Best Ideas – Testing the Limits of Central Banks

April 2019

As of eleven years ago, developed nations were in distress with the collapse of several major financial institutions and a freezing of the commercial paper market. The response was the massive intervention of central banks which not only provided liquidity, but also financial support to the chock points of the financial markets. The biggest surprise to many economists was the muted effects of the massive quantitative easing (QE); many had predicted a jump in inflation and a flight from currency into gold, neither of which happened. A major and lingering impact was actually the exact opposite, that is deflationary conditions which have been manifested in negative interest rates throughout the EU (more on this later). The reason why we focus on QE is that it is with us again. Despite no evidence or threat of a recession let alone the threat of a depression, the ECB announced a reversal of its short-lived hiatus from QE and will start shortly start creating money to purchase assets. This is a massive sea change that has all but been ignored by the media. For those attentive investors, the message is clear: the ECB will engage when there is but a whiff of a slowdown. Turning to the US, the latest news is Mr. Kudlow's announcement that the FED should cut rates. Assuming our analysis is correct, there are numerous implications to the stance the central bankers are taking, and we will attempt to address some of those implications (hint: there is no "free lunch").

Bolstered Credit Quality - At a time when most citizens are obsessing about paying their hard-earned cash into the treasury, some central banks, such as the ECB are not waiting, and are stoking up the printing presses. Whether directly (in the case of the ECB and the BOJ) or indirectly in the case of the FED and the BOE, fixed income (and other) assets are benefiting via the suppression of interest rates and the incentive to go out on the risk spectrum. Hence, both the probability of default and the loss given default levels are muted. Despite concerns about the attenuated length of the current credit cycle, the cycle appears likely to be more attenuated as a result of the support provided by the central banks.

Suppressed Funding Costs – the massive and continuing QE has the impact of suppressing interest rates and bolstering weaker credits (is not that the intent?) and over time, this unnatural state of affairs is having massive impacts. First, those who depend on a spread between assets and liabilities are being eviscerated. The most recent example of this condition is Deutsche Bank, which as of a decade ago was THE powerhouse bank in Europe and now is debating whether to undertake a merger and yet ago issuing additional stock just to survive. May of the UK banks have obtained government capital and the French banks remain challenged. Other institutions such as pension funds have unrealistic return hurdles and have or will be forced to adjust.

Bloated Debt – as can be seen on the below graph, debt has grown [to the point that __]. Perhaps of greatest concern is the level of sovereign debt with Japan taking the lead at a debt to GDP level of 214%:

Japan	214%
Greece	173%
Italy	151%
Portugal	142%
United Kingdom	112%

Source:https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/visualizing-global-debt

Elaborating, per McKinsey, Global debt has grown from $97 trillion to $169 trillion since the crisis but has been stable relative to world GDP since 2014.

Possible Outcomes – the problem with debt, particularly at high levels, is that it exposes parties to rollover risks. For example, the reason why the federal government stepped during the 2008 credit crisis to backstop the money markets was because GE had difficulty rolling over its commercial paper. Regarding some of the sovereign exposures, Italy, with a debt to GDP of 151%, probably cannot repay its debt; the interest on the country's debt is nearing 2% of GDP and the country's deficit is hard to sure. A likely outcome is the ECB purchasing the debt and over time, not counting it as "debt".

Figure I: Summary of EJR Economic Expectations

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	+.5%	+.5%	+2.5%	+3.0%	+3.%
Currency Values	Decline	Decline	Slight Rise	Mixed	Mixed
Stimulus Change	Stable	Little change	Decelerating	Some Growth	Little change
Earnings Trend	Slight Growth	Flat	Slight Growth	Slight Growth	Growth
Interest Rates	Low	Little Change	Little Change	Little Change	Varied
Asset Valuations	Slight Growth	Flat	Varied	Varied	Slight Rise

Regarding interest rates, they appear to be bouncing around on a quarterly basis with little long-term direction. The EU countries and credits cannot afford significant increases in rates. The periphery EU countries are likely to see continued pressure because of increased credit quality concerns.

Figure II: Rising U.S. rates, Japan and Europe emerging periphery credit concerns

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%)
United States	2.30	2.6	2.48	2.8	2.88	3.05
Germany	-0.43	0.05	-0.03	0.50	0.62	1.10

Italy	1.50	1.60	2.51	3.2	3.49	3.52
United Kingdom	0.74	1.23	1.04	1.65	1.59	2.05
Japan	-0.19	0.03	-0.08	0.20	0.52	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.12	1.20
Yuan to Dollars	6.71 $/RMB	6.8 $/RMB
USD-JPY	111.25	110
GBP-USD	1.31	1.35

Regarding various industries, below is a summary of some of the major developments:

Deteriorating:

Below is our summary of the major industries:

Deteriorating:

Agriculture Prices/Ag Chemicals –Volatile agricultural commodity prices are likely to be tied to: i) low farmer income; ii) commodity oversupply; iii) low fertilizer cost; and iv) industry consolidation. Any improvement in the US-China trade relationship is a materially bullish risk factor for agri markets.

