Best Ideas – Coming to Terms

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Winston Churchill once said, "Study history. In history lie all the secrets of statecraft." The secret of statecraft is that it is relatively powerless against the broad forces that cause history to repeat itself in successive centuries and even millennia. The first step toward understanding what is possible in the future is to understand what was impossible in the past.

The benefit of a regime change is the settling of accounts which have long been overdue. U.S. is the largest stakeholder in the IMF and with the new administration's "America First" approach, it is unlikely that the White House will tolerate IMF's "pretend and extend" approach to debtors such as Greece and possibly Italy. The IMF is therefore likely to force Greece and other countries to write down debts to more manageable levels. Therefore, the major question is whether Angela Meckle will gain the political support to either extend more credit or absorb the pain from a major writedown of Greece's debt. Either way, there will be substantial pressure on the EU at a time when it can least afford, as both France and Italy are considering a divorce, while England has filed for a divorce from the EU. Adding to the confusion is the controversy associated with recapitalizing Italian Banking system and the rise of anti-EU Five Star movement, which are expected to drag on for months if not years. Italy and Greece are joined by Portugal and Ireland in the 10%+ non-performing loan league, therefore the likely eventual outcome is a pan European bailout funded by taxpayers. While it is always difficult to determine the timing of a real crisis, conditions are more tenuous than they have been in the past several years. As tension mounts, one should see spreads for the periphery countries to gap out.

Regarding domestic affairs, while the major media remains aghast at the improprieties of our new president, the equity markets are rejoicing at the prospect of lower tax rate, eased regulations, an overall reduction in the cost of doing business, and higher growth prospect. We expect the new president to adjust his behaviors as unsubstantiated accusations cost him political support which will be needed to institute his programs. On balance, we expect that the new environment will be propitious for most industries:

Deteriorating:

<u>Retail Disaster</u> – Amazon will destroy margins for any 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. A filing by Sears and JC Penney would not be a surprise and Macy's might slip from investment grade over the next couple of years. As expected, Walmart is having difficulty being competitive in the web market. The next major target for Amazon appears to be grocers.

<u>US Manufacturing Exporters</u> – The stronger U.S. Dollar against Yen, Euro, and Pound will continue to hurt major exporters. The winners in general are the EU and Japanese firms.

The losers are the major exporters such as CAT and CUM, although both are helped by the rise in the growth prospect. Boeing is protected by the low level of competition, although Airbus has a more robust backlog than Boeing.

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

Improving:

Banking – Higher interest rate and a normal yield curve should aid net interest margins. Reduced regulations should improve cost structures. The smaller banks are aided by the improved margins and the M&A upside.

Defensive Industries – Alcohol, tobacco, and defense are traditional defensive credits and continue to be so.

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.

Technology – While at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels.

Neutral

Airlines – The economic recovery, effective capacity management, and moderate fuel prices have helped. However, in the U.S., the rate of improvement is likely to slow down as margins and load factors slip 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 and FIAT, most of the auto industry prospered over the last couple of years. The European producers are probably in the best shape because of the recent rise in the dollar and yen. Watch for new car sales, used car prices, and weaker profitability as used car inventory is at all time high.

Regarding the global economy, both the U.S. and the emerging markets appear to be safe havens currently as Europe is still struggling through its multitude of festering structural issues, Japan is hobbled by massive debt and little growth, and China is in the midst of a redirection. Below is a summary

Figure I: U.S. and Emerging Markets Expectation

	Japan	Europe	U.S.	China	Emerg Mrkt
Population Change	Decline	Decline	Slight Growth	Slight Growth	High
Productivity Growth	Low	Moderate	Moderate	Moderate	High
Govt Regulation	High	High	Material Reduction	Moderate	Low
GDP Growth	-1.0%	+0.5%	+2.0%	+2.5%	+3.0%
Currency Values	Decline	Decline	Rise	Decline	Mixed
Stimulus Change	Same	Same	Decelerating	Some Growth	Little
Earnings Trend	Declining	Varied	Slight Growth	Varied	Varied
Perceived Safe Harbor	Yes	Yes	Yes	No	No
Interest Rates	Low	Low	Slight Growth	Falling	Varied
Asset Valuations	Varied	Varied	Improving	Varied	Improving

From a credit quality perspective, we expect the environment to be fairly propitious for most U.S. credit.

Regarding interest rates, Europe and Japan are stuck with low growth and high debt levels and therefore have significant difficulty in raising interest rates. Meanwhile, the U.S. is raising interest rates. Hence, rates in the U.S. are likely to be higher because of the FED's action and increased demand, and on the other hand, most major non-U.S. economies are trying to maintain low interest rates. The periphery EU countries are under increasing pressure because of increased credit quality concerns.

Figure II: Rising U.S. rates, Japan and Europe emerging periphery credit concerns

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%)
United States	1.89	2.03	2.36	2.50	2.99	3.40
Germany	-0.42	-0.10	0.30	0.70	1.10	1.55
Italy	1.10	1.18	2.33	2.60	3.33	4.00
United Kingdom	0.53	0.65	1.10	1.56	1.69	2.13
Japan	-0.11	-0.15	0.07	0.15	0.83	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 increases.

Figure III: Rising U.S. dollar

	Current	EJR Est. Year End
Dollars to Euros	0.93 $/€	0.98 $/€
Dollars to Yuan	6.89 $/RMB	6.96 $/RMB
Dollars to Yen	111.1 $/¥	114.2 $/¥
Dollars to Pound	0.80 $/£	0.83 $/£

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