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Best Ideas – A Massive Reset, Nov. 2018

The world is undergoing a massive reset and investors who understand current and pending changes will be in the best position to protect and enhance client wealth. Below is a summary of the major changes.

United States – President Trump is questioning policies which have been in place since the end of World War II with the result being massive uncertainty among our trading partners. The current administration sees little reason for the U.S.'s paying for the bulk of NATO expenditures when Germany is sustaining a massive trade surplus with the U.S. and has tariffs on U.S.-manufactured vehicles greater than those imposed by the U.S. on German vehicles. Likewise, Mr. Trump sees little reason for facilitating the transfer payments to Mexican immigrants while Mexico maintains a massive surplus relative to the U.S. Lastly, the current administration is questioning payments to Iran when it is violating prior treaties and financing hostilities in Syria and Yemen. In the case of North Korea, Mr. Kim is not so sure that Mr. Trump will not follow through on his threats and therefore is forced to try another path to achieve his goals. Lastly, the trade practices of China in connection with the forced transfer of technology are being questioned. The major difference between the current administration and prior administrations is the questioning of prior practices, which as can be expected, are disruptive.

A summary report from Mr. Mueller is also likely to be released after the mid-term elections which is likely to place some pressure on the administration. Additionally, there are likely to be some unsavory news on dealings in the Trump organization. If Democrats regain control of the House, Mr. Trump's legislative efforts will be curtailed.

EJR's View – The fight between Mr. Trump and the Washington status quo is likely to continue for the foreseeable future. However, Mr. Trump is slowly gaining control of major agencies and the economy is doing fairly well. Our view is that Ms. Pelosi will not opt for impeachment but will pressure the White House. Additionally, Mr. Trump might be blocked from appointing a new DOJ head by Congress. Furthermore, the lesson learned during the Clinton impeachment was the party bringing the action was damaged politically.

Growth and Interest Rates – there is little doubt that domestic growth has increased and with it, domestic interest rates. While the underlying growth drivers often remain a mystery to even the most seasoned economists, our view is that the reduction in taxes and regulations have played roles along with a refocusing on what is best for the country. Of concern is increased trade hostilities, but it might be a case of short-term pain for longer term growth. Regardless, it is clear the U.S. is growing faster than most had expected and barring a calamity, is likely to continue growing over the next couple of years.

EJR's View – Rising interest rates are a sign of health for the economy but likely to dampen stock market gains.

European Dis-Union – the European Union is showing more signs of disunion than union. Italy is claiming it will not contribute to the EU's budget unless it is granted relief on the migrant

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crisis, budget matters, turmoil with its banks, and probably some help on rising funding costs. Meanwhile, divorce negotiations with the UK are bogged down and it appears that self-imposed deadlines are unlikely to be met. Lastly, the Greece bailout is likely to be a burden to the Greek economy for the foreseeable future.

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. An arrangement will be reached with the UK and Italy will be helped.

Trade Disputes – the axiom taught by economists post the Great Depression is that trade wars are a disaster and that at all costs should be avoided. The notion is that global trade is an engine for global economic growth and one should overlook some cheating by trade partners as it is immaterial in the overall system. Mr. Trump takes a far different view and believes that his constituency has been hurt and that some egregious abuses need to stop. A prime example is the differing tariffs on autos and China's abuse of intellectual property rights.

EJR's View – Given the self-sufficiency of the US economy, Mr. Trump believes some progress can be achieved and that the economists are wrong. Our view is that the situation will be manageable although the markets remain nervous.

