Best Ideas – Forget the Text Books and "Experts"; navigating a perplexing market

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As is often the case, the markets are teaching supposed market professionals new lessons. The latest is GMO's Jeremy Grantham's reversal on his view that markets are not in a bubble and that there might not be a collapse in margins as he expected for years. Likewise, many professionals have pointed to the length of the bull market, suggesting that the market is materially over-priced. Additionally, market gurus have been predicting interest rates would rise substantially for the past several years, and yet they have not. Lastly, the turmoil and dysfunction in Washington are not normally indicative of propitious conditions and yet the equity markets and economy remain strong.

Our view is that the supposed experts have not grasped the true conditions of the economy. Below are factors which we believe are root cause of the unusual conditions which are befuddling the gurus:

Massive money creation – never before have major central banks engaged in more or less simultaneous and massive money creation. The latest count is that the central banks have created approximately $21 trillion of money and stand ready to create more if signs emerge of material slippage.
Resulting Impact – the markets now have a central banker put, reduced interest rates, and heightened equity valuations. Despite the talk of a return to normal, we do not see it anytime soon.

The Emergence of Tech Bros – the emergence of a massive infrastructure built on the internet and cellphones is driving the global economy in unexpected ways. The "FANG" stocks have been market leaders in the U.S. but are complemented by a series of similar companies such as Uber, Airbnb, We Works, Red Hat, and a host of others which most senior investors have never heard of. Developments in the US are matched by those in other countries, but at a faster pace.
Resulting Impact – the old blue chip firms are rapidly losing market position and are unlikely to recover soon, if at all. Walmart (and most other major retailers) is being hamstrung by Amazon while IBM is debating what it should focus on with both hardware and services fading. The insipid Watson ads underscore the Company's dilemma.

Automation - although it is hard to believe, we are at the initial stages of an automation revolution which will entail a massive change in how our society operates. When firms such as Nike and Adidas can automate the production of shoes, and apparel firms can do the same, manufacturing will be forever altered. Perhaps an early glimpse of this revolution is Tesla and its massive use of robots and the incorporation of technology for self-driving cars.
Resulting Impact – the avenues for the less educated and poorer countries to earn a decent living are becoming increasingly elusive. When tractor trailers employ automation (a matter of when and not if) a massive number of well-paying jobs will disappear, just as Amazon employs no "pickers" in its warehouses. Likewise, developing countries are likely to be deprived of the apparel industry route for providing jobs. The net impact of this development is likely to be the further income disparity, suppressed wage growth and a blow to many industries (see below)

Aging Baby Boomers – the baby boomers have had a massive impact on the economy with the rise of the consumer economy in the 50's and 60's, inflation in the 80's and now, major shifts in housing and the workforce. Although the studies have not yet emerged, we would not be surprised if President Trump received an overweighed amount of support from disgruntled baby boomers, many of whom

are Steve Bannon's targeted market. While some baby boomers are retiring, many are shifting to low-paying jobs because they cannot afford to retire.
Resulting Impact – reduced demand, low inflation, and moderate growth.

The Rise of Corporate Power – a purported core purpose of the FTC and DOJ is to protect consumers against concentration and limited competition. However, in almost every industry, conditions appear to be more concentrated than they were twenty years ago: hospital services, defense, airlines, plane manufacturers, grocery stores, major newspapers, cable providers, banks, credit card firms, etc.
Resulting Impact – corporations are often maximizing profit and repurchasing shares rather than expanding facilities.

Turmoil in Washington – forget the model set by President Reagan who would play cards with the leader of the opposition, Tip O'Neill. Resident Trump's preference appears to be regular abrasive tweets.
Resulting Impact – grid lock, although there is a glimmer of hope for tax reform.

Below is our summary of our outlook for various regions:

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%	+2.5%	+3%	+6.0%	+3.4%
Currency Values	Decline	Rise	Mixed	Neutral	Mixed
Stimulus Change	Same	Same	Decelerating	Some Growth	Little
Earnings Trend	Declining	Varied	Slight Growth	Varied	Varied
Perceived Safe Haven	Yes	Yes	Yes	No	No
Interest Rates	Low	Low	Slight Growth	Varied	Varied
Asset Valuations	Varied	Varied	Improving	Varied	Improving

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

Figure III: 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	1.99	2.15	2.33	2.50	2.82	2.99
Germany	-0.34	-0.20	0.364	0.50	1.23	1.33
Italy	0.55	0.70	1.78	1.92	2.98	3.15
United Kingdom	0.71	0.85	1.27	1.35	1.86	1.99
Japan	-0.095	-0.07	0.055	0.12	0.87	0.92

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 IV: U.S. dollar

	Current	EJR Est. Year End
Dollars to Euros	1.161 $/€	1.22 $/€
Yuan to Dollars	6.63 RMB/$	6.80 RMB/$
Yen to Dollars	114.06 ¥/$	115.00 ¥/$
Dollars to Pound	1.328 $/£	1.315 $/£

Low interest rates – despite the best efforts of all the major central bankers, interest rates remain low. Our view regarding the underlying cause of low rates is the following: increased savings (and reduced spending of many consumers), the replacement of many high-paying factory jobs with automation, the retirement of baby-boomers, and the low birth rates. Corporate interest rates might rise as defaults increase, but this might be several years off. Furthermore, the central banks (i.e. the ECB and BOJ) continue their purchases, thereby depressing global rates. Europe and Japan are stuck with low growth and high debt levels and therefore have significant difficulty in raising interest rates. Meanwhile, the FED has raised interest rates. Hence, ST rates in the U.S. are likely to remain relatively high, 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.

