

The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

1100 13th Street NW, Washington, DC 20005 • kiplinger.com • Vol. 92, No. 27

Dear Client:

Washington, July 2, 2015

The housing recovery will step up its pace heading into the second half of the year and beyond.

That's good news for the economy overall, and especially so for the scores of home builders, craftsmen, suppliers of building materials and others who rely on this key industry for their livelihood.

HOUSING

Through 2015, new-home sales will gain 22% from last year, when 440,000 such homes were sold. Existing-home sales will climb 6.8%, while new-home starts are poised to go up about 9%.

In 2016, sales of new homes will rise 23%. Sales of existing homes will top this year by 6%. We also see a 17% improvement in housing starts, with single-family homes accounting for the bulk of the gain: 25% growth vs. 2% for multifamily units.

Two groups of buyers are making a difference: First-time purchasers of existing homes, whose presence among all buyers rose to 32% in May from 29% last year. Their participation rate will tick up a notch by year-end and hit 35% by the end of 2016.

And people with less-than-stellar credit. More of them are able to secure home mortgage loans as lenders loosen credit terms. The percentage of Federal Housing Admin. loans given borrowers with credit scores of less than 640 is up from 8% in 2013 to 18% today. But general lending guidelines will remain strict...no repeat of the easy-peasy lending ways prior to the recession.

Lending requirements call for a debt-to-income ratio of no more than 45%. Debt includes outstanding student loans, car loans, credit card obligations, etc.







Higher rents are coaxing many first-time home buyers into taking the plunge. The stronger job market and climbing incomes give people more confidence to buy, especially in and around large urban areas where rents are increasing fastest.

Gradually rising mortgage interest rates also play a role. Many first-timers feel that now's the time to purchase a home to beat even higher rates down the road. We see the 30-year fixed mortgage rate rising from 4% now to 4.2% by year-end.

Note that many first-time buyers are a bit older than their predecessors. The recently sagging job market, looming student loan debt and other factors had led many millennials to delay marriage and home buying. That's changing now.

Several builders are moving to accommodate buyers of entry-level homes. For example, Meritage Homes, based in Scottsdale, Ariz., is ramping up construction of starter homes priced in the low \$200,000s. The company typically caters to more affluent buyers at an average selling price of nearly twice that amount. Pulte Homes, KB Home and D.R. Horton, the largest home construction company in the U.S., also report seeing more neophytes entering the ranks of home buyers.

ECONOMIC FORECASTS

	GDP growth 3.5%-4% in second-half '15; 2.5% for the year	
	Interest rates 10-year T-notes at 2.5% by year-end	NEW
	Inflation 2.1% in second-half '15, from 1.1% in first half	
	Unemployment 5.1% by end '15, from 5.3% now	
	Crude oil Trading from \$60 to \$65/bbl. by Aug.	
	Consumer confidence More jobs add to spending momentum	
Click here for exclusive, Web-only details of these Kiplinger forecasts		

**ECONOMIC
TRENDS**

We still think the Federal Reserve will raise interest rates in Sept.
But the mixed jobs report for June likely means that it will be the only hike for the year, with Yellen & Co. opting to wait and see the impact of the Sept. increase before raising rates further. Though the economy added 223,000 nonfarm jobs last month, signs also indicate that the labor market is not close to overheating, which will allow monetary policymakers at the Fed to take their time with rate hikes.

With oil prices appearing to have stabilized at around \$60 per barrel...
Spending by energy firms is beginning to perk up. Orders for drilling gear and other equipment ticked up in May and are likely to continue to increase.

We see investment by businesses overall expanding by 4% this year, but it will probably be late fall before managers loosen corporate purse strings enough to accommodate new spending. The continuing housing recovery will hike demand for a range of manufactured goods, from trucks to tools and industrial machinery. And with vehicle sales staying on a roll, with June sales topping 17 million annualized, automakers will maintain or expand capacity and upgrade factories as needed.

Social media sites are preparing a big push into online commerce. Facebook, Twitter, Instagram and the like will soon feature “buy” buttons that allow their users to purchase products online with a single click or swipe. Young users, in particular, view lots of merchandise on social media and favor the idea of one-step transactions. Online merchants stand to gain by paying fewer swipe fees to credit card companies. And advertisers will be able to tell if social media ads are netting sales, not just likes.