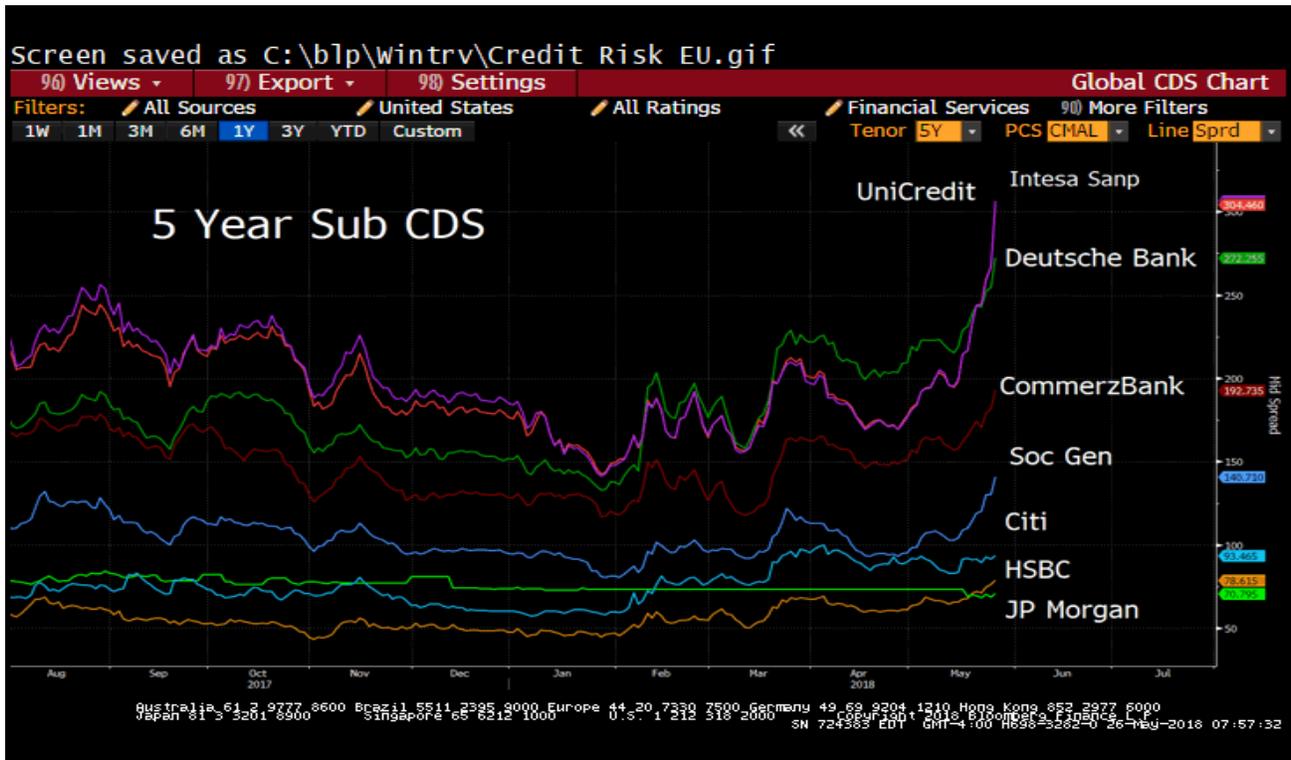
Saudi Arabia - Prince Mohammed bin Salman has incurred the world's wrath by applying 18th century means for dealing with criticism. Killing a critic in an embassy is viewed as unacceptable for a variety of reasons and Saudi Arabia has lost respect in international circles. The upshot is likely to be the punishment of the individuals directly involved but little more; the international community has little impact on Saudi Arabia's internal politics.

China – Mr. Xi has his hands full with the weak stock market, slower growth and some recent scandals.

On balance, we believe the global economy and credit conditions are reasonably strong but are challenged by trade wars and rising interest rates.

Despite our overall propitious view of the credit markets, there are some concerns with the Italian banks at the top of our list. While Deutsche Bank has slipped, if needed, we expect some indirect support from the German government. The below chart indicates concern re. Italian banks.

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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%	+3.5%	+4.0%	3.5%
Currency Values	Decline	Mixed	Rise	Mixed	Mixed
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	Varied	Improving	Varied	Varied

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.

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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	2.75	2.8	2.88	3.05	3.05	3.20
Germany	-0.22	0.05	0.34	0.76	1.02	1.45
Italy	2.35	1.50	3.06	2.65	3.72	3.52
United Kingdom	1.01	1.23	1.41	1.65	1.76	2.05
Japan	-0.07	0.03	0.11	0.20	0.85	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.16	1.20
Yuan to Dollars	6.84 \$/RMB	7.00 \$/RMB
USD-JPY	111.29	110
GBP-USD	1.28	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 (except for 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



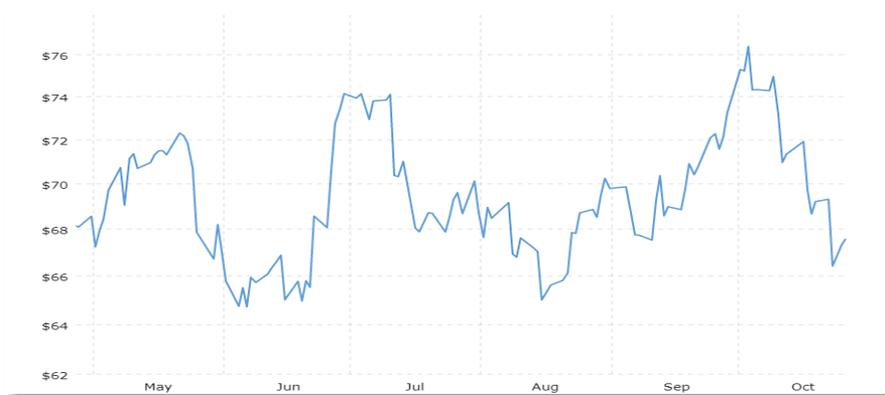
Source: macrotrends.net

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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 – 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.
- **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.

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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.

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:

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.

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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

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.

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,