Best Ideas – Inflection Point

At EJR we aim to provide early, accurate, assessments of credit quality and related developments. While we have been and remain positive on the economy, our view is that there will be increasing evidence of a slowdown over the coming months and quarters. The reasons for this stance are manifold but we will try to address them below. The upshot is that credit quality for many issuers will come under increasing stress although at a measure pace. Listed below are our major concerns:

Washington Woes – While Mr. Trump has often used the term "swamp" to describe conditions in Washington, it is likely that his initiatives will be stuck in the mud over the next couple of quarters. The mode of the country has yet again changed and the major gains from Mr. Trump's election probably have been realized. The Democrat's control of the House is likely to stymie most legislative initiatives and the continued negative press and investigations are taking a toll. Although Mr. Trump might attempt to establish a working relationship with Ms. Pelosi, pressures from the Left is likely to make cooperation difficult. Ms. Clinton voiced an opinion which is probably shared by many fellow Democrats: paraphrasing, it is hard to be civil when your opponent does not share your values. Regardless of one's political beliefs, it appears the focus of many in Washington will be gaining the political edge rather than any tangible progress. The disconnect currently is that despite the turmoil (some would say because of it), GDP growth and unemployment levels have rarely been more attractive.
EJR's View – The fight between Mr. Trump and the Washington status quo is likely to continue for the foreseeable future. Democrats are searching for a lever to make Trump ineffective and Mr. Trump is continuing his pugilistic approach.

China Challenge – Mr. Trump is attempting to reset the US's relationship with China and in the process is triggering major angst. Against this backdrop is the massive growth in China's indebtedness.
EJR's View – The fight will continue but perhaps some progress will be made.

EU Ennui – the divorce between the UK and the EU is progressing and the upshot is likely to be some restructuring struggles. Meanwhile, Italy is questioning is continuation in the Union and Turkey is seeking compensation for the refuges. While the Greece problems have been announced as solved, we have our doubts. Perhaps the most relevant item for financial watchers is he supposed exit of the ECB from quantitative easing.
EJR's View – The EU will continue its troubled ways for the foreseeable future and Germany will provide just enough support to keep the confederation going.

The Middle East Miasma – The murder of Khashoggi has hamstrung relations with Saudi Arabia in the short run but the reality is that the US is less dependent on the Middle East for energy.
EJR's View – The area will remain problematic but will muddle through.

Pension Pandemonium – with the continued growth in selected municipality and state budget deficits and pension shortfalls, it is only a matter of time before restructuring is needed.
EJR's View – While the above is true, several municipalities have restructured, and the markets have taken it in stride.

North Korea Knockabout – it is easy to forget but North Korea is no longer on the front-page item and the latest is a summit with Kim and Trump.
EJR's View – Mr. Kim is trying to find the right path forward. We expect some low level agreement and a moderate level of tension in the near future.

Back to the macro view, we do not see a material threat to the current conditions for the next 12 to 18 months. Below is a summary of our expectations for the various economies:

Figure I: Summary of EJR Economic Expectations

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	+1.0%	+1.5%	+3.0%	+3.5%	3.5%
Currency Values	Decline	Mixed	Rise	Mixed	Mixed
Stimulus Change	Slight Deceleration	Slight Deceleration	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Slight Growth	Growth	Growth	Growth
Interest Rates	Low	Slight Rise	Slight Rise	Little Change	Varied
Asset Valuations	Improving	Varied	Varied	Varied	Slight Rise

Regarding interest rates, 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 likely to see continued pressure because of increased credit quality concerns.

Figure IV: 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	2.83	2.8	2.99	3.05	3.28	3.20
Germany	-0.28	0.05	0.30	0.60	0.97	1.20
Italy	2.15	1.50	3.14	3.35	3.77	3.52
United Kingdom	0.89	1.23	1.31	1.65	2.01	2.05
Japan	-0.11	0.03	0.08	0.20	0.81	0.88

Below are our expectations for major currencies:

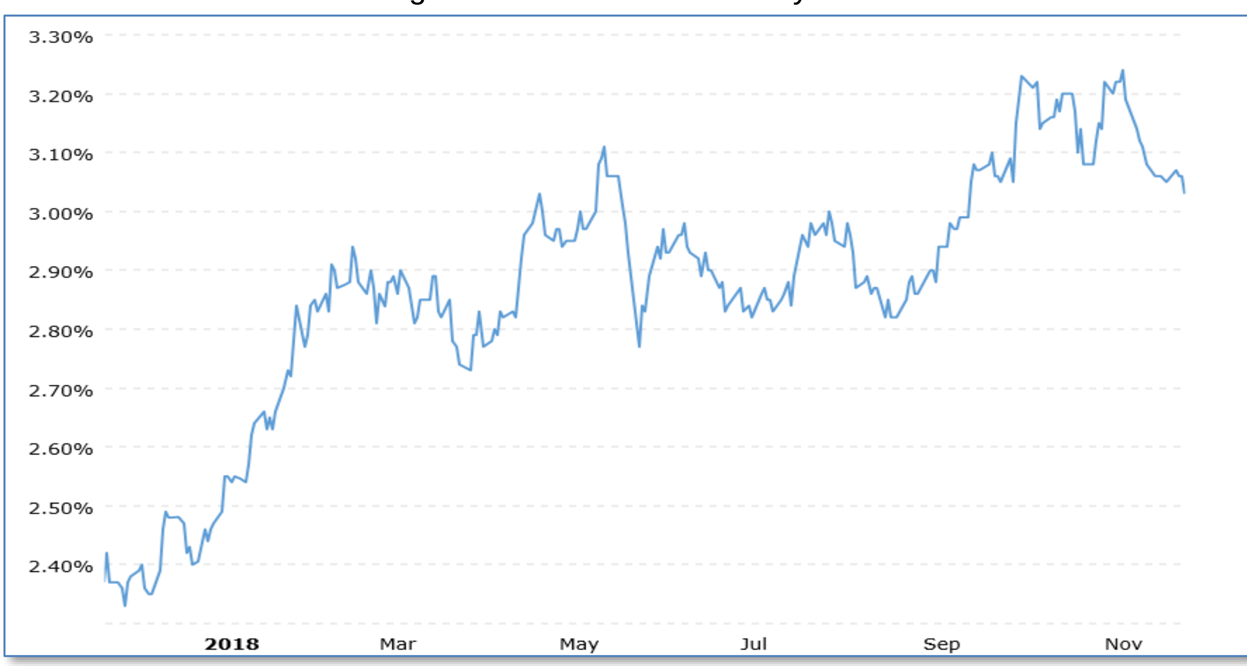
Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.14	1.20
Yuan to Dollars	6.88 $/RMB	7.00 $/RMB
USD-JPY	113.63	115
GBP-USD	1.27	1.35

Some of the major drivers of the economy and our expectations for those drivers are:

- **Interest Rates –** the 10 year is near 2.9% with many calling for an end to the 30 year bull market in rates.
  Prognosis – while interest rates are edging up, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (with the exception of Germany) are concerned about fiscal deficits and therefore are likely to discourage a substantial rise in interest rates and sovereign funding costs.