Airlines – The economic recovery and effective capacity management have helped. Earnings season largely assuaged concerns related to the government shutdown as well as potential capacity creep and near-term demand trends. Jet fuel prices are crucial for airlines, accounting for some 20-25% of airlines' cost structure.

Beverage – This slow-growth industry is in a weak spot. Specifically, rise in tariffs is weighing on U.S. whiskey exports. American whiskey exports slumped in the second half of 2018, taking a blow from higher duties by the country's trading partners following Trump's tariffs on steel and aluminum imports.

Health Insurance – The DOJ submitted a two-sentence letter to the Fifth Circuit Court announcing that it now thinks the entire ACA should be thrown out. Recall that back in

December, Judge Reed O'Connor ruled that eliminating the Individual Mandate penalty renders the entire ACA framework unconstitutional.

Retail – Amazon (and other internet giants) will destroy margins for any industries involved in selling goods, and over time, services. U.S. retail sales recorded their biggest drop in more than nine years in December as receipts fell across the board, suggesting a sharp slowdown in economic activity at the end of 2018. By the end of March 2019, retailers - including Dollar Tree, Abercrombie & Fitch, Kohl's, Gap, J.C. Penney, Victoria's Secret and Tesla - have already announced 4,810 store closures in 2019.

Media – Netflix, other internet distributors, and non-traditional media outlets continue to dis-intermediate traditional media providers and cable firms. Rising competition and increasing programing costs are key factors to watch out for.

Metals and Mining – Some have been given a reprieve as a result of increased demand, rising prices, and expectations of a more amenable regulatory environment. China's official manufacturing PMI (China PMI) reading for March, will be a key data point for global risk assets and metals markets.

Power Generators – This industry faces a triple threat: 1) tighter margins (revenues are often tied to the price of natural gas), 2) more burdensome regulations (i.e. the new federal carbon limits), and 3) reduced demand as a result of solar and wind generation as well as LED lighting and efficient appliances. Pres. Trump's pledge to revive the U.S. coal industry and roll back Obama-era restrictions on emissions – is too late for many companies.

Restaurant Industry - We see an elevated discounting / promotional environment which coupled with rising food inflation will weigh on the margins. We do expect momentum to improve across the casual dining category in terms of foot fall. Supply/demand imbalance, potentially waning pricing power, labor challenges at the store level are the primary issues facing the group in 2019.

Poland/Hungary - European Union's regulatory arm proposed a new method for distributing regional aid under its first post-Brexit budget, shifting part of the funds from eastern Europe to countries in the south of the continent that face unemployment and migration challenges. Funds for Poland would shrink to €64.4 billion compared with almost €84 billion in the 2014-2020 fiscal plan, while Hungary would see a decrease of around 24% to €17.9 billion.

Argentina/Turkey - Erdogan has made Turkey the sick man of Europe again. Confidence in Turkey's economy has managed to inch up in February, up 1.2% MoM, up from 78.5 in January. But the Turkish lira has declined 4.1% in early March against the U.S. dollar after the nation's central bank unexpectedly tightened its monetary policy. Argentina's economy suffered its worst shrinkage during the tenure of President Mauricio Macri. Argentina's GDP fell 2.6% in 2018, underscoring the turmoil that dragged the South American country into recession last year. In December, monthly economic activity was 7.0% lower than the same month the prior year, following a 7.5% dip in November. Further with Argentina's Macri throwing $2.6 billion lifeline to cash-strapped firms, is something the country can ill-afford at this stage.

Venezuela/Possibly Greece – The countries' debt is not sustainable, and it is merely a matter of time before there is another restructuring. Greece's economy is showing signs of a long-awaited rebound. Output grew by 2.3% in annual terms between January and March, marking a fifth straight quarter of expansion - sustainability is what we need to confirm here.

Telecom – Regardless of whether or not the Sprint + TMUS deal goes through, EJR expects wireless competition to remain. If approved, S+TMUS, the industry will focus on transition and building scale. And if the TMUS, S merger falls through, focus will shift towards profitability to fund network needs**.**

Improving:

Chemicals – The chemical industry is riding an upturn in the world economy and continued strength across major end-use markets such as construction, automotive and electronics. Another positive for the industry is a recovery in demand in the energy space – a key chemical end-market that had been out of favor for a spell. The recovery has been driven by the rebound in crude oil prices from their historic lows.

Defensive Industries – Alcohol, defense are traditional defensive credits and continue to be so.

Infrastructure – Watch for massive improvements for firms connected to building; an infrastructure act will enhance the gains.

Packaging – The paper and food packaging industry was and will continue to benefit from e-commerce. However, Amazon could squeeze their margin.

Technology – While at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels. FX swings too might dent earnings in the medium term.

