The Outlook for 2017: Moderate Improvement, but Risks Accompany Growth

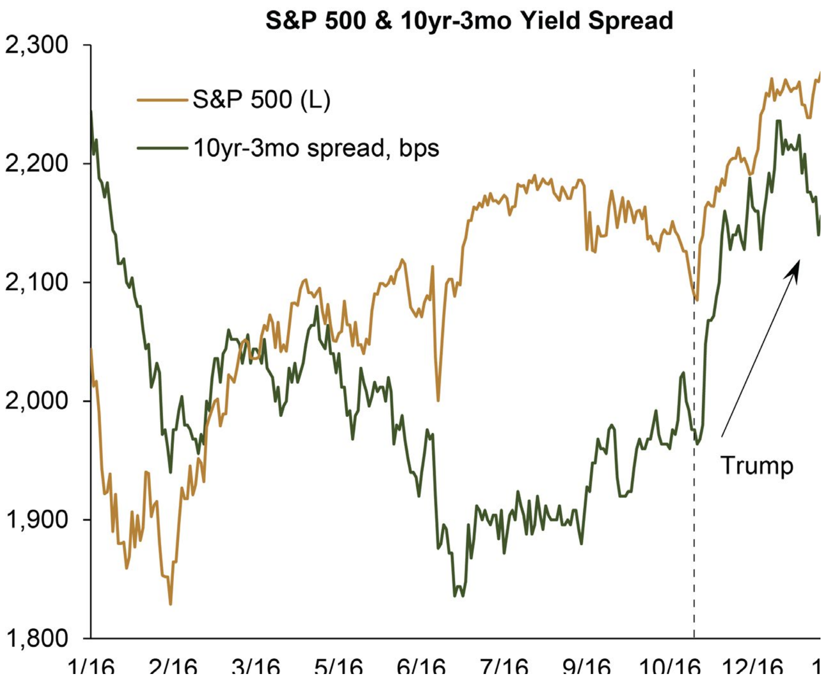
At the beginning of last year, we forecasted that 2016 would be "the eighth year in a row of sickly performance, and a continuation of the worst recovery since World War II." Unfortunately we were right, and even more unfortunately, it was even worse than we expected. But 2017 does in fact look better, and we expect GDP to grow 2.4% in 2017, significantly faster than the forecast of 1.6% for all of 2016.

Our more positive forecast stems from a string of recent improvements in the real economy that started before the election, the surge in consumer and business confidence that started after the election, and President Trump's pro-growth agenda.

Much of the recent data on the economy has taken a firmer tone. While the economy was barely creeping along in the first half of 2016, there were some significant improvements in the second half, all of which point to a stronger 2017. GDP grew at an annualized rate of 3.5% in Q3 - the highest in two years - after having drooled out a measly 0.8% in Q1 and only 1.4% in Q2. And the source of the growth in Q3 puts strong conditions in place to stimulate growth in 2017:

- Productivity rose for the first time in a year in Q3, increasing at a healthy 3.1% annualized rate.
- Investment, a key to future economic growth which had fallen for three consecutive quarters, gained 3.0% in Q3 and a very strong 10.7% in Q4.
- Real after-tax corporate profits finally turned positive on a year/year basis for the first time in six quarters, which (combined with positive investment) signal future growth.
- The services sector (80%-85% of the U.S. economy) as measured by the ISM services index is well into expansionary territory (above 50) at 57.2, and the critical "new orders" components rose a strong 4.6 points to 61.6 - the highest in 17 months.
- Construction, which had slipped earlier in the year, is now growing 4.1% y/y.

