Best Ideas – Major Improvements but Major Risks May 2018

Over the past six months, investors were provided with significant improvements which currently are being offset by continuing and emerging concerns. On balance, we expect the cross currents to continue, thereby requiring extra vigilance for investors. Let's start with the positive first; the major improvements recently have included:

Positives:
Tax Cuts – while normally a major tax overhaul requires a decade or more to accomplish, the recent one was affected in approximately six months, with the result being a massive cut in corporate and some individual taxes. The hope is that the increased growth will offset the lower rates, but time will tell.

Defusing the North Korean Threat – while talks with North Korea regarding denuclearized have just begun, there is hope that they are on the path and with it, join the global community.

ISIS threat – the ISIS group is likely to remain, but their widespread threat in the Middle East has diminished.

On to the threats; there are many and therefore we will address only the most pressing ones from an investor perspective:

Negatives:
Rising interest rates and petroleum prices – the FED is predicting two or three additional rate increases for 2018. With a relatively flat yield curve, the open issue is whether the rise will cause the yield curve to invert.

Trade War – the major issue is whether other countries will silently accept Mr. Trump's tariffs or respond in kind. China, Japan, and Germany appear to be the primary targets, with a focus on the size of the trade deficit and China's forcing a transfer of technology from non-Chinese firms. Our view is that there will be a response, but hopefully it will be a muted response.

Constitutional Crisis – although it has not yet widely evident, there is a constitutional battle raging in Washington whereby Mr. Trump's opponents (and there are many) are attempting to discredit him and ideally (from his opponents' perspective) remove him from office and alternatively Mr. Trump working to thwart their attempts. From our perspective, a major threat to Mr. Trump are the troubles of his personal attorney, Mr. Cohen and the high likelihood that some unsavory details emerge regarding Mr. Trump's business activities. In particular, consulting fees could be construed as bribes. The report of the DOJ inspector general might limit future activities of Mr. Mueller, but the actions in the Southern District of New York remain. Concerns regarding the political fallout are probably restraining Mr. Trump's actions unless damning information emerges from the Inspector General's report.

There are two ways of viewing the above conditions. On the one hand it is the normal result of a new president attempting to address the various problems that have existed for years. One the other hand, it is a president who should not be in office, doesn't get it, and should be removed by any means possible. As we tell our analysts, we check our politics at the door and aim to assess the impact on investors, realizing that political outcomes are relevant. Under the current conditions, although the recovery is fairly mature, there is a possibility that the tax cuts will extend the recovery. Perhaps the largest threat is the rise in interest rates, which we and presumably many others are watching carefully.

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: 10 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 I: WTI – 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.

- **Unpopular Leaders –** the apparent irony currently is that the leaders of the U.S. (Trump), the U.K. (May), Spain (Raju), Italy (Mattarella), and to a lesser extent Germany (Merkel) have been unpopular and yet the economies have strengthened. It begs the question of whether popular leaders are deleterious for the economy. **Prognosis** – we expect Trump will continue his attempts to improve the economy and the major infrastructure spending plans are likely to further stimulate the economy.

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 III: U.S. and Emerging Markets Expectation

	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	2.81	2.8	2.97	3.05	3.13	3.20
Germany	-0.06	0.05	0.56	0.76	1.23	1.45
Italy	0.63	0.65	1.78	1.92	2.87	3.10
United Kingdom	1.10	1.23	1.40	1.65	1.82	2.05
Japan	-0.12	0.03	0.04	0.20	0.72	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.20	1.30
Yuan to Dollars	6.33 $/RMB	6.50 $/RMB
USD-JPY	109.69	110
GBP-USD	1.36	1.45

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,