For firms selling online, picking the right site is key to reaching buyers. With about 71% of Internet users signed up, Facebook casts the widest net. Twitter and Instagram are closer to 25%. Smaller sites, such as Vine, boast far fewer users but draw lots of folks 18 to 24 years old. Pinterest users skew heavily female.

INVESTING

Every investor dreams of hitting a grand slam...investing in the next Apple, Netflix or Amazon.com, for example, while the company is still small and its stock relatively undiscovered. But many prospects fail to realize their promise, so investors who swing for the fences with small-capitalization stocks often strike out.

This is where a well-diversified exchange-traded fund can be a big help.
Consider iShares Russell 2000 Growth ETF, which tracks an index that comprises the faster-growing companies in the small-cap Russell 2000 index. Though Growth holds nearly 1,200 stocks, 51% are in health care and technology.

REGS

Uncle Sam is dialing up fuel economy rules for heavy trucks. Proposed rules would require truck makers to steadily improve the mileage of heavy pickups, vans, buses, delivery trucks, dump trucks and tractor trailers. The rules would kick in with 2018 models and gradually tighten...and include more vehicles...through 2027.

Large pickups and medium-size commercial trucks must improve the most, according to the proposal, with eventual mileage gains of up to 16% over models sold before the final rules take effect. The largest tractor trailers face less-steep mandates: Total efficiency gains of about 12%, including upgrades to both engines and trailers.

On the newly proposed changes to the Labor Dept.'s overtime regulation...
They would make about 5 million more workers eligible for overtime pay as the salary threshold needed for exemption is hiked to an estimated \$50,440 a year in 2016, when the rule is scheduled to become final. The current threshold is \$23,660.

But Uncle Sam stopped short of changing the “duties” test...for now. Employers fear the final rule will include a provision similar to a Calif. reg requiring that more than 50% of a worker’s time be spent on managerial duties or other overtime-exempt work in order for the position to be classified as exempt.

Odds are GOP lawmakers will seek to block funds to implement the moves.



ECONOMY

Entering its seventh year, how much life is left in this economic expansion?

The previous period of growth, which ended in 2007, lasted just six years before giving way to the worst recession in decades. But this time around...

The growth phase isn't slowing down just yet, despite its longevity.

In fact, odds are good it will reach the 10-year mark, a period of expansion seen only twice since World War II...from 1960 to 1970 and from 1991 to 2001. Slow to get started and hobbled by several factors...unusually high unemployment, a weak housing market, etc...the present recovery is only now hitting its stride. Most recoveries from a recession start out faster but also run into trouble sooner.

Many economic indicators are flashing green, signaling further growth in the years ahead. The housing market has found its footing, job growth is steady, consumer sentiment is positive, and high interest rates are still a long way off.

There are concerns, of course...the strong dollar's hit on exports, for one...

But none that look serious enough to derail this expansion anytime soon.

POLITICS

A hurdle for four GOP governors eyeing the White House: Their fiscal records from their gubernatorial terms. Republican presidential hopefuls must show that they are adept money managers and foes of tax hikes to win over the GOP base. But budget gaps and other snags will dog several candidates. Facing scrutiny:

N.J.'s Chris Christie. His decision to skip billions of dollars in payments to the state pension fund earned N.J. another credit downgrade...the ninth such cut since Christie took office in 2010. The state is on the hook for at least \$40 billion.

Scott Walker of Wis. Though he won some GOP fans for his successful effort to rein in state employees' collective bargaining rights, Walker has also drawn fire for missing a \$100-million debt payment to fill a budget hole. His controversial plan to help fund a new arena for Milwaukee's pro basketball team irks conservatives, too.

Ohio's John Kasich. His plan to raise certain state taxes while cutting others was nixed by Ohio's GOP-controlled legislature and could put off Republican voters.

And La.'s Bobby Jindal. He has blamed low oil prices for the \$1.6-billion gap in the state budget. Some La. Republicans are starting to question his tax policies.

IN THE STATES

Voters in several states will get to weigh in on legal marijuana in 2016. Calif., Mich. and Ohio will hold ballot initiatives next year on legalizing pot. Ariz., Maine, Mass. and Nev. might also. Alaska, Colo., D.C., Ore. and Wash. now allow weed for recreational use, and several states have moved to soften their laws against it.

