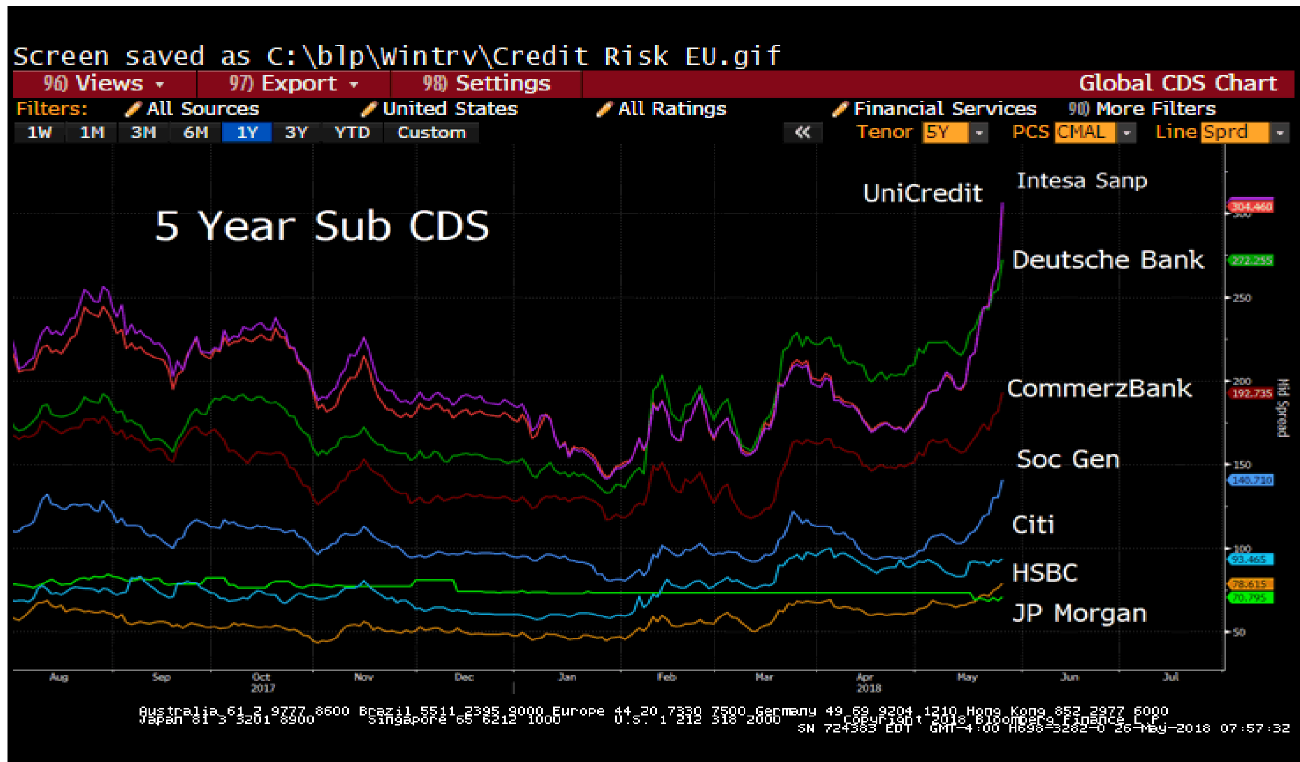
Egan-Jones has a long-established reputation for timely, accurate credit rating calls. EJR's founder was identified by Fortune Magazine as the number one person for warning about the 2007-08 credit crisis. See also academic studies.

Best Ideas – A Developing Reset
July 2018

Regardless of one's political views, it is hard to argue with the notion that the world is going through a major reset, one of which is likely to be debated for decades. The resulting implications for investors is likely to be massive and we believe it is worthwhile exploring the major manifestations.