UK uncertainty – the ruling UK Conservative Party had hoped for a rapid Brexit with a renegotiation of major treaties. That appears to be unrealistic based on recent developments as London is losing a portion of its finance sector, primarily to Frankfurt, Dublin, and Paris. The rise of Labor and the imposition of a transaction tax add to the anxiety. The upshot is likely to be the expansion of banks based in US, France, China, and Japan. German banks are distracted with recent inquiries.

Low default rates – with the overall low interest rates and reasonably strong economies, default rates in developed countries are likely to remain low and therefore corporate interest rates are also likely to remain low.

European rebound – the major problems in Europe have been credit risks associated with some of the Southern European banks, low interest rates, the French presidential election, and of course the never-ending saga of the Greek negotiations. With the partial resolution of the Italian bank problem and the election of Macron, Europe is on the rebound and appears to have been given a respite from terrorist actions. The major unknown is the action of the ECB, but our view is that the ECB stands ready to provide assistance if needed.

China – the country appears to inspire a range of soothsayers whereby one faction is claiming the country is on the brink of falling apart because of the high indebtedness, political corruption, and a raft of other ailments, and the other side claiming the country is going to dominate the globe in a few years because of its massive population base, leadership in key technologies, and support from the central government. Our view is that China will indeed lead in some industries, but that we are unlikely to see a major reordering anytime soon. The overall level of indebtedness is a problem, but China has time to address it. A major issue is whether the high level of government control inhibits growth dependent on rapid technology advances. We expect some accommodation.

Emerging Markets – EM's are diverse and therefore it is difficult to make generalizations. Nonetheless, we expect some of the Asian EM's to continue making rapid gains, and the resource-based economies have for the most part recovered over the past several years. Perhaps the most rapid gains will be in the less-developed areas such as Africa, whereby a slight increase in productivity is relatively easy.

FANG dominance – the broad market is having increasing difficulty in competing with the FANG companies. The once major retailers such as JCPenny, Sears, and Macy's have yet to find the right formula, and are cutting stores, which is unlikely to help, and will probably accelerate the decline. The once powerhouse of IBM reported 17 consecutive quarters of declining revenues and appears to be unable to find a defensible niche. (The shift to the cloud, where AWS is the dominant player, appears to be accelerating IBM's fall.) In the case of grocery stores, Amazon's purchase of Whole Foods has imparted massive loses on Kroger's market capitalization. While the regulators are still trying to understand the new technology world, the FANG companies are causing major disruption.

Technology - the accelerating usage of technology is often hard to anticipate but is leading to massive disruption.

Dismal Energy Prices – fracking, horizontal drilling, and possibly peaking demand are weighing on petroleum prices, thereby pushing down expected trading ranges to $35 to $50 per barrel for WTI. Expect pain for the major offshore producers and others which are reliant on high prices such as the Middle East countries, Russia, and Venezuela. Another major disruptor is the electric car, which with the new Tesla has an extended range over 300 miles per charge. Lastly, news that Germany charging some negative rates for wind-generated electricity is sobering.

Low-quality Employment – while the stated unemployment rate is low, many people are unsettled because of the dearth of reliable (i.e. high-paying) employment opportunities and rising costs, particularly from health insurance. President Trump was able to connect with the disgruntled middle class and now is attempting the hard part, which is delivering on campaign promises.

Russia, Syria and North Korea – conditions in these areas appear to change on a daily basis. The hope is that the risks remain manageable.

Fannie/ Freddie – it is clear to most that Fannie and Freddie need to be restructured; the major problem is finding a workable structure. We expect a framework will emerge shortly and the two will be eased from most government support with the result being a substantial rise in funding costs. (The activities of the two could be curtailed to focus on the direst problems in the housing market).

Resulting Outlook – Despite the problems in the domestic and global economies, assuming the central banks remain vigilant, the domestic and global economy should be in decent shape. (The central banks' expansion of their balance sheets has been a driver of the markets for the past 7+ years and foreign banks are likely to continue to provide support albeit at a lower level.) Both the U.S. and the emerging markets appear to be safe havens despite the uncertainty. (The US is also bolstered by the expected tax reforms and a reduction in some regulatory costs.) Europe is bolstered by the high productivity of most areas other than Southern Europe. Japan is hobbled by massive debt and little growth, and China is in the midst of a redirection. Below is a summary:

Deteriorating:

Retail Disaster – Amazon will destroy margins for any industries involved in selling goods, grocers, 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.

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

Potential Deterioration:

Tobacco – The US FDA's announcement of a new comprehensive plan for tobacco and nicotine regulation is intended to reduce tobacco-related disease and death largely through reduced consumption. As fewer people remain or become addicted to the tobacco products, tobacco companies will need to focus on other areas such as electronic cigarettes that offer higher growth prospects.

Improving:

Defense Industries – with increased tensions and a Republican administration, defense will be fine.

Healthcare – As a full repeal of Obamacare appears less likely, all areas of healthcare 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.

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 as margins and load factors slip from record levels. President Trump's immigration ban will likely affect major airlines in the short term.

Autos and Auto Suppliers – With the exception of Volkswagen and FIAT, most of the auto industry prospered over the last couple of years. Watch for new car sales, used car prices, and weaker profitability as used car inventory is at all-time high.

Banking – Reduced regulations should improve cost structures. The smaller banks are aided by the improved margins and the M&A upside. The flattening yield curve is concerning.

US Manufacturing Exporters – The softening U.S. Dollar against Yen, Euro, and Pound will level the playing field for domestic exporters.