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 – Thinking the Unthinkable; Fathoming the Unfathomable

Oct 2017

(The world is rapidly changing and with it, investment opportunities and perils)

No matter where you look, the developed world is very different today than it was 24 months ago and probably 12 months ago.

United States – a reset

Starting with the U.S., conditions are completely different currently than a couple of years ago whereby currently the country is run by a man who wants to materially change the status quo and believes he was given a mandate to do so. As we speak, massive effort is underway to reverse rules and procedures implemented by President Bush and President Obama to guide the country out of the financial crisis. President Trump is enacting major rollbacks in the regulatory structure in the hope of engendering growth. While a modification of Affordable Care Act remains elusive, Mr. Trump is wasting little time in addressing areas which he believes need attention. We saw early indications of Mr. Trump's willingness to act with 50 cruise missiles launched in Syria in response to Assad's application of chemical weapons and now the attention is on North Korea. Mr. Trump appears to have convinced the Chinese banks to curtail its relationship with North Korea. In response, Kim Jong-un has threatened to explode a hydrogen bomb in the Pacific.

The major issues are:

a) If Kim Jong-un proceeds with his stated plans, where in the Pacific will a bomb be exploded.
b) Will the White House consider it a threat, and
c) How will the administration respond.

Our view is that the period of escalating threats is reaching an end and if Kim deploys a hydrogen bomb, the administration will respond; Trump probably believes he has gained support from China and Russia for a response. On to the response, ***we see Syria as a model for a measured response, while the scale is likely to be significantly larger***. Although we hesitate to speculate on the exact response, our best bet is a stealth aircraft (or cruise missiles) releasing a series of munitions over key areas with a warning of escalation if conditions continue. Coupled with the threat is likely to be an avenue for North Korea to benefit if it behaves in a more responsible manner. ***However, if actions escalate, the impact on credit and equity markets is likely to be significant, at least until investors are confident that future actions will be curtailed.***

As we write, the markets are absorbing the impact of Nevada shootings. We expect little lasting impact.

Europe – the calm masking the storm

European equity, fixed income, and currency markets have been on a tear ever since Le Pen won the French elections. Providing the grease to ease the markets, the ECB has been

hitting bids on anything which comes close to the market and as a result has expanded its asset levels to $5.1 trillion. Consequently, nearly all appears to be golden in the European markets. However, appearances are not reality. Starting with France, Macron is struggling to push through the reforms he promised, which are at the heart of sustainable growth.

Moving down, Spain has not endeared itself to its citizens via its heavy-handed approach towards the upcoming Catalonian vote. We expect the outcomes to be a more independent Catalonia.

In the case of Italy, as expected, voters holding bank securities were spared significant pain via a bailout of the banks while the institutional investors were left with losses and claiming dangerous precedents (General Motors and Detroit's workouts being the latest examples in the U.S. of similar cases).

Regarding Greece, the relevant parties meet, agree on stopgap measures and then agree to meet after six months and presumably go through the routine again. The show is getting old and we expect more realistic write-downs and fix to be put in place post Merkel's election.

On to probably the most problematical and uncertain case in the EU (at least for now) and that is the United Kingdom. Perhaps we should start by addressing the misnomer; the United Kingdom has never been more disunited in its recent history and therefore is unsure of where it is going or how to get there. The core reasons for the UK's exiting from the EU were concerns over immigration and the resulting instability and fear that the UK's crown jewel, its financial services industry, would be hobbled by policies emanating from Brussels and Berlin. The irony is that the UK has suffered more than most countries (other than perhaps France) from terrorist actions and its financial markets are being cut off from the balance of the EU. Perhaps terrorist actions might be worse if immigration was unfettered but it is clear that London's importance as a financial center is being diminished. Perhaps the item adding insult to injury is the amount of money the UK will have to pay to affect the divorce. Regardless of the outcome of the Brexit negotiations, it appears evident that there is little that will stop the UK's continue slippage in its global economic standing.

