Best Idea I. The Trade War or the Election
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I. Trade War & the Election

Regarding our first "Best Idea", the current administration prides itself on being a "winner" and is in the midst of a major tariff battle with China. Unfortunately, Mr. Trump's efforts to win the trade battle might come at the expense of reducing his chances of winning the election. The market is somewhat surprised that the trade war is now escalating thereby raising the question of (i) whether it will continue, and (ii) what is the upshot? The moment of truth is likely to be the G7meetings which might provide an avenue for both parties to take a breather. However, if the current path continues, we see little hope for avoiding a recession in the near future. The fear among many economists is that we are repeating the mistakes made in 1929 of increasing trade barriers and a partial reversal of the gains made via globalization. This is confirmed by the fact that nearly 3 out of 4 economists surveyed by the National Association for Business Economics expect a recession by 2021. Nonetheless, Mr. Trump's arguments regarding the ills of globalization and the forced transfer of technology have resonated with many. Mr. Trump would be hurt by a pre-election recession and therefore might make course corrections.

II. Zero Interest Rates

Regarding the second "Best Idea", we see little chance that the FED is not going to respond to the slashing of rates by the major central banks by also cutting rates to prevent a rise in the dollar. The massive trade deficit leaves the FED little choice. While unemployment remains low, it is a lagging indicator, and more leading indicators are pointing to a slowdown (see auto and homes sales and copper and energy prices).

Given the fact that global interest rates are heading to zero, how do asset prices respond? On the one hand, if CAPM theories remain intact, the "risk-free" rate needs to be adjusted from the typical 3.0% (for the long-term treasuries) to something closer to zero. Assuming the normal risk premium of 3.0%, the capitalization rate would decline from 6.0% to close to 3.0%, which would be a bonanza for equity and most other values. However, is it safe to assume the risk-free rate will remain at 3.0%, or is a safer conclusion that the risk premium is going to gap out? Alternatively, with the chaos, will the "E" (i.e., earnings) portion going to deflate and what used to be $1.00 of earnings collapses to $0.50 because the central bankers' actions are coincidental with a deteriorating economy? Our best bet is that if we slip to zero interest rates the economy will be miserable and that earnings will be significantly weaker. However, lifting ourselves up from zero interest rates will take time and the parties making the decisions (i.e., the major developed countries) have an incentive to keep rates low to make their debt burden more affordable. Hence, Equities and other risk assets should recover.

III. Crypto Currencies II and Possible Sovereign Responses

A major flaw of most market observers is the inability to envision the next couple of levels of development and likely responses. Our view is that we are just at the beginning of innovation in the area of crypto currencies and that the next couple of generations might solve some nascent problems in our markets. A large problem facing us is zero interest rates which as far as we can tell, rarely existed in the course of human history. The message is that it makes no sense to save and that for investors seeking low risk investments, they are effectively punished. (As we speak, there are approximately EUR16T of negative-yielding securities.) Moving out on the risk curve, investors are basically under-rewarded for taking risks, which can be disastrous over the long run. In fact, the long run has already arrived with the hobbling of some major banks focused on lending such as Deutsche Bank and Commerzbank (watch for some major pension plans to announce massive cuts in benefits). The under-lying problem is that major developed country central banks are creating currency and bought a variety of assets (primarily securities issued by the countries' treasuries) thereby depressing interest rates.

Turning to crypto currencies, the major problem has been the lack of security and the fact that the currencies are backed by nothing more than trust. We expect both of these problems to be solved over time. On the first point, there is likely to be a major firm providing security (e.g., Amazon Web Services, Facebook or Oracle) while the second problem can be solved by linking the currency to something people value such as purchasing value in an accepted venue (like the old S&H Green stamps) or a store of value such as gold. However, it is unlikely that the major sovereignties are going to fully accept the disintermediation. (A 1.00% rise in rates on EUR20T costs EUR200B per annum.) Currently, initial coin offerings are regulated and "coins" are treated as currencies. However, we expect such regulation to extend to crypto currency issuance. Therefore, the innovation is unlikely to come from a country which is benefitting from the depressed rates. A currency offering a rate of return equal to inflation and convertible into purchases on a major retail site might be the next generation.

