

The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

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Dear Client:

Washington, June 30, 2017

At midyear, how is the economy doing?
And what does the outlook hold for 2018?

U.S. ECONOMY

Expect GDP growth to remain lukewarm, clocking in at 2.1% for the year as a whole. Economic activity is picking up after the slow start to the year, but the pace is gradual and uneven.

Consumers will still power the economy with their spending. Unemployment will stay low, and most households' finances are in decent shape. Rising home and stock prices make folks feel richer, and thus willing to spend. Credit card use is up.

But shoppers are showing signs of fatigue, as job creation slows and wage gains remain modest.

And some industries will flag as a result.

Among them: Autos, retail and restaurants. After hitting a record in 2016, car sales will pull back. Demand is easing, and used cars are piling up on lots. Overall retail spending will grow, but not by enough to prevent many brick-and-mortar stores from closing. Spending on meals out will log only minor increases.

Some economic headwinds aren't letting up.

Many firms will continue to struggle to find enough skilled workers to fill high-tech and health care positions. Productivity growth will remain sluggish.

State and local government spending won't rise much. Government spending has typically helped lift GDP growth. But now, governors, mayors and legislators are going easy on spending increases as they face weak growth in tax collections.

And low oil prices threaten to derail the recent uptick in drilling activity, sapping demand for pipe, drilling equipment and other gear supplied by U.S. factories.

The biggest bright spots for the economy: Home building, which will go strong for the foreseeable future as builders rush to meet demand, and home prices increase.

Exports, aided by a strengthening global economy and a slightly softer dollar.

Manufacturing, which, aside from energy and automotive sectors, will do OK.

Next year may see growth tick up moderately if Congress passes tax cuts or other fiscal stimulus by late 2017 or early 2018. In that scenario, GDP growth could reach 2.4% or so. Otherwise, expect another year with growth stuck near 2%.

We think a modest tax cut...not major tax reform...is more likely than not.

One economic wild card to watch closely: The direction of interest rates.

The Federal Reserve figures to keep nudging up short-term rates this year and next. Yet yields on long-term bonds declined recently. So far, that appears to be a bet by bond investors that inflation will remain low, not that the economy is in trouble. If yields go on to sink further, that will be a warning that growth is sputtering.

ECONOMIC FORECASTS

GDP growth

2.1% for '17,
versus 1.6% for '16

Interest rates

10-year T-notes up to 2.4%
at the end of '17

Inflation

1.6% at the end of '17,
down from 2.1% in '16

Unemployment

Ending '17 at 4.3%,
same as now

Crude oil

Trading from \$40 to \$45/bbl.
in Sept.

Business spending

Up 3%-4% in '17 after flat '16,
aided by higher exports

Complete economic outlook at
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**GLOBAL
OUTLOOK**

More good news is on the way for Europe's economy. The past six quarters of GDP growth among the 19 countries that use the euro outpaced forecasts and were ranked the strongest since the Great Recession. Europe's GDP expansion for 2017 will tally a solid 1.7% and should maintain its momentum through 2018.

Still, the European Central Bank will be slow to tighten its monetary policy. The ECB is committed to buying 60 billion euros per month of assets through 2017 to inject credit into regional economies and fight against persistently low inflation.

And threats loom on the horizon. Europe's growth is uneven, for instance. It's strong in Germany, France and Italy, but weak in Latvia, Lithuania and Portugal. Also, protectionism is on the rise, credit remains tight, and banking reform is needed.

TRADE

The Trump administration is mulling new restrictions on imported steel, citing national security threats posed by an overreliance on imports.

About 30% of steel used in the U.S. last year was imported, up from 23% in 2009. But new tariffs could violate international trade rules and spark retaliation. Plus...

Restrictions would cause an outcry from U.S. allies, including Canada, South Korea, Mexico and Japan...among the largest suppliers of steel to America. The U.S. already has restrictions on Chinese steel, so any new ones would hit allies. Domestic steelmakers, battling global competition, would welcome new protections.

