Egan-Jones has a long-established reputation for timely, accurate credit rating calls. EJR's founder was identified by Fortune Magazine as the number one person for warning about the 2007-08 credit crisis. See also academic studies.

Best Ideas – The Washington Turmoil Continues

Dec. 2017 – resulting changes in investment opportunities and perils

Some executives believe stability is a sign of exemplar leadership, whereby consensus is built and change occurs in gradual, measured steps. Other executives are hell-bent on changing conditions as soon as possible under the assumption that the status quo is unacceptable and friction is a normal part of the process. Lest anyone is uncertain, the current Washington Executive Branch clearly fits in the latter category. As a result, Mr. Trump is fighting wars on multiple fronts:

- The Mueller Investigations – which are getting dangerously close to senior Trump officials as a result of General Flynn's admissions? (Kushner's directing Flynn to seek assistance from a known foreign agent in connection with the election is of interest).
- North Korea – claiming that the US will take action if China does not cut off petroleum supplies to N. Korea is the latest in the effort to rein-in the mischief.
- Tax Plan – after failing to pass reforms to the Affordable Care Act, the current administration is being tested on its ability to pass any meaningful legislation.

Adding to the concerns is the shape of the yield curve, especially the spread in long and short term rates.

Source: Bloomberg

While GDP is printing at a respectable 3.3% and the stock market is humming, the flattening yield curve is a concern. While we have seen flat yield curves before, they are normally in the context of a severe economic slowdown whereby investors expected the future demand for credit would be significantly below the current demand. While there is little doubt that the post credit crisis economic expansion is one of the longest on record, few expect a significant economic slowdown in the next 18 months. In fact, if the pending tax cut is affected, it is reasonable to assume that demand will be stoked. The basic problem is that the FED is increasing short-term while rolling off longer-term securities is keeping longer rates at higher levels. Below is a summary of global conditions.

United States – muddling through
The over-riding feature in the U.S. appears to be whether Mr. Trump will have a successful presidency. Judging from the media, he is an abysmal failure and a few weeks away from an indictment. Mr. Trump's running battle with the media and non-presidential behavior adds to the controversy. Nonetheless, judging from performance of the stock market, investors believe earnings will remain strong. Key issues are whether market expectations are based on the pending tax bill (which might not happen), low interest rates (which might rise), or the possibility that equity investors are wrong and that the flat yield curve is indicative of a weakening economy. While no one has a perfect view of the future, our view is that the present is the best indicator: growth in the U.S. will be north of 2.5%, unemployment will remain low, and inflation will stay low. While the FED is not currently printing money, it will if needed, other central banks remain engaged in QE, and most investors believe the central banks will remain supportive. Regarding North Korea, the major issues are:

1. What form, if any, will the new tax plan have?
2. If Kim Jong-un proceeds with his stated plans, where in the Pacific will a bomb be exploded?
3. Will the White House consider it a threat, and
4. How will the administration respond?

Our view is that the period of escalating threats is reaching an end and Trump will respond in a measured way if a missile lands close to Guam or a US ally. ***However, if actions escalate the impact on credit and equity markets are likely to be significant, at least until investors are confident that future actions will be curtailed.***

Europe – managing
The crises which faced Europe over the past couple of years remain, with the major changes, being a likely leadership shift to Germany and increasing uncertainty concerning Brexit. Merkel is likely to see her influence curtailed and May is likely to be replaced, but the Brexit negotiations will drag on. France and Italy will continue their struggle to remain competitive, and over time, the European Union will enhance its power over the various states. (Watch for a banking union with ECB depositor guarantees to be put in place).

European equity, fixed income, and currency markets have been on a tear ever since Le Pen lost the French elections. Providing the grease to ease the markets, the ECB has been hitting bids on anything which comes close to the market and as a result has expanded its asset levels to $5.1 trillion. Consequently, nearly all appears to be golden in the European markets. However, appearances are not reality. Starting with France, Macron is struggling to push through the reforms he promised, which are at the heart of sustainable growth.

In the case of Italy, as expected, voters holding bank securities were spared significant pain via a bailout of the banks while the institutional investors were left with losses and claiming dangerous precedents.

Regarding Greece, the relevant parties meet, agree on stopgap measures and then agree to meet after six months and presumably go through the routine again. The show is getting old and we expect more realistic write-downs and fix to be put in place post Merkel's election.

On to probably the most problematical and uncertain case in the EU (at least for now) and that is the United Kingdom. Perhaps we should start by addressing the misnomer; the United Kingdom has never been more disunited in its recent history and therefore is unsure of where it is going or how to get there. The core reasons for the UK's exiting from the EU were concerns over immigration and the resulting instability and fear that the UK's crown jewel, its financial services industry, would be hobbled by policies emanating from Brussels and Berlin. The irony is that the UK has suffered more than most countries (other than perhaps France) from terrorist actions and its financial markets are being cut off from the balance of the EU. Perhaps terrorist actions might be worse if immigration was unfettered but it is clear that London's importance as a financial center is diminishing. Perhaps the item adding insult to injury is the amount of money the UK will have to pay to affect the divorce. Regardless of the outcome of the Brexit negotiations, it appears evident that there is little that will stop the UK's continue slippage in its global economic standing.