And all of that happened before the presidential election. While Donald Trump's victory has been politically divisive, his proposed agenda of tax cuts, increased government spending, and deregulation are definitively pro-growth. Since it may take some time for the plans to be fully implemented due to the practical matters of governing, we don't expect these measures to contribute to GDP growth until later in 2017. But the expectations of those plans have already started taking effect, having kicked in immediately after the election. Business optimism has risen sharply as the stock market continues to set new highs. The S&P 500 has risen over 6% since the day before the election, the equivalent of a staggering annualized rate of 34%. That optimism could unleash much-needed investment that could provide a quick boost to the economy. Consumer confidence, as measured by the Conference Board's survey, also leapt after the election, gaining a total of 12.9 points in November and December to a very strong 113.7. That's the highest level of the entire recovery and the highest in over 15 years. Since consumer spending accounts for 70% of all economic activity, there could be a positive effect on the economy early in 2017. Finally, the yield spread between the 3 month and 10 year Treasury securities has widened, signaling increased confidence that growth will remain robust for at least another three to five quarters.

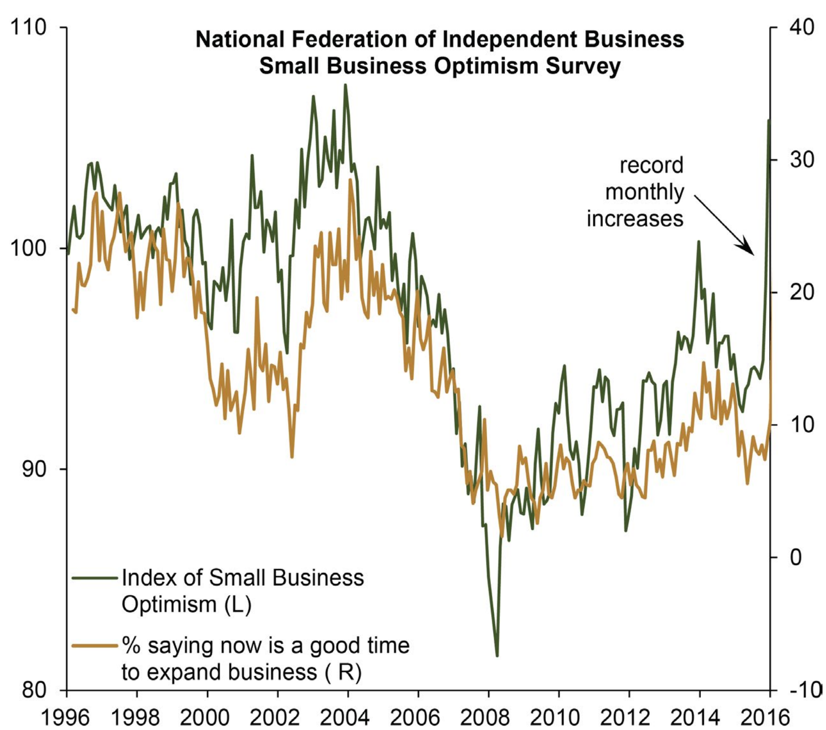


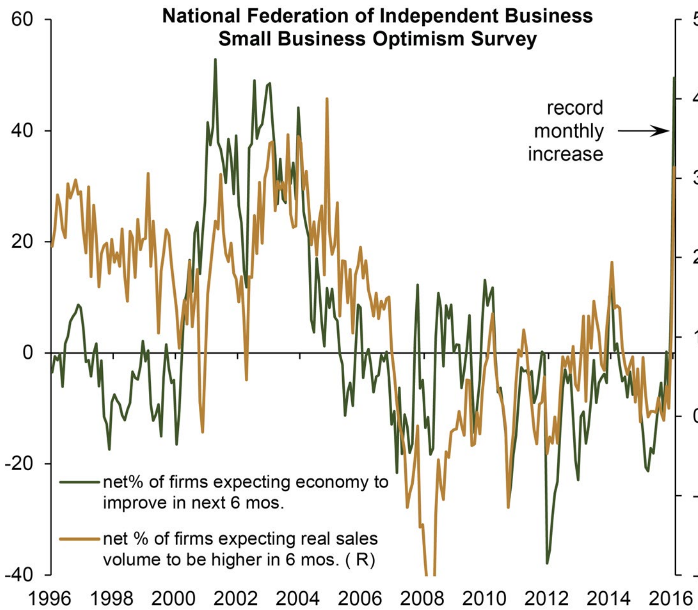
It occurs more frequently than one would think. According to Forbes "The biggest challenge... for fast-growth companies is that their accounts receivable run faster than their sales or their ability to collect… the company's growing, they're even profitable, but because they're not collecting their accounts receivable quickly enough they go out of business…" American Express writes "The ebb and flow of cash in, cash out gets more complicated as you grow. It doesn't take much growth before your monthly expenses exceed your operating credit…"

