Risk Commentary (February 2021)
Actions and Reactions; the Benefit and Bane of Free Money

The theme for this month's Risk Commentary is to highlight some under-appreciated views in the market.

In an effort to offset the travails of COVID, 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.

While the so-called bond vigilantes are now a distant memory, one has to ask whether there are any unforeseen costs of "Free" money. The unfortunate answer is that we do not know. On the one hand, the well-regarded student of the Great Depression and former central bank, Ben Bernanke (aka "Helicopter Ben"), said on multiple occasions that the mistake made during the Great Depression was that the Central Bank did not do enough to replace the depressed demand from the private sector. Likewise, Mr. Keynes was a believer in the Central Bank's involvement to ease the pain. On the other side of the aisle is the vaunted economist Milton Friedman who believe all inflation was caused by excess money printing, and that the excess creation would eventually cause inflation. But wait, aren't the quoted inflation numbers at all-time lows. Are the Central Bankers fighting to get any inflation when their internal targets are 2%? Perhaps they are looking for love in all the wrong places. Perhaps the younger generations are not as interested in the typical consumption patterns and are focused elsewhere. When a millennial was given the opportunity to buy a house at a discounted price, the millennial rejected the offer and said he would far rather be invested in tech firms than real estate. It is hard to argue with this approach since most tech firms are soaring while renters often can live rent free and can move at will.

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. 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	0.43	0.47	1.05	1.14	1.80	1.94
Germany	-0.75	0.17	-0.57	0.25	-0.12	0.05
Italy	0.01	0.00	0.64	0.81	1.52	1.72
United Kingdom	-0.05	0.02	0.29	0.28	0.85	0.98
Japan	-0.11	0.05	0.05	0.06	0.66	0.91

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	1.21	1.25
Yuan to Dollars	6.46 $/RMB	6.73 $/RMB
JPY-USD	104.91	105
USD-GBP	1.37	1.32

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