Neutral

Autos and Auto Suppliers – The seasonally adjusted annualized rate (SAAR) of U.S. light vehicle sales in January, reported by OEMs on Friday, tracked to an estimated ~16.7mm rate. In January, which typically tends to be the slowest sales month of the year, saw industry sales volumes decreased 1.9% YOY.

Banking – Banks' net interest margins face pressure from a more-dovish Fed, leading to lending spread compression, deposit re-mixing, and potential for yield-curve inversion. EJR expects markets to cut 2019, 2020 NIM estimates as Fed rate hikes are subtracted from consensus. The smaller banks are aided by the improved margins and the M&A upside.

Insurance – M&A and Weak core P&C underwriting margins, lackluster overall trends in the life & retirement business are medium term negatives. Though from a long-term perspective, the industry continues to improve with reasonable returns and continued consolidation. For life insurance companies, despite maintaining strong balance sheets and reserve levels, the prospect of higher interest rates has not come to fruition. As a result, life insurers have continued investing in riskier asset classes such as private placements, mortgage loans and mezzanine debt.

Railroads – Though Rail's good growth seems to be running out - and the overall rate of growth in 2018 which had decelerated – continues into 2019. For the first seven weeks of 2019, U.S. railroads reported cumulative volume of 1,730,989 carloads, up 0.1 percent from the same point last year; and 1,867,360 intermodal units, up 0.5 percent from last year. Total combined U.S. traffic for the first seven weeks of 2019 was 3,598,349 carloads and intermodal units, an increase of 0.3 percent compared to last year.

REIT – General consensus is bullish on residential and industrial REITs, a relatively improved outlook for health care and net lease, and more bearish views on malls and office REITs. Vacancy ratios and leverage ratios are at cyclical lows, but several REIT subsectors have begun to show signs of peaking. Notably, the retail segment has faced same store net operating income declines and occupancy rates has fallen modestly. Offsetting the decline in retail has been improvement in industrial REIT, partially due to ecommerce. Apartment prices have risen substantially in many cities including San Francisco and New York. Multi-family is likely to improve due to slow family formation. Suburban offices will likely continue to slide as occupancy rates decline.

Utility Distribution – Distribution firms face long-term issues associated with local power generation from solar. Nonetheless, currently firms are in decent shape. Moreover, highly leveraged utilities will probably have troubles raising equity, as the dividend yield will not be as competitive in a rising rate environment. Although the current Asian LNG and European gas price have fallen below $5/MMBtu, these are not sustainable.

Need to watch:

Big Technology – Media sources say Samsung plans to lower its memory chip output next year to tighten supplies for an expected slowdown. The supply restriction would help maintain or push semi prices up. The company expects bit growth of less than 20% DRAM and a 30% rise for NAND flash. Overall semiconductor industry revenue growth is on pace to achieve 14% Y/Y growth in 2018 or ~8% ex. memory on positive demand trends during the year such as data center, automotive and industrial. The US-China trade-related slowdown combined with poor iPhone sales and auto production volatility kicked off a demand-driven correction reflected in the recent weaker than expected December earnings season. Hopefully, things recover in 2019.

Credit Card Network/Processors – Acceptance of Bitcoin and other cryptocurrency would be a significant negative to the credit card network like Visa and MasterCard and credit card processor like First Data.

Exploration and Production and Servicing Firms (Energy) – As oil prices moved higher, despite natural gas prices continuing to fall, E&P index has rebounded in the YTD period. Oil prices were lifted early in the week after Saudi Arabia signaled it would reduce output in February to levels "well below" the OPEC production agreement and as the U.S. issued sanctions on Venezuela's state-owned oil company. Watch for nat gas price volatility, with the recent natural gas prices decline reflecting the possibility of the market looking beyond the polar vortex that engulfed much of the Midwest with near-term weather forecasts now calling for warmer-than-average temperatures across much of the East Coast.

Healthcare – According to Axios, a new analysis from U.S. federal government actuaries say that Americans spent $3.65 trillion on health care in 2018. This represents $11,212 per person, with 59% of the spending going to hospitals, doctors, and clinical services. Prescription drug spending was up 3.3% year over year. Most of the increase was due to higher prices, not increased use of services.

Tobacco – The rising U.S. teen e-cigarette use threatens the tobacco market. Over the past year, the number of high school students who have used e-cigarettes in the past 30 days has skyrocketed by about 75%, as per CDC's annual National Youth Tobacco Survey. That means roughly 3M, or about 20% of high school kids, are using e-cigarettes, up from 1.73M, or 11.7% in last year's National Youth Tobacco Survey. The Food and Drug Administration move to ban menthol cigarettes, amid its ongoing crackdown on e-cigarettes would prove a particularly big blow to BAT, whose Reynolds American subsidiary paid $25B in 2015 to acquire Lorillard Inc. and Newport, the top menthol brand in the U.S.

Wireless Providers – Competition in wireless is heating up. We expect the change in data plans to be essentially neutral to ARPU but watch for SG&A spend.