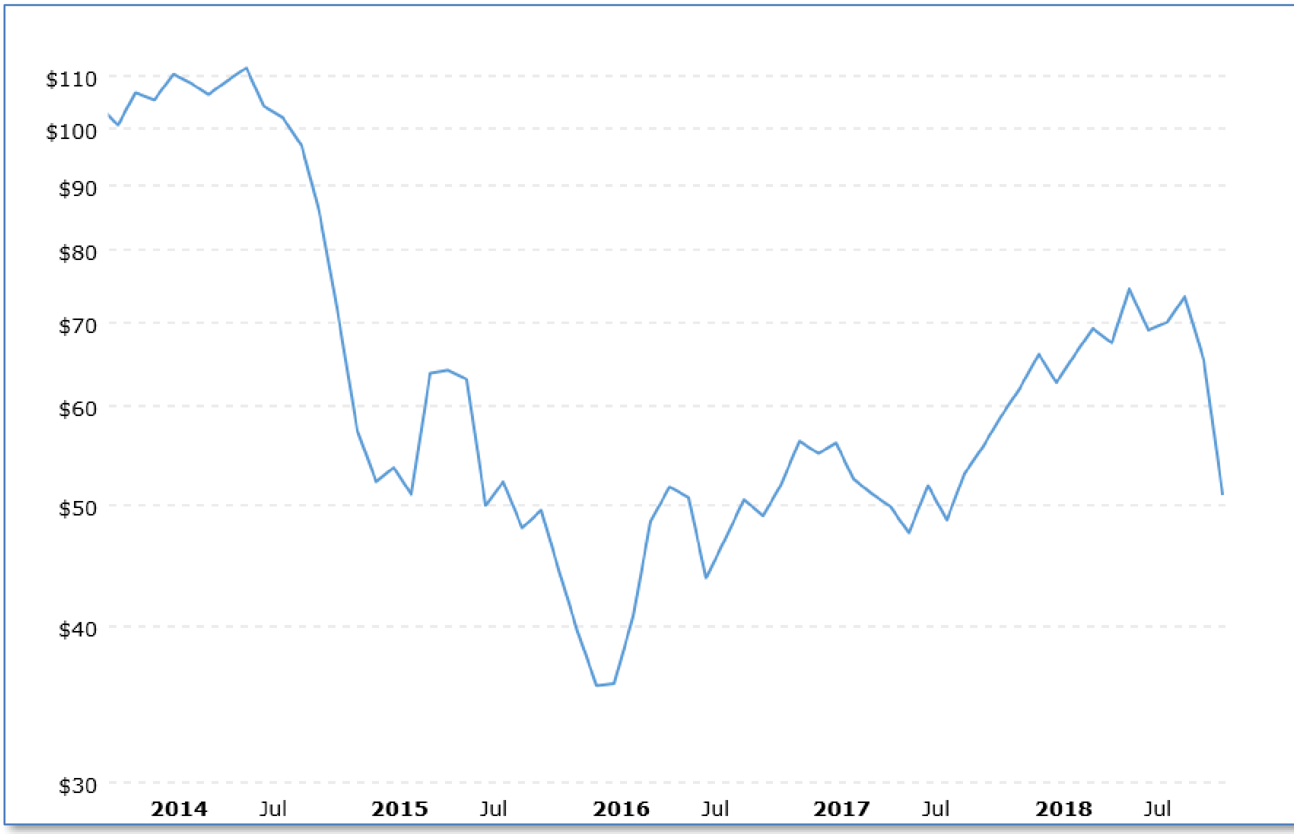
Figure I: 10 Year US Treasury Yield



Source: macrotrends.net

Petroleum Prices – as can be seen in the chart below, petroleum prices have collapsed. While it is always difficult to divine the underlying causes of the petroleum prices, it appears that the supply is outrunning demand.
Prognosis – watch for a reversion to the mean.

Figure II: WTI – Recent Crude Oil Prices

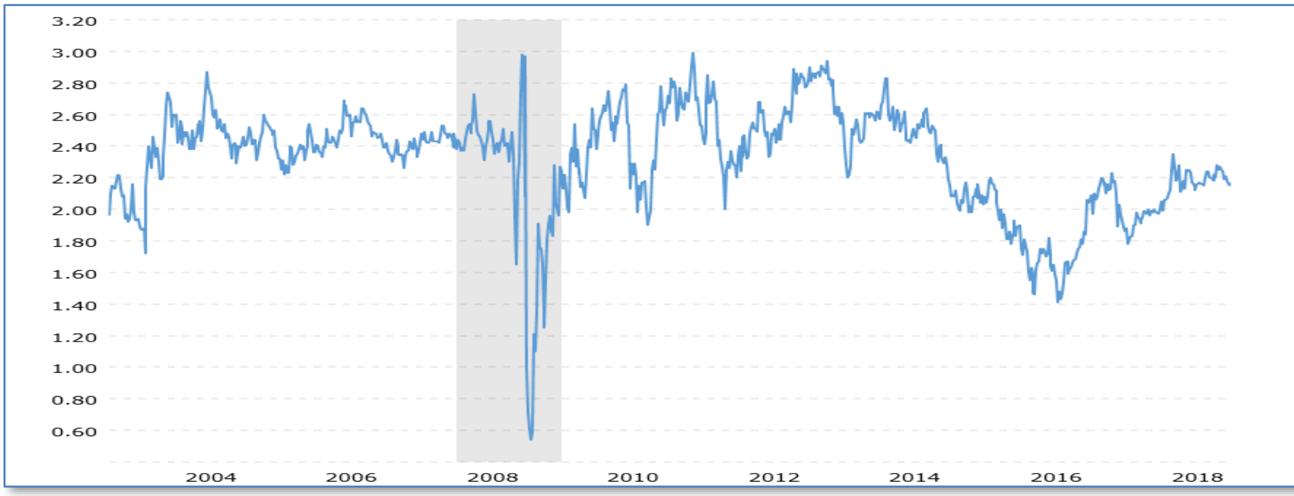


Source: macrotrends.net

- **Central Banks' Money Creation –** the central banks of the developed countries have approximately $20 trillion in assets which have been used to suppress interest rates and support equity values. While the FED is no longer growing its balance sheet, other central banks are growing by approximately $300M per month. Such central bank support is historically rare and in our opinion is a major reason for the buoyant market.