Listed below are items which should be classified as "sea changes" as they fundamentally change the investing climate:

European Union:
The Italian Job – the election of an extreme left and extreme right party comes with some extreme proposals including the possible repudiation of EUR200+B debt, the possible exit from the EU and the possible replacement of the euro with the lira. While most of these proposals appear to be implausible now, obviously Italian voters are frustrated and there are likely to be at least some measures to appease them. The below chart indicates concern re. Italian banks.



THE issue in guiding likely future actions is whether Germany is willing to provide some comfort to Italy to keep them in the EU. Our view is they will and therefore the drama will remain for the next couple of quarters and be resolved over time.

Brexit – like most divorces, this one is far messier and more protracted than most would have believed. While there is talk of a revote or possibly ignoring the referendum, we expect an eventual separation and a coming to terms.
Trade Wars – we expect that German will make adjustments to maintain access to markets.

United States:
Tax Cuts – taxes are omnipotent in the sense that they affect us all and while not the only factor driving decisions they are certainly a major consideration. The major impact of the Tax Law is:

- **Corporations' tax cut** – corporations are less likely to redomicile outside the US and are more likely to make capital investments, which now have accelerated depreciation.
- **Reduced personal taxes** – while these cuts are not permanent (what is?) the net effect is tax payers will have more disposable income.
- **Non-deductibility of State and Local Taxes (SALT)** – taxes in the Northeast, West Coast and Illinois have effectively been increased by approximately 35% with the result being greater pressure on some states which are already having difficulty balancing budgets. The upshot is likely to be a repeat of Detroit's problems in Chicago, Connecticut and other governmental issuers.

Increased Interest Rates – the FED has increased rates by 50 basis points over the past year and appears likely to further increase rates by 50 basis points by year end. The result has been a partial normalization of the economy although the FED's balance sheet still has over $10T in assets created via electronic means.
Increased Interest Rates – over the past year, the 10 year treasury has risen 35%
Improved Growth and Employment – there is little doubt that both of these have improved over the past couple of quarters.
Stress in High Yield – this needs to be watched.
Constitutional Crisis – the investigations of the Trump campaign has been setback by claims of spying. The end result increasingly appears to be a damning DOJ Inspector General report, a negative report from Mr. Mueller, major changes in personnel and then a stabilization of conditions.

China:
Trade Wars – like Germany, we expect that China will make adjustments to maintain access to markets.
North Korea – while in the past, China had surreptitiously supported North Korea in its adventures, the stakes are currently increased via tariffs and other sanctions by the U.S. Furthermore, unlike prior administrations, the current U.S. administration is unwilling to tolerate false treaties nor further material escalations in nuclear missile testing. We expect N. Korea will be brought into the world economic zone shortly.
South China Sea Islands – given tensions in trade and elsewhere, China is likely to ease up on new developments for the time being.

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%	+1.8%	+2.8%	+5.0%	+4.0%
Currency Values	Decline	Mixed	Rise	Mixed	Rise
Stimulus Change	Decelerating	Decelerating	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Growth	Growth	Growth	Growth
Interest Rates	Low	Flat to Rise	Slight Rise	Little Change	Varied
Asset Valuations	Improving	Improving	Improving	Improving	Improving

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	2.70	2.8	2.82	3.05	2.97	3.20
Germany	-0.30	0.05	0.32	0.76	1.07	1.45
Italy	1.88	1.50	2.82	2.65	3.57	3.52
United Kingdom	1.00	1.23	1.25	1.65	1.72	2.05
Japan	-0.11	0.03	0.03	0.20	0.71	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.16	1.30
Yuan to Dollars	6.6 $/RMB	6.50 $/RMB
USD-JPY	110.24	110
GBP-USD	1.31	1.45