Leaving best to last, Germany remains an outward powerhouse; its automobile, machinery, chemical, and pharmaceutical industries guarantee a strong balance of payments and a seat at the world economic table. However, the century-old challenges facing Germany remain albeit with different names and players. The country's core challenge is how to co-exist among divergent players who never quite trust German intentions and who are quick to claim unfair conditions in an effort to improve their standing. Russia remains a mystery to most Germans and yet Germany is dependent on Russian gas supplies to fuels its industries and heat their homes. Appeasement in the Middle East appears to be the best path and yet integrating immigrants into German society appears to be elusive. Angela Merkel is holding the game together, but four terms is a bit much for any politician.

On balance, the EU is muddling through but when one adjusts for the massive $5.1T growth in the ECB's balance sheet, the area remains stressed. However, as long as the ECB does not rapidly shrink its balance sheet, the EU should probably be fine. **Perhaps the major item to watch for is the ECB's shrinking its balance sheet, which is unlikely to be anytime soon.**

On to China, we do not see any major change; the S&P downgrade was expected and is manageable. Japan has shown some growth recently, but the country is at the far end of normal expectations concerning sovereign debt to GDP and is likely to remain challenged for the next several years.

Hence, on balance, the US remains strong, and is likely to experience a Pax-Americana growth period of 2.5+% over the next several years if it can defuse the North Korea threat or address it with little long-term pain.

Benign Global Outlook - Regarding the global economy, both the U.S. and the emerging markets appear to be safe havens currently as Europe is still struggling through its multitude of festering structural issues, Japan is hobbled by massive debt and little growth, and China is in the midst of a redirection. Below is a summary

Figure I: U.S. and Emerging Markets Expectation

	Japan	Europe	U.S.	China	Emerg Mrkt
Population Change	Decline	Decline	Slight Growth	Slight Growth	High
Productivity Growth	Low	Moderate	Moderate	Moderate	High
Govt Regulation	High	High	Material Reduction	Moderate	Low
GDP Growth	+1.0%	+1.8%	+2.5%	+5.0%	+4.0%
Currency Values	Decline	Mixed	Rise	Decline	Mixed
Stimulus Change	Same	Same	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Varied	Slight Growth	Varied	Growth
Perceived Safe Haven	Yes	Yes	Yes	No	No
Interest Rates	Low	Low	Slight Growth	Falling	Varied
Asset Valuations	Varied	Varied	Improving	Varied	Improving

From a credit quality perspective, we expect the environment to be fairly propitious for most U.S. credit.

Regarding interest rates, Europe and Japan are stuck with low growth and high debt levels and therefore have significant difficulty in raising interest rates. Meanwhile, the U.S. is raising interest rates. Hence, rates in the U.S. are likely to be higher because of the FED's action and increased demand, and on the other hand, most major non-U.S. economies are trying to maintain low interest rates. The periphery EU countries are under increasing 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	2.10	2.20	2.38	2.40	2.82	2.90
Germany	-0.305	-0.20	0.36	0.50	1.19	1.35
Italy	0.48	0.55	1.744	1.85	2.935	3.05
United Kingdom	0.80	0.85	1.33	1.40	1.87	2.0
Japan	-0.116	-0.03	0.034	0.06	0.826	0.95

Below are our expectations for major currencies: the dollar is likely to be slightly stronger relative to other currencies because of the slight rise in interest rates and the possibility of additional increases.

Figure III: Rising U.S. dollar

	Current	EJR Est. Year End
Dollars to Euros	0.84 $/€	0.85 $/€
Dollars to Yuan	6.60 $/RMB	6.65 $/RMB
Dollars to Yen	111.8 $/¥	113.2 $/¥
Dollars to Pound	0.739 $/£	0.755 $/£

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Comments on Central Banks Impact - Central banks have been the dominant forces in the markets since the 2007-2008 credit crises and although the US is shrinking its balance sheet are in the process of scaling back, other central banks have not yet followed. Given the fact that the central banks now own $21 trillion of assets, and there is pressure for tapering, what might this tapering result in? Our view is that we might be on the verge of a major reset as a result of the normalization of the markets. The first item to examine might be inflation, which was nonexistent for years in most of the developed economies until recently. If inflation is real, then why is the yield curve flatter than normal? The short answer is that we are not sure, but if inflation is now an issue, the longer yields should start showing some increases.

Deteriorating:

<u>Retail Disaster</u> – Amazon will destroy margins for any industries involved in selling goods, and over time, services. Nearly all the major retailers will be trading sideways at best for the next couple of years. A filing by Sears and JC Penney would not be a surprise and Macy's

might slip from investment grade over the next couple of years. As expected, Walmart is having difficulty being competitive in the web market. The next major target for Amazon appears to be grocers.

Media – Netflix, other internet distributors, and non-traditional media outlets continue to dis-intermediate traditional media providers and cable firms. Note, print media continues to suffer.

Improving:

Banking – Higher interest rate and a normal yield curve should aid net interest margins. Reduced regulations should improve cost structures. The smaller banks are aided by the improved margins and the M&A upside.

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

Healthcare – Hospitals will be hurt, but nearly every other area should see improvement.

Infrastructure – Watch for massive improvements for firms connected to building.

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.

Technology – While at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels.

US Manufacturing Exporters – The weaker U.S. Dollar helps, but the major driver is the health of the global economy.

Neutral

Airlines – The economic recovery, effective capacity management, and moderate fuel prices have helped. However, in the U.S., the rate of improvement is likely to slow down as margins and load factors slip from record levels.

Autos and Auto Suppliers – With the exception of Volkswagen and FIAT, most of the auto industry prospered over the last couple of years. The European producers are probably in the best shape because of the recent rise in the dollar and yen. Watch for new car sales, used car prices, and weaker profitability as used car inventory is at all-time high.