Prognosis – while numerous factions have argued against any quantitative easing, the central banks are now committed and unlikely to pull back any time soon especially with the high levels of debt to GDP for many sovereignties. Our view is that if there were a major setback in the markets, the central banks would re-engage.

Figure III: Five Year Forward Inflation Expectation %

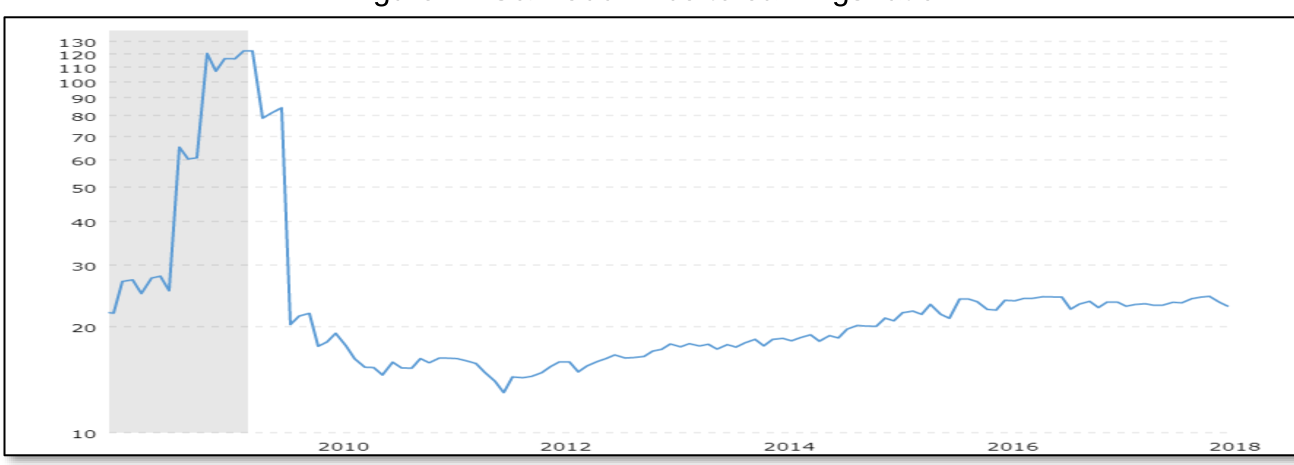


Source: macrotrends.net

- **The Tax Act –** the corporate tax rate has been reduced from approximately 40% to 21% while depreciation allowances have been increased substantially. The net effect is approximately a 30% rise in a corporation's after-tax earnings.
  Prognosis – a 30% rise in earnings is massive (although not all corporations were taxed near 40%) and provides a huge stimulus to the economy.

- **Growth/ Stock Market Valuations –** the stock market has had an eight year run with the normal concern that we are overdue for a downturn. However, from an earnings perspective, valuations do not appear to be too attenuated (see below).
  Prognosis – conditions have improved in most countries for economic expansion and perhaps we will see at least a couple more years of growth.

Figure III: S&P 500 Price to earnings ratio



Source: macrotrends.net

- **Inflation –** most economic commentators have predicted that inflation would rise dramatically although to date, it has not. However, the tightening labor force is resulting in wage pressures.
  Prognosis – Our view is that inflation remains tepid and because of the use of technology and the ease of "transportation" via the internet and transit services.

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

Deteriorating:

Retail Disaster – Amazon (and other internet giants) will destroy margins for any industries involved in selling goods, and over time, services. (Watch for the next major wave with virtual reality technologies.) 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; we question the long-term effectiveness of its attempt to go up-market online. Watch Amazon's war with Netflix.

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:

Airlines – The economic recovery, low fuel prices, effective capacity management have helped. However, the increased competition is likely to depress margins especially as load factors slip from record levels.

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; an infrastructure act will enhance the gains.

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.

Neutral

Autos and Auto Suppliers – With the exception of Volkswagen, most of the auto industry has prospered over the last couple of years. Watch for new car sales, used car prices, and weaker profitability as used car inventories are at all-time high. Electric autos will threaten revenues and margins for traditional internal combustion engine vehicles,