Risk Commentary (April 2021)
Infection Point

The market is on the verge of a major inflection point; the uncertainty is which way is it heading. Over the past few weeks, the equity market has been fairly volatile despite no real change in the macro fundamental outlook. The U.S. Fed has remained dovish, and the US stimulus was released as planned. European COVID-19 situation is lagging behind that of the US and UK. After a year of global effort, the major economies are on the verge of becoming inoculated from the dreaded COVID19 disease. Unprecedented is probably the best way to describe the massive undertaking of drug discovery and rollout. Hence, after a year of lockdown, it appears consumers are anxious for a return to normal and make up for some delayed spending. Now for the concerning issues. A massive rise in social spending combined with tax increases has many worried that the recovery will be stalled by non-productive spending. Providing support for this notion is the recent rise in interest rates, although some would argue the rise was driven by the expected increase in spending. The big issue facing most investors is whether inflation is going to kick-up and result in massive disruption in portfolio positions.

While it is difficult to assess the future, it is worthwhile to note some of the major forces shaping the markets over the next couple of quarters, and most importantly, possible outcomes:

Figure I - Changes in Major Market Forces

	Result	Inflationary	Deflationary
COVID Recovery	Increased Spending	Yes	
Central Bank Quantitative Easing	Suppressed Interest Rates	Yes	
Increase Social Spending	Increased Spending	Yes	
Increased Taxes	If passed, only partially offset higher spending		Yes
Rising Deficits/ Indebtedness	MMT Concerns	Yes	

There are signs the market is struggling with the new conditions such as tighter cover rates in recent Treasury auctions and the rise in some of the crypto currencies. Assuming we have properly identified some of the major forces driving the market over the next couple of quarters, it appears the forces leading to increased inflationary pressure outweigh those on the deflationary side. Hence, perhaps the recent rise in interest rates is here to stay. In Europe, the major differences have been and continue to be a lower overall rate of growth and lower, and in many cases, negative interest rates. A major assumption in the above chart is whether the current administration is going to continue its approach; our view is that despite the protestations of the Republicans, the current administration is likely to be remembered as one of the most progressive since FDR and will succeed in advancing a variety of pro-spending legislation. For those Milton Friedman followers, the expansion in currency beyond the growth in the economy, normally results in inflation. The QE of the central banks has delayed but perhaps not completely eliminated inflationary pressures. ***In retrospect, the first few quarters of 2021 might be remembered as a major inflection point in the economy***.

In an effort to provide some context to the current situation, the rise in petroleum prices (per Figure A, WTI up from a low of $20 to $61.50) and the rise in housing (per Figure B, housing starts have been rising over the past twelve years and are currently near 1.58M per annum). (Figures A through E are sourced from Macrotrends.)

Figure A: Petroleum Prices (WTI)

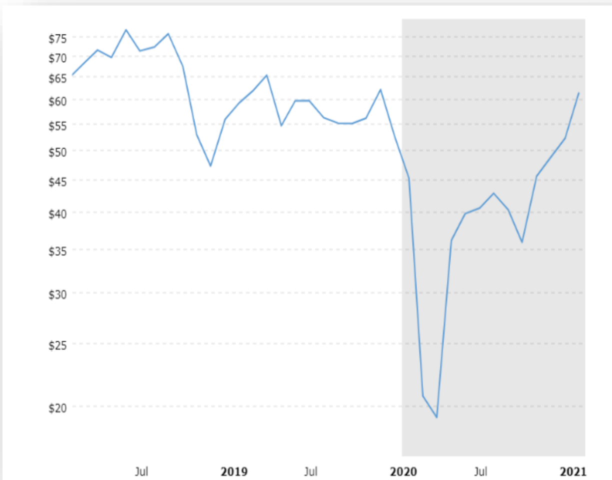
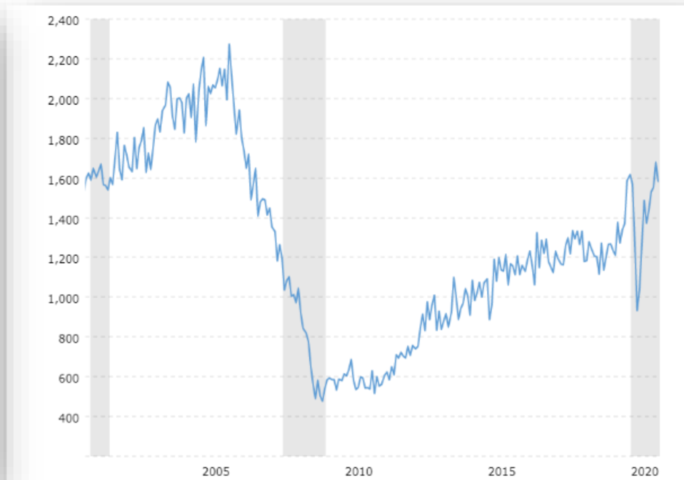


