

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 Premium on Understanding, October 2018

The true heroes in the financial markets are those few who understand the dynamics driving the markets and have the courage to act or if in the research area, articulate the concerns so clients can act. Egan-Jones has been in the fortunate position of recognizing the dangers early and was thus identified by Fortune Magazine as the number one firm for warning about the credit crisis. The question facing investors now is whether we are facing a similar vent, especially in the near future. Our view is we are not and that if conditions became dicey, the central banks would again swing into action to flood the markets with liquidity. While a full scale market rout is unlikely, what is likely are skirmishes on a variety of fronts. Listed below are those which are worth monitoring.

Washington Turmoil – Mr. Trump has been under regular attack for the past four years and appears to enjoy the controversy. The heart of the problem is that the current administration is questioning the status quo and in the process threatening the lifestyles of the Washington regulars. The media have a love/hate (mostly hate) relationship because they question Mr. Trump's fitness to serve on the one hand and they love the increased viewership on the other hand. A switch of the House from Republican to Democratic control would be a blow to Mr. Trump's efforts, but the outcome remains uncertain despite recent polls. Watch for more fireworks over the coming weeks. The irony is that despite the turmoil (some would say because of it), GDP growth and unemployment levels have rarely been more attractive.

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. Furthermore, the lesson learned during the Clinton impeachment was the party bringing the action was damaged politically.

European Dis-Union – the planned divorce between the UK and the EU is not progressing as planned and it appears the lawyers are the only ones making progress. Meanwhile, Italy is questioning its continuation in the Union and Turkey is seeking compensation for the refugees. While the Greece problems have yet again been announced as solved, we have our doubts. Perhaps the most relevant item for financial watchers is the supposed exit of the ECB from quantitative easing.

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.

The China Syndrome – Mr. Trump promised to "Make America Great Again" and part of that is to reset trade relations with its major trading partners. The country on the forefront is China, which has to date, resisted Mr. Trump's efforts to reset the relationship. 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

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.

and that some egregious abuses need to stop. A prime example is the differing tariffs on autos and Chinas 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.

The Middle East – Here again, Mr. Trump is resetting past relationships by cutting the flow of money to various groups and breaking the Iran treaty. In a rarely seen exchange, Mr. Kerry is attempting to patch up old treaties to the consternation of Mr. Pompeo.

EJR's View – While the Middle East remains a tinder box, the most likely course is for Iran to make some adjustments.

North Korea – challenges from the “Rocket Man” were regularly cover stories as of six months ago, but since have faded as Mr. Kim tries to find the right path forward. We expect some low level agreement and a moderate level of tension in the near future.

Regarding some challenged credits, that is prior powerhouses in turmoil, Deutsche Bank, Danske Bank, and Tesla appear to be the main stories. In the case of the first two, watch for the usual solution of retrenchment, more spending on compliance and some material fines. In the case of Tesla, the darling appears to be turning into a dog, with the watershed events being the on-screen pot smoking incident and the possible criminal charges. Given the fact that most of the majors are introducing their own electric vehicles, it is not clear where a savior might be found.

Back to the macro view, 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.

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.

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	2.95	3.0	3.07	3.1	3.23	3.20
Germany	-0.10	0.05	0.47	0.76	1.10	1.45
Italy	2.54	1.50	3.3	2.65	3.75	3.52
United Kingdom	1.18	1.23	1.59	1.65	1.93	2.05
Japan	-0.07	0.03	0.13	0.20	0.92	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	6.87\$/RMB	7.00 \$/RMB
USD-JPY	113.9	110
GBP-USD	1.3	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 (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.

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.

Figure I: 10 Year US Treasury Yield

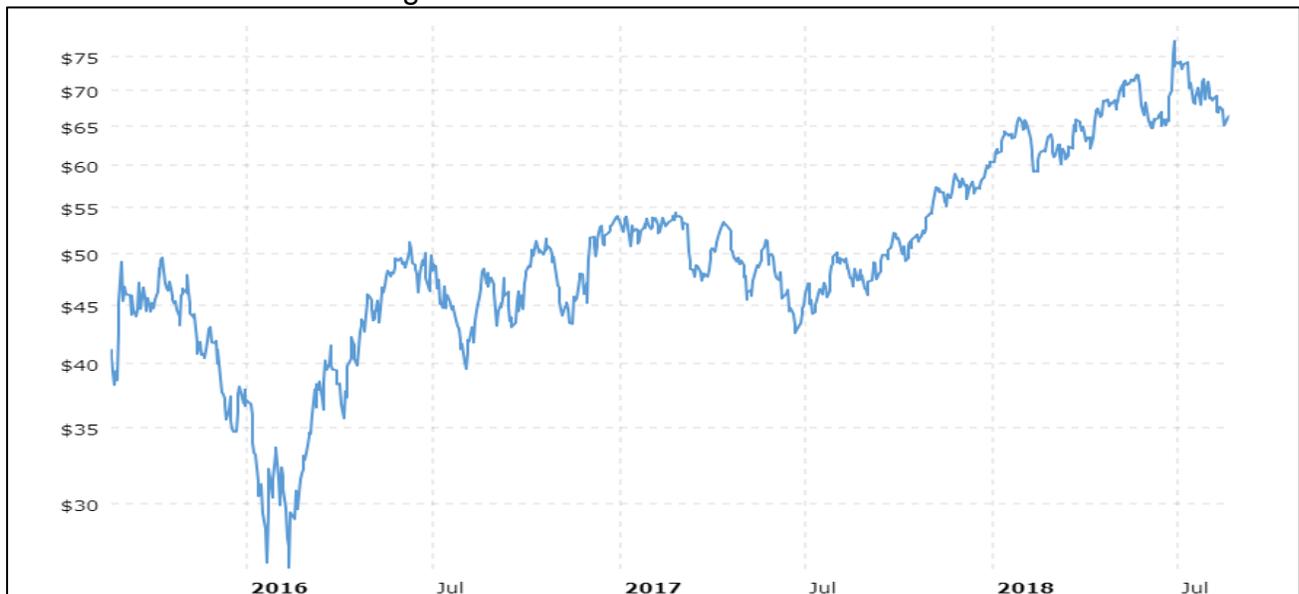


Source: macrotrends.net

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 II: WTI – Recent Crude Oil Prices



Source: macrotrends.net

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.

- **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

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.

- **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.

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.

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.

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,