And right now, small businesses are very eager to grow more rapidly. The National Federation of Independent Business (NFIB) Index of Small Business Optimism skyrocketed by a record monthly amount in December to the highest in 12 years. Within the survey, the percentage of firms saying now is a good time to expand their business also leapt a record monthly amount to the highest in over 11 years. The net percentage of firms expecting the economy to improve also rose a record monthly amount to the highest in almost 15 years, and the net percentage of firms expecting higher sales rose to the highest in over 11 years. While the sudden desire to grow rapidly is certainly welcome in a sluggish economy, small businesses may be unaware of the risk of bankruptcy that accompanies that rapid growth.

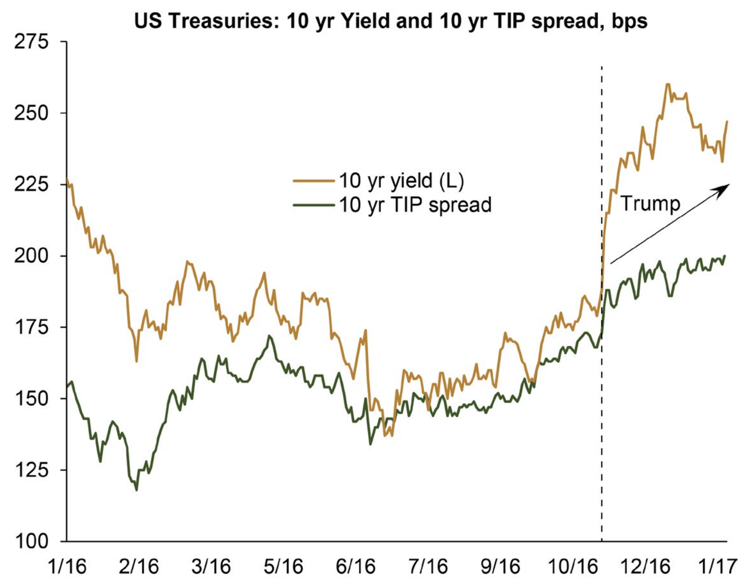
GROWTH BRINGS SIGNIFICANT RISKS

But the rapid growth that could result from Trump's proposals comes with risks. Paradoxically, businesses undergoing rapid growth are more susceptible to bankruptcy. As a company's sales accelerate, so do the expenses of producing those sales. If those expenses accelerate faster than the outstanding accounts receivable (A/R) are paid, the company finds itself in a negative cash flow situation, and it goes bankrupt. For example, say a company has $500 in A/R outstanding this month from previous sales. But sales are increasing rapidly to $800 this month, and it cost $600 to produce those goods. $600 is going out the door, and $0 is coming in until those outstanding ARs are paid, meaning that the company may not have enough money to pay its own bills – bankruptcy.





