Risk Commentary (Sept. 2020)
What's Next

Our prior installment argued that we are engaged in a New Paradigm whereby the global central bankers have spared us pain. Below are the two lead paragraphs:

> In the past, when there was a major market disruption, one could count on several years of misery before the economy returned to normally. It was usual for businesses to expect several years, and in some cases much longer periods, of weak demand, weaker margins and an overall disruption in conditions. That paradigm has been replaced by one whereby the central banks step-up by providing massive liquidity and support such that a down-turn lasting more than a couple of quarters is quickly eased with the government leading the way with massive direct and indirect expenditures. This new paradigm raises questions of whether there are unexpected costs for such hyper-interventionism and what are the likely results.
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> Perhaps it is worthwhile to review the context of the current situation. In the past, when a central bank engaged in unorthodox activity such as purchasing the securities issued by its own government or own market, there would be a howl of protests for the league of bankers, and that country quickly became an international pariah such that access and costs to the capital markets became restricted. Currently, all the developed markets are engaging in various forms of "quantitative easing" such that investors who might be concerned about a debauching of the currency has no place to go. Hence, what began as an experiment during desperate times has morphed into an expected reaction to any material market disruption.

The major issue facing investors is less where we have been or even where we are, but more where we are heading. In addressing this question, there are a few givens which although are not immutable, would cause major pain if they changed. The first concerns interest rates: will they revert to "normal" levels and if so, when? Our view is that interest rates cannot return to normal levels anytime soon because the groups setting rates simply cannot afford any major change. Assuming the central banks ultimately answer to the politicians who appoint them (forgetting the regular protestations of independence), the politicians simply cannot afford any material rise in rates. For example, a doubling of Italy's interest rate from the current approximately 2.5% to 5.0% would translate in a rise in annual interest expense from EUR60B to EUR120B and a near tripling in the operating deficit from EUR37B to a clearly unsustainable EUR97B (i.e., approximating 6.0% of GDP). Adding further proof of the continued policy of low interest rates was the FED's announcement today that rates would remain low for the foreseeable future.

The upshot of this policy is that those entities which depend on more normal spreads in long and short interest rates (i.e., pension plans and some insurance providers) will have increasing difficulty and will need to make adjustments. Additionally, there is a limit to government largesse. Increase federal deficits and or increased currency do increase the claims on a country's assets and if the country is not growing faster than the growth in money supply and debt, over time, the pressures are likely to be manifested in the value of the currency.

Another item on our "Worry List" is the additional debt industries are taking on to weather the COVID19 storm. Many observers forget that the additional debt places pressure of companies' financial flexibility and is a drag on future returns.

Lastly, with the approaching election, the parties are developing fiscal platforms to address various needs: perceived, immediate, aspirational, and ideological. Another stimulus program is likely prior to the election, with both parties quibbling over details while raising their overall spending plans. While the previous stimulus efforts had unclear or debatable results, another is required to satisfy the demand for action during the unrelenting coronavirus pandemic. We expect that it is unlikely to be the last. Spending plans encompassing broad policy initiatives, financed in some cases by new taxes on wealth and higher incomes, are described as "transformational." Such no-growth policies, if manifested in a presidential administration, pose a risk to creditworthiness of businesses deprived of commerce, individuals deprived of employment, and ultimately to governments deprived of revenues.

We have reviewed the various industries and have identified the following as the most vulnerable (see our Industry Review for additional information).

Airlines
Aircraft & Equipment Leasing
Autos and Auto Suppliers
Consumer Finance
Energy Equipment & Services
Hotels Restaurants & Leisure
Marine
REITs
Retail
Textiles Apparel & Luxury Goods

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

Figure I: Summary of EJR Economic Expectations (next 12 months)

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	-5.0%	-6%	-7%	-4%	-4%
Currency Values	Decline	Decline	Slight Rise	Decline	Mixed
Stimulus Change	Rising	Rising	Rising	Rising	Little change
Earnings Trend	Down	Down	Down	Down	Slight Decline
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.

Figure II: Current and Expected Interest Rates

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%)
United States	0.26	-1.12	0.70	-0.78	1.46	-0.47
Germany	-0.64	0.30	-0.40	0.26	0.06	0.28
Italy	0.54	0.04	1.18	0.07	2.08	-0.04
United Kingdom	-0.01	-0.34	0.31	-0.17	0.89	-0.13
Japan	-0.06	0.29	0.05	0.33	0.62	0.49

Source: https://tradingeconomics.com/bonds

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.19	1.1
Yuan to Dollars	6.85 $/RMB	7.1 $/RMB
USD-JPY	105.8	110
GBP-USD	1.33	1.25