Leaving best to last, Germany remains an outward powerhouse; its automobile, machinery, chemical, and pharmaceutical industries guarantee a strong balance of payments and a seat at the world economic table. However, the century-old challenges facing Germany remain albeit with different names and players. The country's core challenge is how to co-exist among divergent players who never quite trust German intentions and who are quick to claim unfair conditions in an effort to improve their standing. Russia remains a mystery to most Germans and yet Germany is dependent on Russian gas supplies to fuels its industries and heat their homes. Appeasement in the Middle East appears to be the best path and yet integrating immigrants into German society appears to be elusive. Angela Merkel is holding the game together, but four terms is a bit much for any politician.

On balance, the EU is muddling through but when one adjusts for the massive $5.1T growth in the ECB's balance sheet, the area remains stressed. However, as long as the ECB does

not rapidly shrink its balance sheet, the EU should be fine. **Perhaps the major item to watch for is the ECB's shrinking its balance sheet, which is unlikely anytime soon.**

On to China, we do not see any major change; the S&P downgrade was expected and is manageable. Japan has shown some growth recently, but the country is at the far end of normal expectations concerning sovereign debt to GDP and is likely to remain challenged for the next several years.

Hence, on balance, the US remains strong, and is likely to experience a Pax-Americana growth period of 2.5+% over the next several years if it can defuse the North Korea threat or address it with little long-term pain.

Benign Global Outlook - Regarding the global economy, both the U.S. and the emerging markets appear to be safe havens currently as Europe is still struggling through its multitude of festering structural issues, Japan is hobbled by massive debt and little growth, and China is in the midst of a redirection. Below is a summary

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%	+1.8%	2.0%	+5.0%	4.0%
Currency Values	Decline	Mixed	Rise	Decline	Mixed
Stimulus Change	Same	Same	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Varied	Slight Growth	Varied	Growth
Perceived Safe Haven	Yes	Yes	Yes	No	No
Interest Rates	Low	Low	Slight Growth	Falling	Varied
Asset Valuations	Varied	Varied	Improving	Varied	Improving

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

Regarding interest rates, Europe and Japan are stuck with low growth and high debt levels and therefore have significant difficulty in raising interest rates. Meanwhile, the 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 under increasing pressure because of increased credit quality concerns.

Figure II: 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	1.90	2.05	2.31	2.45	2.86	3.01
Germany	-0.265	-0.15	0.47	0.80	1.26	1.35
Italy	0.86	0.95	2.21	2.33	3.30	3.50
United Kingdom	0.80	0.75	1.38	1.45	1.94	2.05
Japan	-0.085	-0.03	0.05	0.08	0.86	0.95

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 III: Rising U.S. dollar

	Current	EJR Est. Year End
Dollars to Euros	0.85 $/€	0.90 $/€
Dollars to Yuan	6.64 $/RMB	6.85 $/RMB
Dollars to Yen	112.8 $/¥	114.2 $/¥
Dollars to Pound	0.747 $/£	0.785 $/£

