# Risk Commentary (October 2020)
# A Course Change?

The Lost Year is rapidly drawing to a close and with it is the growing realization that the coming year will likely be substantially different than the current one. Starting with the major driver for the global economy, COVID19, we expect that one of the many vaccines is likely to prove at least partially effective and that most businesses will open albeit, many at reduced levels. The item, which is neglected by many market observers, is the level of damage inflicted on some by the increased level of indebtedness. For example, a firm which has seen its leverage doubled because of the crisis will remain hobbled for several years. Some areas such as many store-based discretionary consumer retailers will find few options for avoiding a restructuring. Nonetheless, the market anxiously awaits an end to the crisis and with it a hopeful return to some normalcy.

Given the chaos we have experienced, perhaps it is worthwhile to take stock of what the coming year might hold. While making predictions is always dicey, below are some initial thoughts:

GDP Growth – watch for major rebounds based on comparisons from depressed levels and pent-up demand (see our projections by country on page 3).

Interest Rates – the central banks have placed a thumb on the scale in an effort to ease the economic pain. The major open issue is the timing of a withdrawal of support and the corresponding impact on the economy. It appears that both political parties have in part embraced the Modern Monetary Theory (MMT), the central tenant of which is that federal debt levels for developed economies are irrelevant since the individuals and businesses have no alternative. Note, this MMT approach continues a trend toward further weakening of currencies tie to stores of wealth with (i) FDR's ending the free exchange of currency to gold, (ii) Nixon's decoupling the US dollar from gold in 1971, and (iii) now the unfettered printing of currency. (Figures A through F are sourced from Macrotrends)

Figure A: 10 Year US Treasury Yield


Inflation - While the growth in money supply typically results in inflation, to date there has been little. The underlying reasons appear to baffle economists, but the leading causes appear to be tepid demand and a shift in consumption patterns. Global population growth rates have slowed, household formation rates have slowed, and consumption has shifted to relatively inexpensive electronic/software-based services. Yes, homebuilding is up, but is still off from normal levels.

Figure B: Housing Starts Historical

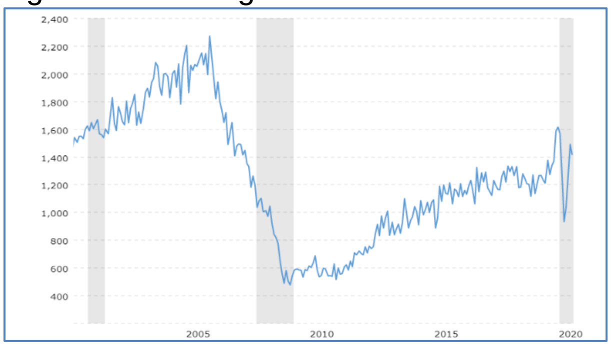


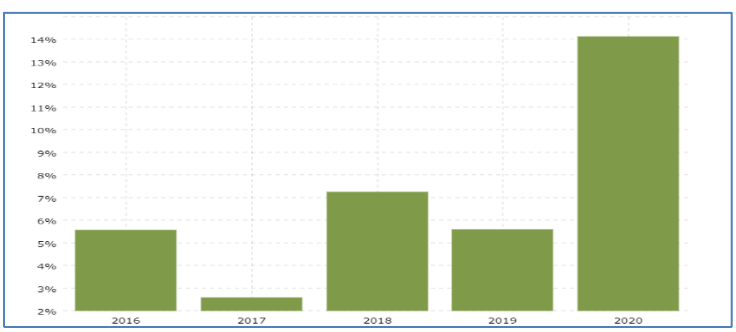

Figure C: National Unemployment Rate


Figure D: 5 year Forward Inflation Rate%


Figure E: SP500 PE Ratio


Overall Credit Quality – This is our "wheelhouse" and while there is little doubt that the country has weathered the worst of the COVID19 storm, (i) hopefully there will not be a relapse and (ii) many issuers are pressed as a result of increased debt levels and tepid demand.

Figure F: National Debt Growth by Year




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
Autos and Auto Suppliers
Consumer Finance
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% | 5% | 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 expect a slight rise in rates as economies recover.

Figure II: Current and Expected Interest Rates

| | 5 year | | 10 year | | 30 year | |
|---|---|---|---|---|---|---|
| | Current (%) | Year End (%) | Current (%) | Year End (%) | Current (%) | Year End (%) |
| United States | 0.27 | 0.35 | 0.69 | 0.80 | 1.47 | 1.55 |
| Germany | -0.73 | -0.70 | -0.55 | -0.45 | -0.12 | -0.02 |
| Italy | 0.54 | 0.60 | 0.88 | 0.97 | 1.77 | 1.87 |
| United Kingdom | -0.08 | -0.02 | 0.23 | 0.33 | 0.78 | 0.86 |
| Japan | -0.11 | -0.05 | 0.02 | 0.10 | 0.61 | 0.71 |

Source: https://tradingeconomics.com/bonds

Below are our expectations for major currencies:

Figure III: Currency

| | Current | EJR Est. Year End |
|---|---|---|
| **USD-EUR** | 1.17 | 1.20 |
| **Yuan to Dollars** | 6.79 $/RMB | 6.82 $/RMB |
| **JPY-USD** | 105.6 | 106 |
| **USD-GBP** | 1.29 | 1.27 |

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