Ballot measures on pot could drive young people and Democrats to the polls during next year's presidential election, which could loom large in states such as Ohio. Millennial voters support legalization at much higher levels than older groups do. But GOP voters are coming around on legal pot, too, especially for medicinal use. Cannabis oil, which shows signs of mitigating several illnesses and can't be smoked or otherwise used to get high, is already legal in 15 states...most of them red states.

State and local governments are scrambling to hire top technology talent.

Governments can't pay private sector salaries and benefits, and trained IT personnel are in short supply. So public agencies are offering other perks...flexible scheduling, faster promotions, more paid training gigs, etc. They're also recruiting more millennials to replace retiring baby boomers, pitching public IT jobs as a fulfilling career path. But state and local agencies will still have to lean on outsourcing and cloud services.

The biggest concern: Finding enough computer security experts. That skill is in very high demand as data thefts spread in both the public and private sectors. Sensitive government data is an increasingly attractive target of online espionage. Other challenging recruitment areas include app development and big data analytics.



TRADE

The Export-Import Bank of the U.S. isn't about to go out of business, even though Congress let its lending authority lapse at the end of last month. Though the bank, which provides credit to foreign buyers of U.S. goods and services in order to facilitate exports, won't be able to make new loans or loan guarantees, it will continue to service existing contracts, which currently run at \$100 billion or so. U.S. manufacturers, from giants such as Boeing to small firms, depend on Ex-Im aid when selling to overseas clients whose shaky finances might otherwise block the deal. Congress is sure to reauthorize new bank lending later this year, despite stiff opposition from tea partyers, who see the program as corporate welfare.

THE WORLD

Africa's economic future is brightening, now that the Ebola scare is receding and the global economy is revving up a bit. As a whole, Africa's economy will see growth rise 4.5% this year and a brisk 5% in 2016, from a 3.9% rate in 2014. Ethiopia and Uganda will set the pace in East Africa, while Nigeria will lead in the west. Other standouts include Egypt, Tunisia, Rwanda, Mauritius and Ivory Coast.

Industries showing the biggest potential for expansion: Agriculture. Farming accounts for about 25% of Africa's GDP, with plenty of room to grow. Africa is home to most of the world's remaining virgin farmland, and farm yields could double or triple with the right investment. Corn, cocoa and coffee are already substantial export crops.

Infrastructure. Spending on ports, roads, housing and wider electric service figures to fuel growth as investors rush to cash in on filling such basic needs.

Services. An expanding middle class in many parts of the African continent will increase demand for a variety of services...from tech and telecom to banking.

Europe is looking to rev up its digital economy. European Union officials are working on a plan to reduce the red tape that inhibits European Internet start-ups and holds back e-commerce across the EU's 28 different online markets. Currently, just 15% of Europeans shop online at firms based in EU nations other than their own. Officials think more Web commerce and more tech firms should be an economic boon, once the plan to streamline Europe's Web regulations takes effect, likely in 2016.

A more robust European Web also bodes well for American Internet firms, which will see more demand for online services as Europe's digital business grows.

One of the few groups that stand to gain from the chaos in Iraq: The Kurds, who are proving their mettle as fighters in the war against Islamic State militants, unlike the regular Iraqi military. The Kurdistan Regional Government in the north has held its own against ISIS with little help from Baghdad and is staking out borders for what could be a future independent Kurdistan...one with some very rich oil fields.

Expect calls for a full-fledged Kurdish state to get louder. Arming the Kurds is an increasingly popular idea in Congress, where faith in a unified Iraq is slipping.

An overlooked aspect of the financial mess in Greece: The security concerns for the U.S. and Europe. Greece is in no shape to hit its NATO defense spending goals, and risks drifting away from its Western allies. Meanwhile, evaporating border control opens a back door to Europe for Mideast migrants seeking asylum...and terrorists, too.

Yours very truly,

Knight/Kiplinger
THE KIPLINGER WASHINGTON EDITORS

July 2, 2015

P.S. Excel users: Save hours of time organizing your data by joining us on July 20 for a 75-minute interactive webinar on Excel's handy PivotTable function. Visit store.kiplinger.com/pivot_table.html to register for this informative session.