IV. The Coming Collapsing: Likely Origins and Potential Responses

Regarding the third "Best Idea" our belief is that we will enter a recession (regardless of Mr. Trump's actions), with the major question being when. The normal recovery is approximately seven years and we are now at nearly twelve years. Furthermore, over the past seven years debt has grown fast than growth and despite the talk of MMT (Modern Monetary Theory), real cash will be needed to repay debts. Lastly, most leading indicators of economic indicators are flat or down:

Housing Starts
Auto Sales
Shipping
Copper and Wood Prices
Steel Prices
German GDP down over the past two quarters
Argentina struggling to avoid its ninth sovereign debt default

The major issue is when the broad downturn will come and more importantly, how to prepare. Below are a few thoughts:

China – investors regularly point to China's foreign currency reserves and control of the economy as reasons for not worrying. However, this notion is belied by the frequent runs on various asset classes. (We particularly worry about the massive capital improvements including residential and commercial construction which appear to be unsupported from a credit quality perspective.) The factors which might provide a catalyst are the changing status of Hong Kong and the pressure from tighter margins and lower revenues as a result of the tariffs. Watch for China's cutting the renminbi to 9 per US dollar and causing apoplexy in the markets.

Structured Finance – concerns remain that structured finance which remain opaque will be deemed as risky investments. Areas which are particularly vulnerable are CMBS, CLOs and auto-based transactions.

European Banks – the negative interest rates on approximately EUR16 trillion of assets translate into little to no profitability for those institutions which heretofore has depended on positive spreads between long and short-term rates. It is little wonder that the European banks have lost market position and that some are at risk of losing their investment grade status. Even if this problem were to be addressed tomorrow, which it will not be, many institutions are in a precarious position.

Politics – the current administration is attempting to reset numerous relationships and with that effort comes increased chances that cold conflicts will become hot.

A short-term offset to the many of the above problems is that the central banks of the developed world are fully engaged in QE and as a result, investors have assumed there is NO credit risk nor need for time premium for approximately $14 trillion of securities.

Even though the central banks are the elephants in the pool, other investors are forced to play by their rules (that is, accept the negative yields) or sit on cash. In our opinion, negative interest rates exist today because of an odd set of circumstances: (i) major currencies are no longer convertible into precious metals such as gold or silver, (ii) central banks believe it is within their mandate to maintain economic wealth, particularly the value of the stock market, (iii) central banks have been given the authority to print currency and to use such newly-minted currency to purchase securities, and (iv) since most central banks of developed countries have undertaken similar policies over the past several years, there are few places for investors to "hide". Furthermore, the excess liquidity is spreading to most markets such that interest rates globally are suppressed. The nomination of Ms. Lagarde as head of the ECB is likely to continue the ECB's "whatever it takes" policy which translates into a continuation of QE.

Therefore, even though unemployment rates in the U.S. have reached 50-year lows, the FED is highly likely to cut rates to ensure the dollar does not become uncompetitive. While many point to Sir John Maynard Keynes as the guiding authority on monetary stimulus, the current action goes far beyond what the typical Keynes acolyte would have considered prudent. Given the fact that unemployment, at least in the US is at 50-year lows and there is nary a hint of recession, what is the basis of the idiocy we are currently experiencing. Our view is that several massive "problems remain in the global economy and that the central banks and more importantly, leading political figures, would rather address symptoms rather than the underlying causes. The major problems include:

European Union – neither Italy nor Greece can afford their outstanding debt and the banks holding the debt do not have the capital to absorb losses. Hence, the drive to suppress interest rates.

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	+.5%	+.1%	+1.5%	+1.0%	+1.0%
Currency Values	Decline	Decline	Slight Rise	Decline	Mixed
Stimulus Change	Slight Deceleration	Some Growth	Some Growth	Some Growth	Little change
Earnings Trend	Slight Growth	Down	Slight Growth	Slight Growth	Growth
Interest Rates	Low	Little Change	Little Change	Little Change	Varied
Asset Valuations	Slight Growth	Flat	Varied	Varied	Slight Rise

Regarding interest rates, they appear to be bouncing around on a quarterly basis with little long-term direction. The EU countries and credits cannot afford significant increases in rates. The periphery EU countries are likely to see continued 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	0.28	1.6	0.41	1.85	0.9	2.4
Germany	-0.92	-70	-0.71	-.40	-0.19	.20
Italy	0.3	1.25	0.87	2.20	1.92	3.20
United Kingdom	0.28	.80	0.41	1.20	0.9	1.50
Japan	-0.34	0.03	-0.28	0.20	0.13	0.55

Below are our expectations for major currencies:

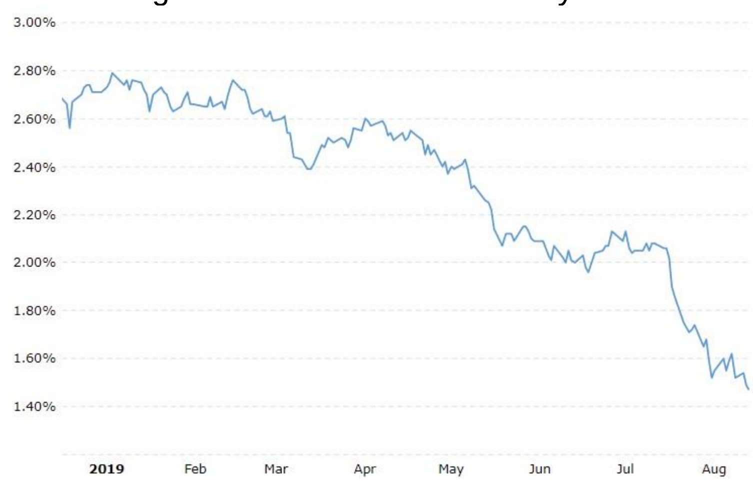
Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.10	1.05
Yuan to Dollars	7.14 $/RMB	7.2 $/RMB
USD-JPY	105.94	110
GBP-USD	1.21	1.20

