Best Ideas – A Method to the Madness
February 2017

While half of the population is mourning Ms. Clinton's loss, and the other half is rejoicing that they will be able to reclaim some lost ground, nearly all are befuddled by President Trump's general approach:

> "Is it wise to call the President of Taiwan when for the past twenty years every other US president has ignored the country?"
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> "Is he serious about building a wall on the Mexican border and forcing Mexico to pay for it?"
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> "A 20% tax on goods from Mexico? Can he do it and isn't that what caused the Great Depression?"
>
> "A freeze on nearly all government hiring? Really?"

Meanwhile, the stock market has reached new highs, business optimism has returned, and interest rates, including Bund yields are rising. So what gives - why the disconnect?

Our view is that there is a method to the madness and that President Trump will be viewed as one of the most activist presidents in history (FDR's or LBJ's alter ego?). There will probably not be a department in the federal government which does not undergo a significant change during President Trump's term, and much of it within the next 18 months. We are at the early edges of the transformation but major shifts are already taking place.

There are a variety of ways that we can structure the balance of this month's piece but per our nature, we will front end the likely impact on investors. ***The major themes likely to be manifested for the balance of the year are reduced regulation, reduced taxes, rising optimism, reasonable growth, rising interest rates, and a rising dollar (despite the best efforts of Washington to keep it down).*** Most of these factors have contributed to the rising stock market. But can it continue, and what should we expect? Our view is that like most successful businessmen, Mr. Trump is relatively simple and will be guided by what he perceives as his mandate in winning the election, and that is to provide a more attractive environment for the average working family. He has witnessed the inefficiency of government and will do what he can to cut regulations and taxes. Probably every person selected by the transition team shares that value. While defense expenditures are likely to remain high, President Trump is probably more willing to use force than President Obama, and therefore perversely might be less likely to need to show force.

Turning to where the overall economy is heading and what might be surprises, below are a few givens:

Stronger Earnings – President Trump focuses on growth and is likely to establish policies to foster growth.

Energy Prices – petroleum prices have whipsawed in their movement over the past 24 months. While supply and inventories have grown in the US, prices have risen supposedly because of cutbacks by OPEC and increased growth, although we have our doubts about both of these items. Perhaps the best measure will come after Saudi Arabia's flotation of Aramco. In the meantime, the most likely outcome is a trading range between $45 and $55.

Dollar Strength – is likely to be strong because of the growth of the US economy, a likely rise in rates, and the safe-haven aspect of the US. While Japan is not growing, its currency has been aided by the flight to safety.

Industry Consolidation – as the market is awash with funds, the big players are seeking to take advantage by consolidating their businesses, and in turn, bargaining power. Mergers such as that between AT&T and Time Warner will see an erosion of consumer value in the long run.

European and Japan Vulnerability – both Europe and Japan have been held together by unconventional economic policies which are in the process of running their course and perhaps might be overdue for some corrections as evidenced by the disastrous state of many European banks (tell me again how a bank makes money when rates are negative). The efforts of the Trump administration to normalize economic conditions will pressure Europe and Japan to follow, and they will likely have significant problems doing so.

China's Weak Shadow Banking System – while we are not close to the problem, our understanding is that many of the shadow banks have promised returns which are unsustainable and will have trouble making adjustments.

Regarding specific industries, below is a summary:

Deteriorating:

Retail Disaster – Amazon will destroy margins for most industries involved in selling goods, and over time, services. Nearly all the major retailers will be trading sideways at best for the next couple of years. Sears, Macy's, and other department stores will continue to suffer as will many shopping malls. Sears is likely to remain in the intensive care unit.

US manufacturing exporters – the stronger dollar and weaker yen will hurt major exporters. The winners in general are the EU firms. The losers continue to be the major exporters such as CAT and CUM, although both should be aided by increased infrastructure spending. Boeing is protected by the low level of competition, but President Trump is likely to pressure margins and enhance competition.

Media – Netflix, other internet distributors, and non-traditional media outlets continue to dis-intermediate traditional media providers and cable firms.

Improving:

Banking – a higher and more normal yield curve should aid net interest margins. Reduced regulations should improve cost structures.

Healthcare – Hospitals will be hurt, but nearly every other area should see improvement.

Infrastructure – watch for massive improvements for firms connected to building.

Metals and Mining – some have been given a reprieve as a result of increased demand, rising prices, and expectations of a more amenable regulatory environment.

"Sin" Industries – alcohol and tobacco will benefit from the laissez faire approach.

Technology – while at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels and recently announced weak earnings.

Neutral

Airlines – the economic recovery and moderate fuel prices will help; we believe most airlines will continue to improve over the next couple of years. However, in the US, the rate of improvement is likely to slow as margins and load factors fall from record levels. President Trump's immigration ban will likely affect major airlines in the short term.

Autos and Auto Suppliers – with the exception of Volkswagen, most of the auto industry was prospering. The European producers are probably in the best shape because of the recent rise in the dollar and yen. However, watch inventory levels.

Regarding interest rates, it is clear that the ECB and the BOJ are encouraging negative interest rates in an effort to revive their economies, although the FED's increase will pressure all rates. On the next page are our expectations with the general trend being a rise in European rates.

	5 year		10 year		30 year	
	Current	Year End	Current	Year End	Current	Year End
United States	1.92	1.95	2.46	2.53	3.07	3.22
Germany	-0.40	-0.1	0.43	0.6	1.16	1.45
Italy	0.92	1.08	2.271	2.35	3.33	3.51
United Kingdom	0.61	0.65	1.42	1.46	2.05	2.13
Japan	-0.93	-0.92	0.09	0.15	0.84	0.96

Below are our expectations for major currencies: the dollar is likely to be slightly stronger relative to other currencies because of the slight rise in interest rates and the possibility of additional rate increases.

	Current	EJR Est. Year End
Dollars to Euros	0.926	0.96
Dollars to Yuan	6.88	6.96
Dollars to Yen	112.7	114.2
Dollars to Pound	1.25	1.20