Risk Commentary (January 2021)
Avoiding Well-Meaning, but Wrong Advice

A sound approach to risk management and superior investment performance involves not only listening to those who are right but perhaps as or more important is recognizing who is likely to be wrong. The environment has massively changed over the past couple of years and with it the attendant risks and rewards. This installment aims to provide a roadmap for navigating the new environment,

Energetic Central Bank Actions - Let's start with the major driver in most economies including the United States and that is the actions of the central bank. Once again (the last time was the 2008 Credit Crisis), the FED has created the liquidity and buying power to sop up demand from any willing (and a few unwilling) sellers. However, unlike 2008, the FED has swung into action at a far more rapid pace. The upshot of this action has been a suppression of interest rates, both in terms of Treasuries and spreads, and a massive upside move in the stock market. Rather than the massive bankruptcies predicted at the end of the first quarter of 2020 and beginning of the second quarter, with the exception of a few hard-hit industries (see Egan-Jones's Industry Review), for the most part, the economy has remained intact.

Now for the part which few economists have yet to figure out. Nearly all economists believe that the creation of money in excess of the growth of the economy produces inflation. The thought being that more currency is chasing the same amount of goods and therefore prices will rise and rise rapidly. In fact, this warning was loudly sounded as of the last credit crisis in 2008 and yet little has happened. The burning question is why has this time-tested theory failed. Unlike the typical economist, we are willing to say we are not certain. However, we suspect the answer lies in structural global changes in the economy including lower birth rates, the globalization of the workforce, the shift away from hard goods and towards electronic soft goods with minimal "manufacturing" costs and global markets. Regardless, it appears low (and in many cases negative) interest rates are here to stay which leads us to or next stop.

Shifting Valuations – If risk-free interest rates (i.e., Treasuries) are likely to remain low and in turn, risk premiums are to remain low, then valuation measures such as Price/earnings ratios and capitalization rates need to be reviewed. While there is likely to be some "stickiness" in the revisions, especially in the real estate area which is reeling from hotel and shopping mall mishaps, provided risk free rates and risk premiums remain low, then adjustments will be made. The risk here is of course one of a reversion to the mean, that is, as a result of some external event (i.e., a war or another catastrophe), there is a major risk-off event causing an increase in interest rates and risk premiums.

Inverted Business Models – When most senior investment professionals were learning their craft, there was an emphasis on hard assets. That is a business that owned its manufacturing facilities, had valuable inventory, and solid customers was the type of business which was likely to prosper over time. Currently, the exact opposite appears to be the case. The most valuable businesses are generally those with few hard assets, no inventory, and customers whose credit quality is far from certain. Think of a firm such as Salesforce.com, Slack, HubSpot, theTradeDesk, and others which are selling computer code, which probably could be replicated by a smart IT person, have little inventory, and have customers all over the would whose credit quality rarely is a factor in the process. Nonetheless, as evidenced by the success of Salesforce.com and others like it compared to the traditional blue chips such as GE, GM, Ford, and others, the newbies are creating massive value.

Probabilities of Default and Loss Given Default – the new environment has created havoc on traditional notions of which firms are likely to default and in turn, the recovery in an event of default. Perhaps the best example is that of the cruise lines and theater chains, which appear able tap the equity markets despite having miserable credit metrics. Our view is that investors are "looking across the valley" to times when business returns to normal.

Perhaps all these items support the concept that intelligence and robust thinking continues to have a place in our increasingly complex world.

The media has discussed Joe Biden's electability more than more than his policies. The 77-year-old's economic agenda is not as detailed as others and does not contain similar sweeping proposals, but his plan for the U.S. is still ambitious and represents more than a reassuring reset button for Americans rattled by Trump. Revitalizing the middle class and making it more racially inclusive is the cornerstone of Biden's campaign. Focus is expected to be in enhancing the medical cover for the American people. Biden's healthcare proposal will expand Obamacare so that 97% of Americans are insured and cost $750 billion over 10 years. To help him achieve this, the new administration would adopt a pro-growth, progressive tax code, aimed at raising nearly $4 trillion in additional revenue over a decade.