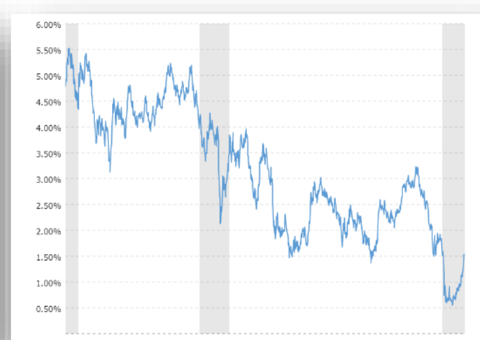
Figure B: Housing Starts



As if on queue, yields have jump to reflect the optimism rising over 100bps over the past six months. This is the moment we have all been waiting for – a pick-up in inflation and with it, bond yields! The entire investment community has been laboring under negative or barely-there coupons and the past several weeks have provided some hope finally, yields would provide a modicum of return. In fact, it doesn't even have to be a real return (i.e., nominal return less inflation). Anything would be better given the massive amount of negative yielding instruments in the market.

Figure C: 10 yr. Treasury Yields-5 yrs.

Figure D 10yr Treasury Yields-20yrs.



Is it real? Is it sustainable? And most importantly, how might we adjust exposures? While all this might be encouraging to a yield bull or a treasury bear, as usual, we encourage some perspective. For starters, yields have a long way to go before they begin to approach more normal levels. Assuming inflationary expectations drive interest rates, it is worthwhile to focus a bit on inflation. The godfather of inflation studies, Milton Friedman preached that at its core, inflation was caused by excess money creation. By almost any measure, over the past several years, money creation has exceeded GDP growth, and yet inflation has remained quiescent. With the rise in most interest rates over the past month, is it possible that Friedman acolytes might be vindicated?

The problem with Dr. Friedman's analysis is that it has been and for better or worse, for the past 15 years, it has been and remains wrong. Despite the massive money printing among the developed countries relative to GDP growth, and of course the corresponding drop in the velocity of money, to date, inflation has been low, and based on the five year forward expectations, will remain low. As can be seen below, the expected inflation rate (on average) over the five-year period that begins five years from today is 1.91%.

Figure E - 5 Year 5 Year Forward Inflation Expectation

Might the Dr. Friedman's theory remain sound, but it is just a matter of time before the inflation monster rears its head. While possible, there are a few items to consider before jumping in the new inflation bandwagon. First is the eight-hundred-pound gorilla in the form of the central banks which have had a tendency of buying anything moving in an attempt to keep rates down; it is unlikely that the central banks are going to reverse course soon. Second is a review of the major expenditures for the typical consumer to determine whether costs are going to increase substantially. On the housing front, the move away central office and towards telecommuting is likely to suppress housing costs. Moving on to transportation, with the emergence of new technologies and increased competition, transportation costs are likely to remain under control. Lastly, clothing, food and education are unlikely to experience major rises over the near future. Hence, on balance, the recent rise might simply reflect the waning of the COVID19 crisis, the Washington chaos settling down, and apparent rebound in the housing market.

