I would put my bet on the second scenario. I think the establishment has been warming to Trump only because they detested Ted Cruz more. With Cruz in decline, the GOP movers and shakers will start lending their support for electable alternatives to Trump. Anyway, that's my thinking today. Tomorrow I may change my mind.

BP: So who's going to win the general election?

NH: All depends on who's running.

If for some reason Sanders is the Dems' choice and he goes head to head against Trump, the passion and vitriol will be off the charts. With a quasi-socialist battling a quasifascist, we will truly be able to relive the mood of the 1930s. I have no idea who would win that—probably Trump, so help us God.

If it's Clinton against Trump, Clinton will win—but perhaps by a surprisingly narrow margin. She will be the candidate that no one really likes but feels they have to vote for anyway. Either outcome, especially a Trump loss, will be socially and politically damaging for the country. It is likely that post-election rancor could build into active resistance networks, possibly along class lines. I'm not at all happy about this prospect. If Rubio is nominated, it will also be a close election—but here I think the GOP has a realistic shot at winning.

Right now, the futures markets are giving the election to Clinton: A $100 share of the winner-take-all action costs $60 to $65 for those betting on the Democrats, compared to less than $40 for those picking the Republicans.

BP: Are these expectations having an impact on financial markets?

NH: Not much right now, because everyone assumes government will still be divided under any scenario. Therefore policy will remain in gridlock. What's scary is a possible replay of the 2008 election, when Obama and McCain debated each other just as global markets were plummeting and fear was spreading. Only this time let's imagine it's Sanders versus Trump, each one essentially asking voters to give them a sweeping mandate to move the nation in radically different directions while the fate of the economy, like a loaded gun, lies on the table. The heart races just to imagine the prospect.

BP: Finally, let's turn to generations. If you had to choose one noteworthy transition facing each generation in 2016, what would that be?

NH: I'll start with Boomers. It will be a landmark year for them in the economy: With the large 1946-born cohort hitting age 70 this year, we should finally see Boomers beginning to retire in force. Though most people retire well before then, Boomers have thus far surprised everyone by working longer than their parents. But due to heavy tax and benefit penalties on workers starting at age 70, even these workaholics will make their final exit from the workforce. And in each future year, another large cohort will follow. Up until now, America has been delaying the economic and fiscal burden of a slower-growing workforce.

No more delays. Now it hits.

BP: What about Generation X?

NH: One need only look onstage during the GOP debates to see the major storyline for Xers in 2016: This generation is finally rising to political prominence—and they are doing so almost entirely on the Republican side. Rubio, Cruz, Paul, and Christie are all Xers, all vying for the Republican nomination. And then there are those who never declared or dropped out, like Governor Scott Walker, Governor Nikki Haley, Governor Bobby Jindal, Senator Joni Ernst, House Speaker Paul Ryan...the list of rising Xers goes on and on. Many have immigrant backgrounds. Then look across the aisle to the Democrats, and you hear a lot more about candidates too old to be Boomers (Sanders, Biden, Brown) than too young. Only one Democratic Xer, Martin O'Malley, with precisely zero chance of winning the candidacy, has even mild name recognition.

Really, this wave of relative youth is an extension of a broader political trend. Whether in Congress or in state legislatures, Xers nationwide—especially first-wavers who were born in the 1960s and came of age with Reagan—are storming into GOP leadership positions. This generation almost single-handedly catapulted the GOP to its momentous takeover of Congress in 2014 and of many statehouses in recent years. (See CW: "Incoming Gen Xers Carry the Midterms.")

This could be the year that Xers finally take charge of the White House. Sure, President Obama is an Xer, but he's a fringe Xer, born in 1961. He digs hip-hop, came from a broken family, thinks of himself as a "post-Boomer" fixer. But when he moralizes to the American public, you sense the Boomer gene. Unlike Obama, the current crop of GOP candidates truly embodies the classic Xer temperament: survivalist, pragmatic, distrustful of large institutions, very pro-family, ready to tear down the system to build a better one, and basically libertarian in outlook.

Interestingly, this GOP "youth" movement could lead to a precise reversal of the age gap we saw in 2008. Back then, the GOP candidate (John McCain) was 25 years older than the Democratic candidate (Barack Obama). Now let's imagine that Marco Rubio (born in 1971) wins the nomination. That means that in 2016 the Democratic candidate (Hillary Clinton, born in 1947) will be 24 years older than the GOP candidate. So the tables are turned. I'm not sure what the GOP theme song would be, but I'm pretty sure it won't be Fleetwood Mac.

BP: And what about Millennials in 2016?

NH: I'm wondering—and I know I'm not alone—whether 2016 will be the year when Millennials finally show up in the economy. Up until now, most Millennials have kept their lives on hold, waiting for better economic prospects before checking the box on life's major milestones—settling on a career, buying a home, and starting a family.

But 2016 could be when we start seeing the tide turn. The gigantic 1990 birth cohort will reach 26 this year, precisely the age when young adults start becoming firsttime homeowners and impactful consumers.

Yet this prediction is not a foregone conclusion. Depressed household formation among Millennials, once thought to be a temporary effect of the Great Recession, has persisted years after young adults were supposed to start buying homes. Despite soaring rental prices and record-low interest rates, Millennials have opted to stay put where they are, either at home with Mom and Dad or in a shared apartment. In fact, the share of Millennials living independently today is even *smaller* than it was in 2010. (See SI: "Did You Know? Millennials Keep It in the Family.")

Another question is where Millennials will go—if anywhere—once they buy a home. This generation is unlikely to migrate out to the suburbs to one of the 40 million McMansions sitting vacant. They'll likely opt for something in the inner suburbs that affords them more space than an urban apartment without losing the distinct flair of city life. (See II: "The Housing Market's Slow Train to Recovery.")

BP: Anything else you'd like to mention?

NH: I'll close with this: Whatever happens, all eyes will be on Millennials in 2016. This could be a difficult year economically and a critical year politically. Whether as consumers or investors or voters, Millennials may have the power to determine where the nation is heading by the beginning of 2017.

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