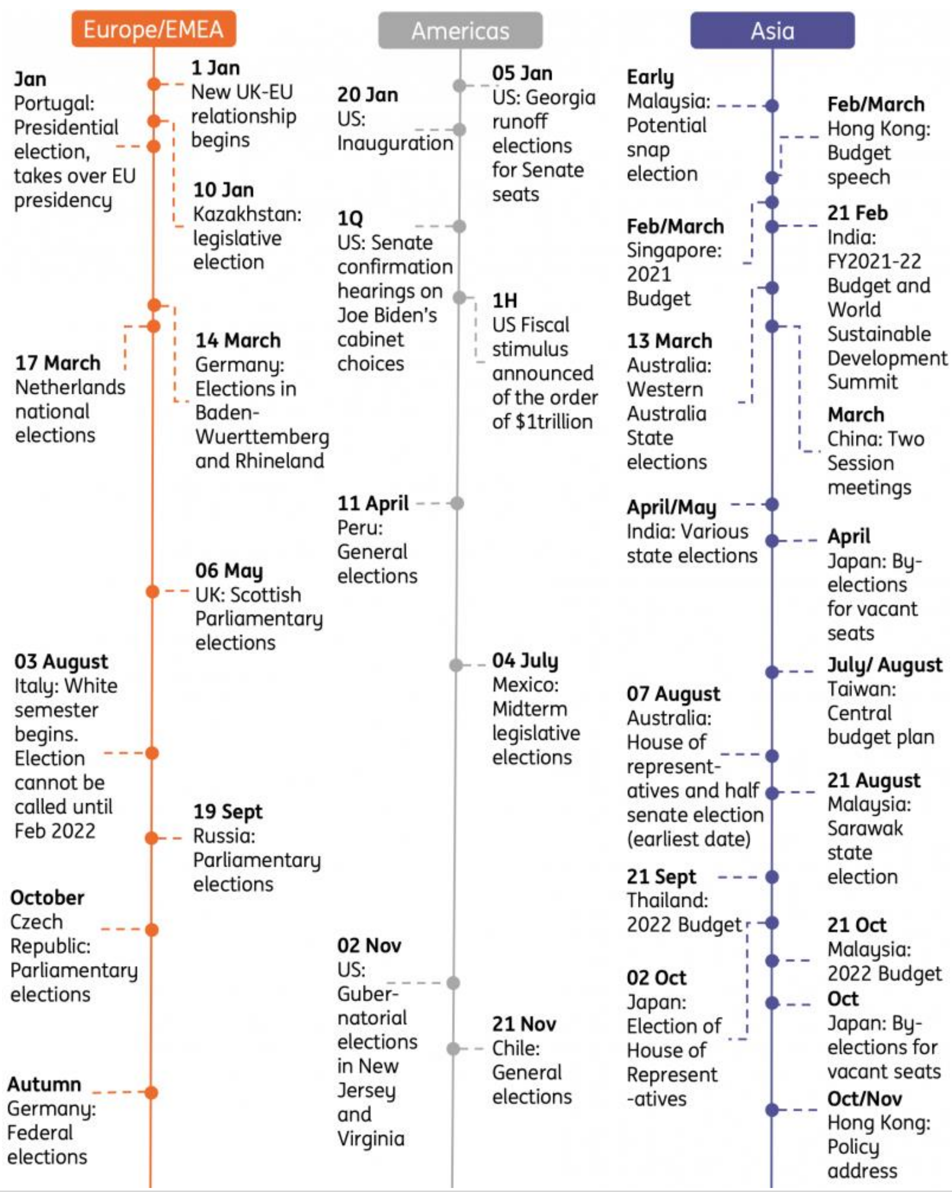
Below is a partial listing of potential changes:

Corporate Taxes – a rollback of the Trump tax reforms
Personal Taxes – a substantial rise, for all, particularly those making over $200K
Petroleum/ Natural Gas – increased regulation, likely a de facto ban on fracking
Student Loans – many forgiven over time
Healthcare Insurance – broader coverage, more government support
Automobiles – an increased push for electric vehicles
Banking/ Finance – tighter regulation and more support for CRA
State and local governments - more federal support

This month's economic activity data were grimmer for the US (retail sales, regional business surveys, jobless claims) than for China (IP, FAI, retail sales, retail sales), or Europe (flash PMIs). But the mood was improved with the helpful direction of negotiations around Brexit and US fiscal stimulus. The baseline assumption which had assumed 60/40 odds of a Brexit deal, and a $1trn US fiscal package in Q1 2021 - both have come true.

While the virus will create nuisance for policy-makers and weigh on business cycle volatility over the next two to three months, the key themes for 2021 would be i) spurt in global GDP growth rates, ii) firmer but sub-target inflation in US, Europe, Japan and China; iii) relatively measured but positive pace of central bank balance sheet growth, and iv) variable degrees of fiscal deficit drags across the Developed and Emerging economies.

In the next twelve months, from Peru to India, the Netherlands to Australia, many elections and political events have the potential to shape the economic outlook. The US political calendar in 2021 will kick off with the run-off elections for Georgia's two Senate seats. Those hoping that Brexit will disappear off the news agenda forever from 2021 may be a little disappointed. Even if a deal is agreed, it will inevitably be a basic one. A free-trade agreement will avoid tariffs, but may not prove to be a particularly sustainable trading platform in the long-term. On paper, 2021 promises to be a relatively quiet period for Asia, with possible snap elections resulting from the perennially weak government in Malaysia the likely highlight on the calendar. Japanese elections for the House of Representatives are unlikely to be very eventful, rubber-stamping Prime Minister Yoshihide Suga's hold on power.



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	0.37	0.44	0.93	.95	1.66	1.70
Germany	-0.74	-0.65.	-0.58	-0.50	-0.18	-0.15
Italy	-0.10	0.05	0.53	0.65	1.44	1.60
United Kingdom	-0.08	0.02	0.22	0.28	0.77	0.92
Japan	-0.11	0.05	0.02	0.03	0.64	0.70

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	1.23	1.25
Yuan to Dollars	6.53 $/RMB	6.73 $/RMB
JPY-USD	103.2	105
USD-GBP	1.36	1.32

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