In an effort to offset the travails of COVID (and assist with re-election campaigns), nearly every major country's central bank has effectively printed currency and injected it into the economy. Most banks are buying securities under the guise of "Quantitative Easing" which of course has the effect of suppressing interest rates and causing investors to invest in riskier assets. Additionally, many developed countries are distributing checks to all citizens below a certain income threshold in the hopes of stimulating the economy. (Note, this is not unemployment insurance but rather a payment to all citizens.) In fact, the largess is not limited to the U.S; the latest round supposedly included $4B for Central America. Lastly, with lingering effects of COVID, it is probably safe to assume that more distributions can be expected and recently there was a news story suggesting that all mothers be provide payments of $2,400.

So where does that leave us? Time will tell, but my suspicion is that for every action, there is a reaction. If one country is printing currency faster than others, the profligate's currency over time will slip, adjusting for differentials in productivity and investment flows. Unfortunately, some countries are rapidly approaching an inflection point whereby it is increasing obvious that debt cannot be repaid via normal sources. Japan appears to have reached that point long ago but has been saved by the low need for external capital. Italy appears to be approaching the event horizon (i.e., the point in a black hole where nothing, including light cannot escape) but currently has the support of the ECB (see the return of Mario). All this discussion is interesting but perhaps the more relevant point is market sentiment; one can be right on the fundamentals but wrong on the timing. Periodically, the markets deliver such a reminder with the latest example being the burning of short sellers of a few high-profile stocks. Nonetheless, normally the fundamentals win and therefore it may be wise to bear them in mind but to watch the madness of the crowds.

Credit Front - The areas which are likely to experience the greatest stress are listed below (see our Industry Review for additional information) in addition to selected municipal credits such as MTA, New York City, and selected airports.

Airlines
Aircraft & Equipment Leasing
Energy Equipment & Services
Hotels Restaurants & Leisure
Commercial Marine
REITs (selected)
Retail
Textiles Apparel & Luxury Goods

Below is a summary of our expectations for the various economies:

Figure I: EJR Normalized Economic Expectations (next 12 months)

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	1.0%	2%	3%	4%	6%
Stimulus Change	Moderating	Slight Rise	Moderating	Moderating	Little change
Earnings Trend	Slight Rise	Slight Rise	Slight Rise	Rise	Rise
Interest Rates	Negative	Negative	Zero	Low	Varied
Asset Valuations	Flat	Flat	Varied	Varied	Slight Rise

Regarding interest rates, the EU countries and credits cannot afford significant increases in rates. The periphery EU countries (e.g., Italy) are likely to see continued pressure because of increased credit quality concerns. Regarding trends, we had expected a slight rise in rates as economies recover but the market turmoil, tepid growth and central banks' money creation are depressing rates.

Figure II: Current and Expected Interest Rates

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%) *
United States	0.87	0.96	1.69	1.85	2.39	2.57
Germany	-0.68	0.16	-0.35	0.18	0.24	0.32
Italy	-0.04	0.01	0.64	0.75	1.65	1.81
United Kingdom	0.35	0.48	0.78	1.01	1.32	1.52
Japan	-0.10	0.04	0.07	0.10	0.64	0.89

Source: https://tradingeconomics.com/bonds
https://www.bloomberg.com/markets/rates-bonds/government-bonds/us
*expected to trade in 12-month time

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
USD-EUR	1.18	1.25
Yuan to Dollars	6.57 $/RMB	6.40 $/RMB
JPY-USD	109.75	105
USD-GBP	1.38	1.32

Source: https://www.x-rates.com/table/?from=USD&amount=1

Egan-Jones has a long-established reputation for timely, accurate credit rating calls. EJR's founder was named by Fortune Magazine as the number one person for warning about the 2007-08 credit crisis. See also academic studies.