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

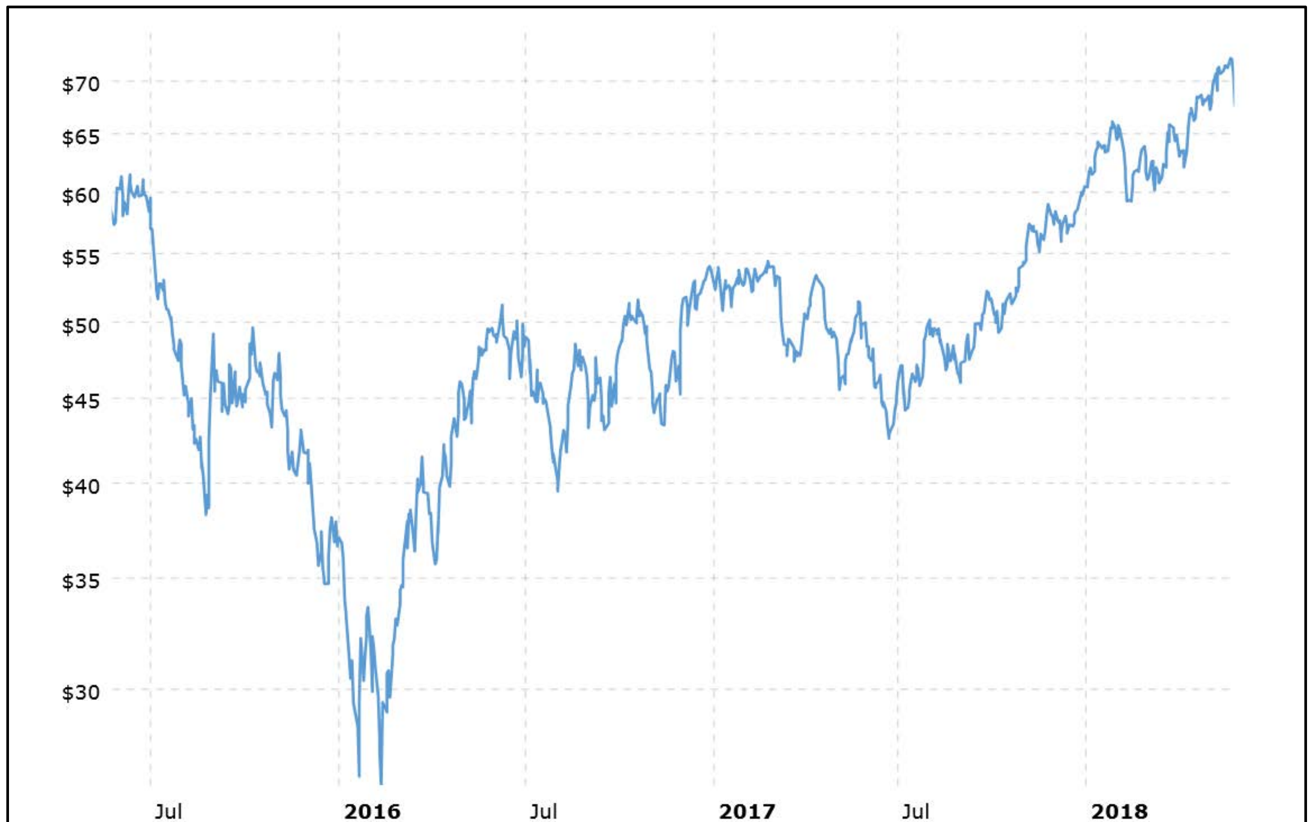
- **Interest Rates –** the 10 year has hit 2.95% with many calling for an end to the 30 year bull market in rates.
  Prognosis – while interest rates are edging up, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (with the exception 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: 5 Year US Treasury Yield

Source: macrotrends.net

Petroleum Prices – as can be seen in the chart below, petroleum prices have come roaring back after a collapse in late 2015. While it is always difficult to divine the underlying causes of the petroleum prices, it appears that the restraint of the major producers and the global economic growth are the major drives.
Prognosis – watch for a reversion to the mean.

Figure II: WTI – 5 year 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.

- **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.

The major gainer in the currency markets has been the pound as the market believes the UK will be able to negotiate Brexit gracefully and growth will resume. (We are not so sure.) From a credit quality perspective, we expect the environment to be fairly propitious for most U.S. obligors. Regarding various industries, below is a summary of some of the major developments:

Deteriorating:

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

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,