Also in the crosshairs: Aluminum imports, raising alarm from some buyers that say domestic supplies aren't enough to meet demand or lack necessary quality. Manufacturers that use aluminum want some imports excluded from new tariffs.

INVESTING

With markets still high despite this week's dip, are there any bargains left? Note these seven cheap stocks that are well-positioned for faster growth through new business strategies, according to *Kiplinger's Personal Finance* magazine.

Cenovus Energy is a highly regarded high-tech energy firm that extracts oil from Canadian tar sands. Few energy stocks have been harder-hit by a sector sell-off. A big bet to buy tar sand assets from ConocoPhillips for \$13 billion could pay off.

CVS Health has 9,600 retail outlets and a huge pharmacy benefits business. Its share price is about one-third below its 2015 peak of \$113, but the drugstore chain has ample free cash flow to both battle growing competition and invest for the future.

Delta Air Lines is facing higher labor and fuel costs, while its share price has been stuck for two years. But the airline has a promising mix of healthy finances, cash generation and long-term growth, plus a tempting price-earnings ratio of just 10.

Nike, the shoe and clothing giant, has a plan to overcome retail headwinds: Speed up development to get shoes to market faster and offer more personalization. Despite a recent jump, the stock is still below its 2015 high and looks like a bargain.

Shire is an Irish pharmaceutical giant and a leader in treating ADHD... attention deficit/hyperactivity disorder. The company's share price fell dramatically after it bought Baxalta for \$32 billion in 2016, but its stable of drugs is promising.

Tenneco is a sprawling conglomerate that spans energy to auto parts. Global regs will ratchet up demand for its emission controls and suspension systems.

Tesoro Corp. is a giant U.S. refinery that also owns 3,000 retail gas stations. Its access to low-cost crude via 10 refineries gives it a solid spot in the energy market.

On tap for emerging markets investors: More domestic Chinese stocks. Index provider MSCI said it will add 222 Chinese companies, worth over \$2 trillion, to its emerging markets benchmark, ranging from Bank of China to Tsingtao Brewery. China has been lobbying MSCI for years to include its domestic stocks in the index.

An estimated \$18 billion of foreign capital could pour into Chinese companies after MSCI adds the shares in mid-2018. While China opens financial markets to more foreign investors, concerns remain about corruption and lack of liquidity. Still, there's mounting demand to own parts of China's fast-growing service economy.



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POLITICS

Despite calls from within her own party that it's time to step down... House Democratic leader Nancy Pelosi isn't going anywhere anytime soon.

Pelosi has been the chamber's top Democrat since 2003, but she's taking heat from a handful of colleagues who say the San Francisco lawmaker is a liability in centrist districts, citing the recent loss in the Atlanta-area special election.

Republicans are happy to paint Pelosi as an out-of-touch, far-left liberal when tying her to Democratic candidates. President Trump is weighing in, too, saying he hopes she stays because she's such an easy target to beat up on.

But Pelosi has staying power, surviving a tough 2016 leadership election. The challenge came from Ohio's Tim Ryan, 43, who won one-third of the caucus by appealing to noncoastal members. Pelosi, 77, still has no heir apparent.

Retirement isn't in the cards before 2018. Pelosi wants to stick around and see if Democrats can win back the House so she can retake the speakership.

ENERGY

Bipartisan bills raising the ethanol content of gasoline face an uphill climb.

Currently, most retail outlets can't sell gas containing more than 10% ethanol during summer because of ozone emissions. Two recent bills would OK summer sales on gasoline with higher ethanol blends, increasing the ethanol limit from 10% to 15%. The 15% blend is several cents cheaper per gallon than the 10% blend. Since demand would rise for corn-based ethanol, the farm industry backs the move. The oil industry, meanwhile, is fighting back to avoid taking a significant hit on summer gas sales.