Some of the major drivers of the economy and our expectations for those drivers are:

- **Interest Rates –** the 10 year is near1.46% with many calling for an end to the 30-year bull market in rates.
  Prognosis – while interest rates edged up earlier this year, 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.

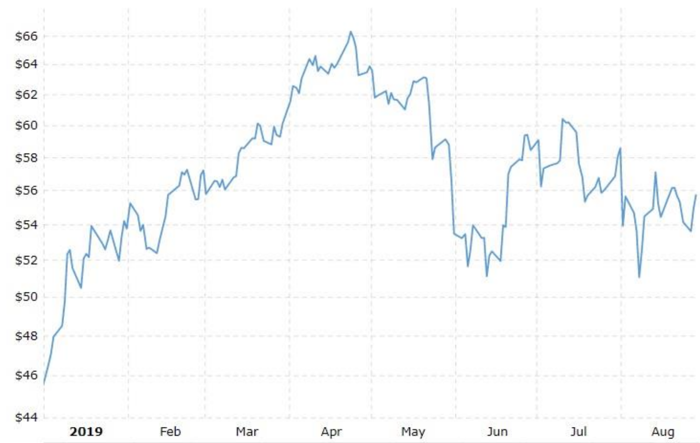
Figure IV: 10 Year US Treasury Yield



Source: macrotrends.net

Petroleum Prices – as can be seen in the chart below, petroleum prices have partially recovered. While it is always difficult to divine the underlying causes of petroleum prices, it appears that the supply is outrunning demand.
Prognosis – trade tensions and technology are conspiring to depress prices with the result being major angst among the totalitarian regimes.

Figure V: WTI – Recent Crude Oil Prices



Source: macrotrends.net

- **Central Banks' Money Creation –** the central banks of the developed countries have approximately $21 trillion in assets which have been used to suppress interest rates and support asset 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.

Figure VI: Five Year Forward Inflation Expectation %

Source: macrotrends.net

- **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 VII: S&P 500 Price to earnings ratio

Source: macrotrends.net

- **Inflation –** most economic commentators have predicted over the past ten years 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.

Regarding various industries, below is a summary of some of the major developments:

Below is our summary of the major industries (see our Industry report)

Deteriorating:
Agriculture Prices/Ag

Airlines
Beverage
Health Insurance
Retail
Media
Metals and Mining
Power Generators
Restaurant Industry
Italy/Poland/Hungary
Argentina/Turkey
Venezuela/Possibly Greece
Telecom
Traditional Retailing

Improving:
Chemicals
Defensive Industries
Infrastructure
Packaging
Technology

Neutral:
Autos and Auto Suppliers
Banking
Insurance
Railroads
REIT
Utility Distribution

Need to watch:
Big Technology
Credit Card Network/Processors
Exploration and Production and Servicing Firms (Energy)
Healthcare
Tobacco
Wireless Providers

Major debt levels

Country	Last		Previous
Japan	253.0	17-Dec	250.0
Italy	132.2	18-Dec	131.0
Singapore	112.2	18-Dec	111.0
France	98.4	18-Dec	98.4
Spain	97.1	18-Dec	98.1
Canada	90.6	18-Dec	89.7
Argentina	86.2	18-Dec	56.6
Euro Area	85.1	18-Dec	87.1
United Kingdom	84.7	18-Dec	85.1
European Union	80.0	18-Dec	81.7
Brazil	77.2	18-Dec	74.1
India	68.7	17-Dec	69.6
Germany	60.9	18-Dec	64.5
South Africa	55.8	18-Dec	53.1
China	50.5	18-Dec	46.8
Mexico	46.0	18-Dec	46.0
Hong Kong	38.4	16-Dec	37.0
Turkey	30.4	18-Dec	28.3
Switzerland	27.7	18-Dec	29.3
Venezuela	23.0	17-Dec	31.4
Saudi Arabia	19.1	18-Dec	17.2
United Arab Emirates	18.6	18-Dec	19.7
Russia	13.5	17-Dec	12.9

https://tradingeconomics.com/country-list/government-debt-to-gdp