Best Ideas – Toxic?

Sept. 2017

The administration is in turmoil, but does it matter?

President Trump has alienated himself from major executives, major Republican leaders, the media apparently most Democrats, probably most Washington regulars. Nonetheless, he continues with the same strident approach. It is hard to recall a similar president in recent history. Is there a method to the madness or, just madness. Perhaps the more relevant question is whether it matters. With US and global growth reaching recent highs (3% growth in the latest quarter), perhaps the political climate is less relevant. **Or perhaps a better interpretation is that it does not matter until it does!** Our view is that a hobbled presidency is not necessarily a positive unless conditions careen out of control. In fact, one could argue that an "unpredictable" president might be a positive in curtailing the actions of nationalist rulers such as Putin (and most other global leaders). Against the backdrop of improved global growth, some of the below items are likely to be relevant over the next couple of quarters:

North Korea – while the friction is uncomfortable, Trump appears to be attempting a path to rein in the threats of Kim Jong-un by both threatening to act and pressuring China via economic actions. On the one hand is the risk that these actions escalate the crisis and on the other hand, is the hope that Kim Jong-un will have an incentive to behave? Despite the rhetoric, the risk to the US mainland is minimal and Kim Jong-un probably realizes any action he takes will be met in kind.

US debt limit – the drama is back with a twist, which is President Trump warning that no raise will be accepted without funding for a wall along the Mexican border. We expect a rapid resolution.

Withdrawal of Central Bank Support – the central banks might withdraw market support by limiting QE and shrinking balance sheets.

Increased tensions with China – the soreness over China's building of islands in South China Sea continues and hopefully does not careen out of control into a conflict.

The Administration's continued ways – staff turnover continues, the Mueller investigation is ongoing, and Mr. Trump sees no reason to act "presidential".

Given the normal woes facing investors, the current ones are more or less manageable, with the two major risks probably being North Korea and Central Bank actions. Provided these two issues remain under control, the relatively strong global growth is likely to counter other woes. The daily optics arising from Washington are unbecoming in the same manner that the public is reminded of the existence of the mafia and the drug cartels only when there is friction with other gangs or law enforcement. Below are the major themes we believe are still driving the market:

Low interest rates – with global sovereign interest rates near or below zero, the FED has attempted some semblance of normalcy with a rate rise. This effort is encouraging, but is unlikely to be enough; we expect other major central banks including some outside the developed countries to continue QE efforts.

Japan – with debt to GDP near 240%, a shrinking population, a rapidly rising dependency ratio, and negative interest rates, there are numerous ways Japan could become "unglued" in the near future. However, it has not, and in fact has shown some evidence of growth.

China – the underlying premise for the Communist Party's power is supposedly that it is able to deliver an improved standard of living to most of its citizens (we question the notion that if it fails, as Russia has, there will be a change in the political structure). The country is shifting from an export and infrastructure building economy to a more balanced economy. Furthermore, the shift from the rural to urban areas (particularly the large cities) has cause major disruptions. Lastly, China's attempts to extend its reach in the South China Sea have increased tensions.

European Union – the European Union is being tested in the areas of immigration, Brexit, banking sector weakness, and the wisdom of a common currency at a time when national EU budgets are not coordinated. In contrast to the US, if a state is weak economically, transfer payments from the federal government assist the state in bridging the gap, and usually, there is a shift of factories to the lower-cost, weaker states such as the shift from the North to the South during the last century. Adding to the woes is the sovereign debt increase, the low GDP growth, and the rise in the ECB's balance sheet. While most observers are focused on the pain to the UK of the pending Brexit, the decline in trade is likely to hurt both sides.

United Kingdom – the UK separated from the EU primary because of the immigration issue. The problem facing the country is the harm which might be caused by the "passporting" problem whereby financial institutions in the UK could not easily conduct business in the EU. (Financial services account for 12% of national output according to Fortune Magazine.) Although negotiations have begun, it might be years before we have an accurate fix on how the ultimate rules will be written and interpreted. Rest assured, Paris, Frankfurt, Amsterdam, and Dublin are hoping to assume some of the services previously conducted by London (perhaps New York will be the primary beneficiary). In the meantime, rents are likely to become more reasonable in London.

Russia – although the country's economic power has ebbed with the price of petroleum and other natural resources, Putin is determined to make Russia relevant on the global scene and whenever possible, extend influence. There is little doubt that Syria is a disaster, but perhaps the larger question is whether it is of great significance strategically.

Central Banks – the over-riding consideration in this market is what the massive buyers (i.e., the central banks) are planning. Below is as indication of their size and influence:

> "Central banks own $25tn of financial assets (a sum larger than GDP of US and Japan, and up $12tn since Lehman"
> The Liquidity Supernova & the "Keynesian Put." by BofA's Michael Hartnett

Middle East – although this area appears to always be cause for concern, the retreat of ISIS and the relative calm in the area is encouraging. Furthermore, with the US's increasing energy independence and the soft petroleum prices, the area might become less important on a relative scale.

While the afore-mentioned issues are causes for concern, they are all manageable provided the central banks continue providing liquidity. The central banks' expansion of their balance sheets has been a driver of the markets for the past 7+ year and is likely to continue to provide support albeit at a lower level. The major factors which have propelled the market since last Nov. and appear to still be present are: the expected tax reforms, growth via the emerging markets, and a reduction in some regulatory costs.

Resulting Outlook – Despite all of the problems in the domestic and global economies, assuming the central banks remain vigilant, the domestic and global economy should be in decent shape. Both the U.S. and the emerging markets appear to be safe havens and despite uncertainty, 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:

Figure I: Major 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, ST 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 concern and UK might be hurt by Brexit uncertainties.

Figure III: Slightly 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	1.71	1.80	2.13	2.20	2.24	2.45
Germany	-0.35	-0.10	0.35	0.55	1.11	1.33
Italy	0.72	0.9	2.02	2.19	3.19	3.33
United Kingdom	0.44	0.75	1.03	1.32	1.70	1.95
Japan	-0.15	-0.10	0.0	0.12	0.82	0.89

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	0.84 $/€	0.85 $/€
Dollars to Yuan	6.59 $/RMB	6.80 $/RMB
Dollars to Yen	110.32 $/¥	112.25 $/¥
Dollars to Pound	0.78 $/£	0.76 $/£

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, 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:

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.

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.

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. Watch for the economic growth prospect in U.S.