Best Ideas – The Three Demons, Sept. 2018

Nearly every analysis of the global economy includes a caveat that this recovery has been going on 10 years, pushing it far beyond any other post war recovery. While there are numerous concerns, we will address the three major ones and assess the chances that will emerge from concerns to full blow crises.

Constitutional Crisis – President Trump has been under attack since announcing his candidacy, and last week reminded voters of his vulnerability. A summary report from Mr. Mueller is also likely to be released in mid to late Sept., adding to the pressure on the Administration. Additionally, there are likely to be some unsavory news on dealings in the Trump organization. The issue is that if the Democrats regain control of the House and with impeachment proceeding shortly thereafter. The basis might be testimony that Trump knew about some Russian meetings or that inappropriate payments were made via his campaign. Additionally, Me. Trump might be blocked from appointing a new DOJ head by Congress.
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.

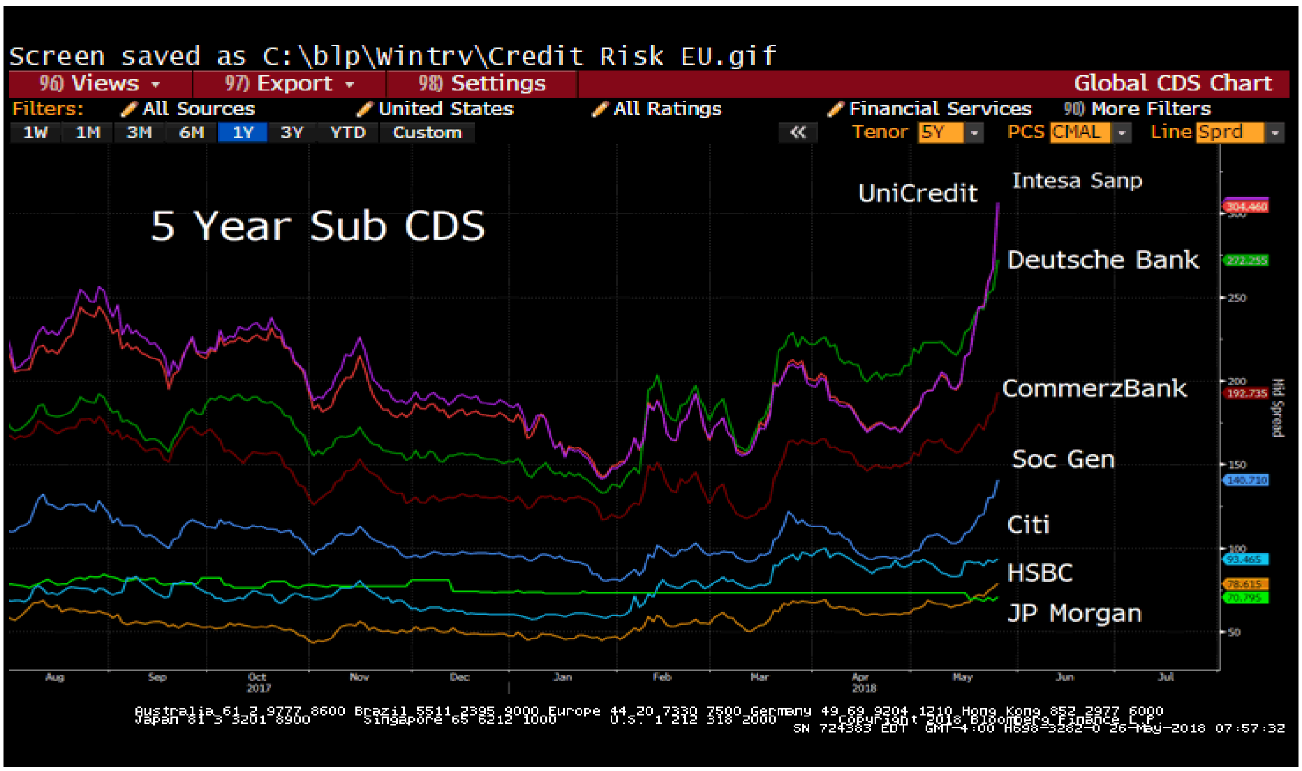
European Dis-Union – the European Union is showing more signs of disunion than union. Italy is claiming it will not contribute to the EU's budget unless granted relief on the migrant crisis, budget matters, turmoil with its banks, and probably some help on rising funding costs. Meanwhile, divorce negotiations 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 overlooking 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 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.

(One could add the perpetual demon, the Middle East and particularly Iran, but with

increased US energy independence, the threat is fading.) On balance, we believe the global economy and credit conditions are reasonably strong and will remain so.

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.



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.

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:

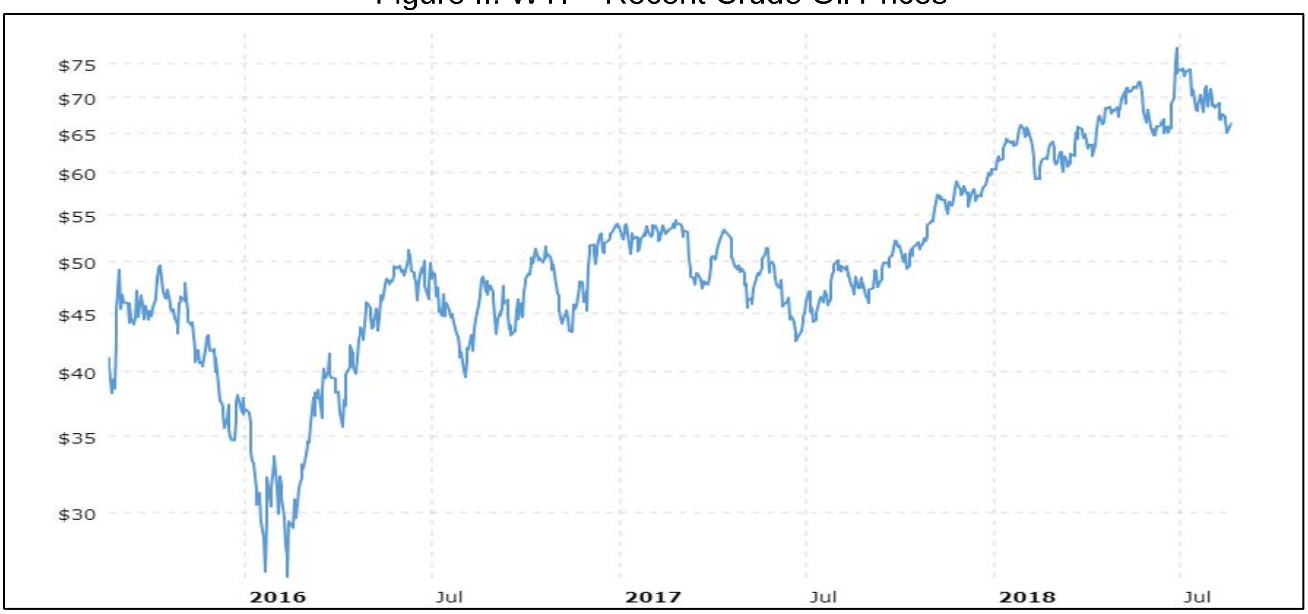
- **Interest Rates –** the 10 year is near 2.9% with many calling for an end to the 30 year bull market in rates.
  Prognosis – while interest rates are edging up, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (with the exception of Germany) are concerned about fiscal deficits and therefore are likely to discourage a substantial rise in interest rates and sovereign funding costs.

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

- **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

- **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.

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,