THE STATES

Note these state laws taking effect July 1 that are sure to affect businesses.

A new tax on online transactions in three states, Ind., Minn. and Va.

The laws will require out-of-state sellers to collect sales tax on online purchases. Ind. and Va. call for taxes after \$100,000 in yearly sales. A legal challenge is pending.

Nev. will roll out a new fiduciary standard for all financial planners, similar to the recent federal rule. Financial planners and brokers will be required to alert clients about any compensation they might receive for investment advice. With uncertainty surrounding the federal rule, other states are looking to follow Nev.

Ind. is blocking localities from enacting "ban the box" ordinances... laws that prohibit employers from asking about an applicant's criminal history during the hiring process. It's the first state law to block the growing movement.

The Hoosier State will also bar direct sales from carmakers to consumers.

But Tesla gets an exemption to continue the practice. Ind. joins Ariz., Md., Mich., Texas and Va. with a law that bans direct sales. The ban helps protect jobs at dealerships. Ind. excepted carmakers licensed before July 2015, which Tesla was.

TELECOM

Uncle Sam is looking for ways to improve internet service in apartments and other multitenant buildings, such as malls, condos and college dorms.

The Federal Communications Comm. is scrutinizing rules for the telecom contracts that owners strike with web providers and even mulling preempting local regulations.

Building owners should monitor the action, since it may affect who is allowed to install telecom services. Small telecom firms want the FCC to prevent a free-for-all on telecom wiring inside buildings, which they say harms long-term investments and service quality. Google is a leading voice arguing for easier access to properties.

IMMI-GRATION

America's northern neighbor is boosting efforts to lure foreign talent.

Canada figures it can capitalize on tougher U.S. immigration policy and surveys showing foreign students are down on the U.S. Among Canada's moves: Touting cheaper tuition, waiving application fees and improving student retention.

While Canada is a prime example, expect other countries to follow suit.



BENEFITS

In a big push to retain and attract the best and most talented workers...
Employers are bolstering benefit packages, ranging from health care and personal finance advice to teleworking arrangements and relaxed dress codes.

Topping the list: Wellness and other health-related benefits. HSAs... health savings accounts...which allow employees to save money on a tax-free basis for qualified health care costs, are on the upswing. And telemedicine services are also quickly gaining traction to let workers access doctors via digital devices.

Believe it or not, more and more workers want to stand while they work, prompting employers to install so-called standing desks. Extended periods of sitting are increasingly cited as contributing to obesity, heart disease and other health issues.

Among other new popular company perks: Identity theft protection.
The benefit addresses growing concerns about hackers accessing online accounts.

CONGRESS

No chance the nation's air traffic control system will be privatized when legislation to reauthorize the FAA...Federal Aviation Admin... finally passes. Congress is running out of time, as the current law expires Sept. 30. Expect a short-term extension for three to six months before the final bill is passed. While major airlines support privatization, others, such as private pilots, oppose it.

But note other airline reforms affecting fliers that will eventually take hold:
Official bans on in-flight cell phone calls and on bumping travelers who have boarded. Also, a quick-refund rule for add-ons fliers buy but don't get, such as early boarding.

TECH

Given the intense interest in the commercial use of drones by Amazon...
It won't be long before the mechanical buzzards are seen all over the skies in your neighborhood and elsewhere. Amazon's autonomous drones, guided by GPS, can fly at heights of up to 400 feet at speeds of up to 50 miles per hour, carrying items that weigh up to five pounds. The company is working on beehive-like towers to take the place of conventional warehouses for deployment of delivery drones. Look for the U.S. Patent and Trademark Office to OK the "beehives" before long.

Wish you could easily repair electronics and other items by yourself?
You're not alone, and now there's a "right to repair" movement under way among all sorts of techies, including farmers using high-tech agriculture equipment. Over the years, manufacturers have made it harder for folks to fix stuff at home. Moreover, electronics firms are wary about releasing info for do-it-yourselfers. Of course, repair work is also lucrative for manufacturers and outside repairers. Apple alone, for example, earns up to \$2 billion per year from fixing iPhones.