source: IHS, NFIB, Euler Hermes



source: IHS, Fed, Euler Hermes

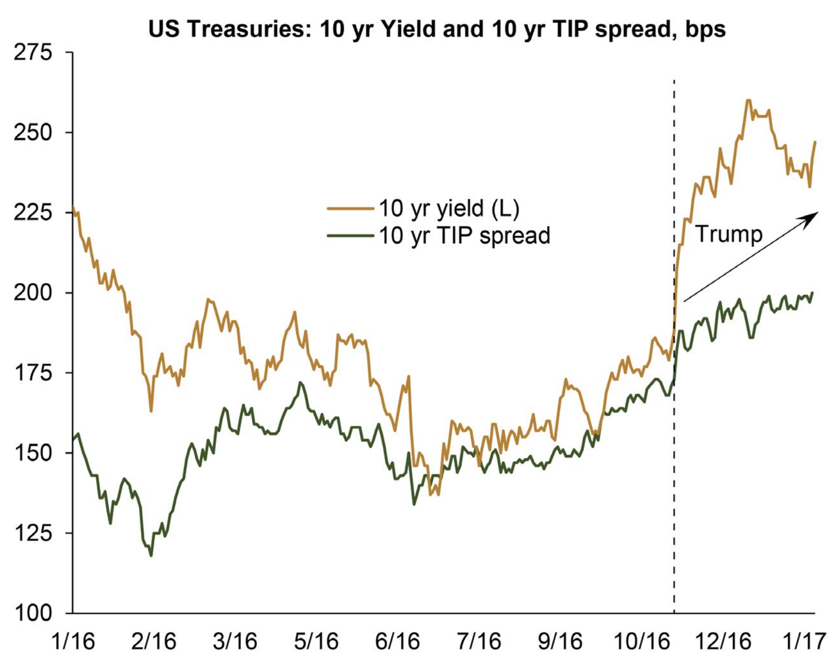
On top of the risks of small business bankruptcies, business bankruptcies of all sizes are placed at an additional risk by some of Trump's proposals. His plans to cut taxes, increase spending, and curb trade and immigration are already increasing inflationary expectations and driving up interest rates. Inflationary expectations can be measured as the difference in yield between a normal Treasury note and a Treasury note that is Inflation Protected (TIP). The TIP spread on the 10-year Treasury note has gone from 1.73%, or 173 basis points (bps), to 200 bps since the election. The yield on the 10-year note itself has soared from 188 bps to 250 bps over the same time period.

Higher interest rates make financing more expensive and can lead to increased bankruptcies. In fact, as shown in the Bankruptcies vs. Interest Rates chart below, the link between interest rates and bankruptcies is quite strong. In particular, note the upturn in rates in Q4-16. If that trend continues, bankruptcies would tend to rise, and it would occur at a time when the amount of private sector credit outstanding is near record highs.

There are other risks to Trump's proposals. His plans would not only raise interest rates, but they would also increase government debt. That debt would then have to be rolled over at higher rates, further straining the budget. Higher interest rates would also drive debt prices down, posing a risk to creditors who hold that debt. Finally, if a trade war were to break out, it could cause significant damage to the global economy. Outside of the Trump plans, there are other impediments to more rapid growth including problems with seasonal adjustments that appear to underestimate GDP growth in the first quarter of every year, an aging workforce with inadequate skills, and a still reticent consumer.

WHAT THIS MEANS FOR YOUR BUSINESS / WHAT TO WATCH FOR

Despite the risks, the negatives are surely outweighed by the positives in 2017. Improvements in productivity, construction, investment and profits will all contribute to growth next year. The stable services sector will provide a



source: IHS, Fed, Euler Hermes

firm foundation for 2017 as well. And on top of all that, the pro-growth measures of the Trump plan will give the economy a boost along with the soaring consumer and business confidence it has already inspired. It's clearly a more hopeful outlook.

But beware that rapid business expansion and rising interest rates do carry an increased risk of bankruptcies. If a small customer starts to suddenly ramp up orders, it may be growing too fast, and it could go into negative cash flow and be unable to pay its vendors back. A sure sign that a company is expanding too fast is that it stops paying its bills on time, and if it continues, bankruptcy may be next, leaving trade creditors at a loss. A trade credit insurance policy can help mitigate against this risk as well as provide protection against slow payment.

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