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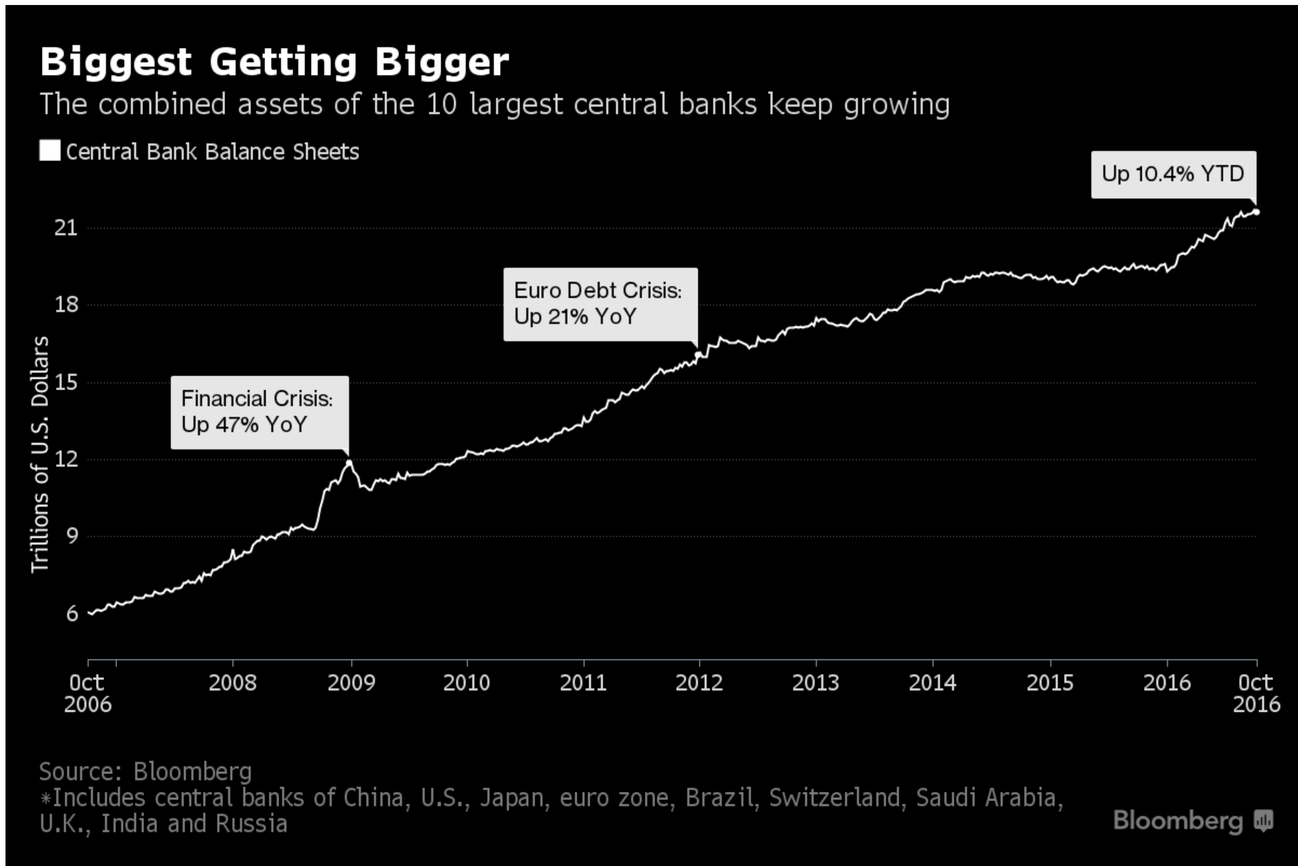
Comments on Central Banks Impact - Central banks have been dominant forces in the markets since the 2007-2008 credit crisis and although the US is shrinking its balance sheet are in the process of scaling back, other central banks have not yet followed. Given the fact that the central banks now own $21 trillion of assets, and there is pressure for tapering, what might this tapering result in? Our view is that we might be on the verge of a major reset as a result of the normalization of the markets. The first item to examine might be inflation, which was nonexistent for years in most of the developed economies until recently. If inflation is real, then why is the yield curve flatter than normal? The short answer is that we are not sure, but if inflation is now an issue, the longer yields should start showing some increases.



Regarding domestic affairs, while the major media remains aghast at the improprieties of our new president, the equity markets are rejoicing at the prospect of lower tax rate, eased regulations, an overall reduction in the cost of doing business, and higher growth prospect. We expect the new president to adjust his behaviors as he matures in the job. On balance, we expect that the new environment will be propitious for most industries:

Deteriorating:

Retail Disaster – Amazon will destroy margins for any industries involved in selling goods, 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. The next major target for Amazon appears to be grocers.

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.

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.

US Manufacturing Exporters – The weaker U.S. Dollar helps, but the major driver is the health of the global economy.

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 down 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. The European producers are probably in the best shape because of the recent rise in the dollar and yen. Watch for new car sales, used car prices, and weaker profitability as used car inventory is at all-time high.