At least 15 states are mulling so-called fair repair bills to help consumers.

GAMBLING

OK, we know it's silly to handicap the 2020 presidential race this early.
But that's not stopping two of Europe's biggest legal betting houses from laying early odds. Both British-based Ladbrokes and Ireland's Paddy Power give President Trump 2-1 odds to win reelection. Vice President Mike Pence comes in second, and Democratic Sen. Elizabeth Warren of Mass. is the third favorite. Feeling daring with your betting money as the holiday approaches? At Paddy Power, actor Dwayne "The Rock" Johnson is 25-to-1 and actor George Clooney is 100-to-1.

Yours very truly,


THE KIPLINGER WASHINGTON EDITORS

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JUNE 2017 ■ IDEAS TO ACT ON NOW

How to Hide Your Online Footprint

New privacy rules approved by the Federal Communications Commission last October would have barred internet service providers, such as Verizon, AT&T and Sprint, from collecting and selling information about your online activities without your consent. Congress voted to repeal the changes before they took effect, so technically, nothing has changed. But privacy advocates worry that the rollback will encourage ISPs to ramp up efforts to sell customers' browsing history to advertisers and third-party data brokers. If you're concerned, check an ISP's privacy policy. Some, such as Verizon, allow you to opt out of having your information collected and sold. When searching for information you'd prefer to keep to yourself, make sure the website you're visiting is encrypted to block the ISP's ability to view what you're reading or posting. You'll see a small lock in front of the address, followed by *https*. For more-comprehensive protection, consider installing a virtual private network, which sends your internet traffic through the VPN's servers, so an ISP can't see the domain name you're visiting.

IRS Audit? Now What?

The IRS's individual audit rate was 0.7% last year, or one out of every 143 returns. And the bulk of the reviews were correspondence exams done by mail, usually focusing on one or two issues. But these statistics are no comfort if you're one of the unlucky few who receive an audit notice from the IRS. Here are some tips if you do get such a letter: Don't panic. Make sure you're prepared. Pull together records to support the numbers you reported on your return, and try your best to reconstruct missing documents if you have some gaps. Organize your records—don't bring in a shoebox full of receipts. Consider contacting a tax professional to go along with you or to go in your place. See kiplinger.com/letterlinks/auditprep for even more tips on handling an IRS audit.

The Best Bank for You

Some banks and credit unions are making all the right moves to win satisfied customers. To identify the crème de la crème, *Kiplinger's Personal Finance* is introducing its list of best banks and credit unions in the United States. Among national banks, TD Bank and U.S. Bank tied for the top spot. The credit union winner is Langley Federal Credit Union, which anyone can join by paying a fee of as little as \$5 to one of several Virginia causes. Ally Bank takes first place among internet banks. We also selected the best bank in each of four regions: People's United Bank in the East, Flagstar Bank in the Midwest, Trustmark National Bank in the South, and Bank of the West in the West.

Alphabet Soup

Mutual funds are introducing two new share classes in response to the Department of Labor's fiduciary rule, which requires brokers to act in their clients' best interests. Investors who work with brokers have traditionally purchased a load fund's Class A shares and compensated the brokers by paying front-end commissions. Investors in A shares also paid annual 12b-1 fees to provide additional, ongoing compensation to brokers. In part because the charges vary widely with the type of fund, the DOL decided that the traditional fee structure poses a potential conflict of interest. A broker may recommend a fund type with a higher fee, even if a fund more appropriate for the investor is available. A new share class, called T shares, sets the load and 12b-1 fee at a uniform 2.5% and 0.25%, respectively, across all funds and firms.

T shares, however, may be a transitional solution because they still rely on a commission-based pay structure. That's where "clean" shares come in. Some firms that typically charge loads will issue shares free of both loads and 12b-1 fees. Advisers will still charge for advice. But that charge will be separate from your purchase of shares, giving you a clearer picture of what you're paying for.

Surviving Amazon

Despite competition from Amazon.com, warehouse club Costco Wholesale (symbol COST, trading at \$180 as of May 31) is flourishing with a surprisingly effective way to keep Amazon at bay: selling food. In fact, 80% of Costco's customers go to its cavernous stores specifically for groceries, according to a recent survey. Amazon is pushing into the food business with its grocery delivery service, Fresh. But Costco may still beat Amazon's prices because shoppers who buy in bulk at Costco get deep discounts. Plus, Costco offers a grocery delivery service through Instacart.com. And Costco sells things you still can't find on Amazon. Costco's stock trades at 30 times estimated year-ahead earnings, well above the stock market's overall price-earnings ratio of 18. But analysts argue Costco deserves a rich valuation because it's one of the few retailers that can thrive in the age of Amazon.

Your Rights on Flights

The airline industry is still dealing with the repercussions of an April incident in which a United Airlines passenger involuntarily bumped from a flight was dragged off the plane by airport security. If you're involuntarily denied boarding, the airline must offer an alternative that's scheduled to get you to your destination within one hour of your original arrival time or compensate you according to federal rules. The airline is required to pay you twice the price of your original one-way fare, up to \$675, if your arrival is delayed between one and two hours for domestic trips or one and four hours for international travel. If your arrival is delayed longer, the airline owes you four times the price of your one-way fare, up to \$1,350.

Don't Forget This Tax Bill

Do you have someone helping around the house as a nanny, housekeeper, gardener, or caregiver for a child or perhaps an elderly parent? If so, you're likely an employer in the eyes of the IRS if you hire the person yourself and control how the work is done (rather than being assisted by someone who is self-employed or works for an agency). The so-called nanny tax applies if you pay a household employee more than \$2,000 in wages during the year. In that case, at tax time you'll need to include a Schedule H with your return and pay the 15.3% Social Security and Medicare tax on the wages you paid. Plus, if you pay more than \$1,000 to an employee in any calendar quarter of 2016 or 2017, you'll also owe the federal unemployment tax—and you'll probably owe a state unemployment tax, too.

Claiming Residency for State Taxes

If you buy a second home in another state, you may be able to count it as your residence, saving you money if the new state has a lower state income tax. But in general, you need to be able to prove that the low-tax state is your permanent home. For starters, you need to spend more than 183 days in the state you claim as your domicile. It's a good idea to keep a diary or log showing the number of days you spend in each state during the year. Register to vote in your new state and, if you receive a jury summons, perform your civic duty. Apply for a library card, and change your driver's license and car registration. Open an account at a local bank, and keep receipts of ATM withdrawals.

Principles and Profits

Few mutual fund operators combine principles and performance with as much success as Parnassus Investments. We think highly enough of one of its funds, Parnassus Mid-Cap (PARMX), to include it in the Kiplinger 25, the list of our favorite funds. All Parnassus funds shun companies that manufacture weapons, make alcohol or tobacco products, are involved in gambling or nuclear power, or conduct business in the Sudan. Companies that make the cut are assessed on five core principles: environmental impact, corporate governance, innovation and employee friendliness, community engagement, and treatment of customers. Analysts also look for firms that have a competitive advantage, offer products and services that are becoming more relevant to customers' daily lives, and that have strong management.

Roth IRA Losses

Gains and losses inside IRAs are ignored by the IRS. So if you have poorly performing investments inside your Roth IRA, you can't deduct the loss on your return. However, if you close all of your Roth accounts, including those with gains, you might be able to get Uncle Sam to help shoulder the loss. If the total recovered is less than your tax basis in the accounts, then you can take the loss as a miscellaneous itemized deduction on Schedule A to the extent the loss exceeds 2% of your adjusted gross income. Your basis in the Roth is the total of all contributions plus any converted amounts.