Best Ideas – "Not on My Watch"; Collapsing Interest Rates

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Rarely have investors been willing to intentionally lose money on investments and yet as of today, there are approximately $13 trillion of investments with such characteristics. Why are we in such a state, and more importantly, what does it portend? We will attempt to answer these questions, and in the process, provide some insight to the underpinnings of this market and possible future direction.

In our opinion, negative interest rates exist today because of an odd set of circumstances: (i) major currencies are no longer convertible into precious metals such as gold or silver, (ii) central banks believe it is within their mandate to maintain economic wealth, particularly the value of the stock market, (iii) central banks have been given the authority to print currency and to use such newly-minted currency to purchase securities, and (iv) since most central banks of developed countries have undertaken similar policies over the past several years, there are few places for investors to "hide". Furthermore, the excess liquidity is spreading to most markets such that interest rates globally are suppressed. The nomination of Ms. Lagarde as head of the ECB is likely to continue the ECB's "whatever it takes" policy which translates into a continuation of QE.

Therefore, even though unemployment rates in the U.S. have reached 50-year lows, the FED is highly likely to cut rates to ensure the dollar does not become uncompetitive. While many point to Sir John Maynard Keynes as the guiding authority on monetary stimulus, the current action go far beyond what the typical Keynes acolyte would have considered prudent. Given the fact that unemployment, at least in the US is at 50-year lows and there is nary a hint of recession, what is the basis of the idiocy we are currently experiencing. Our view is that several massive "problems remain in the global economy and that the central banks and more importantly, leading political figures, would rather address symptoms rather than the underlying causes. The major problems include:

European Union – neither Italy nor Greece can afford their outstanding debt and the banks holding the debt do not have the capital to absorb losses. Hence, the drive to suppress interest rates.

Japan – Japan has little to no growth and has used the stimulus of the BOJ to support the markets.

United States – the QE was established to stimulate the markets and the FED is unwilling to unwind its balance sheets quickly. Furthermore, the administration is unwilling to let the dollar strengthen significantly more lest exports become less competitive.

The upshot is that the model of funding short and investing long is in jeopardy and as a result, lending banks and pension plans are in trouble.

Back to the macro view, we do not see a material threat to the current conditions for the next 12 to 18 months. Below is a summary of our expectations for the various economies:

Figure I: Summary of EJR Economic Expectations

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	+.5%	+.5%	+2.5%	+3.0%	+3.0%
Currency Values	Decline	Decline	Slight Rise	Mixed	Mixed
Stimulus Change	Slight Deceleration	Little change	Decelerating	Some Growth	Little change
Earnings Trend	Slight Growth	Flat	Slight Growth	Slight Growth	Growth
Interest Rates	Low	Little Change	Little Change	Little Change	Varied
Asset Valuations	Slight Growth	Flat	Varied	Varied	Slight Rise

Regarding interest rates, they appear to be bouncing around on a quarterly basis with little long-term direction. The EU countries and credits cannot afford significant increases in rates. The periphery EU countries are likely to see continued 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	1.79	1.6	2.03	1.85	2.56	2.4
Germany	-0.69	-70	-0.36	-.40	0.24	.20
Italy	1.19	1.25	1.95	2.20	2.96	3.20
United Kingdom	0.62	.80	0.81	1.20	1.44	1.50
Japan	-0.25	0.03	-0.15	0.20	0.38	0.55

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.11	1.20
Yuan to Dollars	6.88 $/RMB	6.8 $/RMB
USD-JPY	108.44	110
GBP-USD	1.24	1.30

Some of the major drivers of the economy and our expectations for those drivers are:

- **Interest Rates –** the 10 year is near 2.08% with many calling for an end to the 30-year bull market in rates.
  Prognosis – while interest rates edged up earlier this year, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (except for Germany) are concerned about fiscal deficits and therefore are likely to discourage a substantial rise in interest rates and sovereign funding costs.

Figure IV: 10 Year US Treasury Yield

Source: macrotrends.net

Petroleum Prices – as can be seen in the chart below, petroleum prices have partially recovered. While it is always difficult to divine the underlying causes of petroleum prices, it appears that the supply is outrunning demand.
Prognosis – trade tensions and technology are conspiring to depress prices with the result being major angst among the totalitarian regimes.

Figure V: WTI – Recent Crude Oil Prices

Source: macrotrends.net

- **Central Banks' Money Creation –** the central banks of the developed countries have approximately $21 trillion in assets which have been used to suppress interest rates and support asset values. While the FED is no longer growing its balance sheet, other central banks are growing by approximately $300M per month. Such central bank support is historically rare and in our opinion is a major reason for the buoyant market.
  Prognosis – while numerous factions have argued against any quantitative easing, the central banks are now committed and unlikely to pull back any time soon especially with the high levels of debt to GDP for many sovereignties. Our view is that if there were a major setback in the markets, the central banks would re-engage.

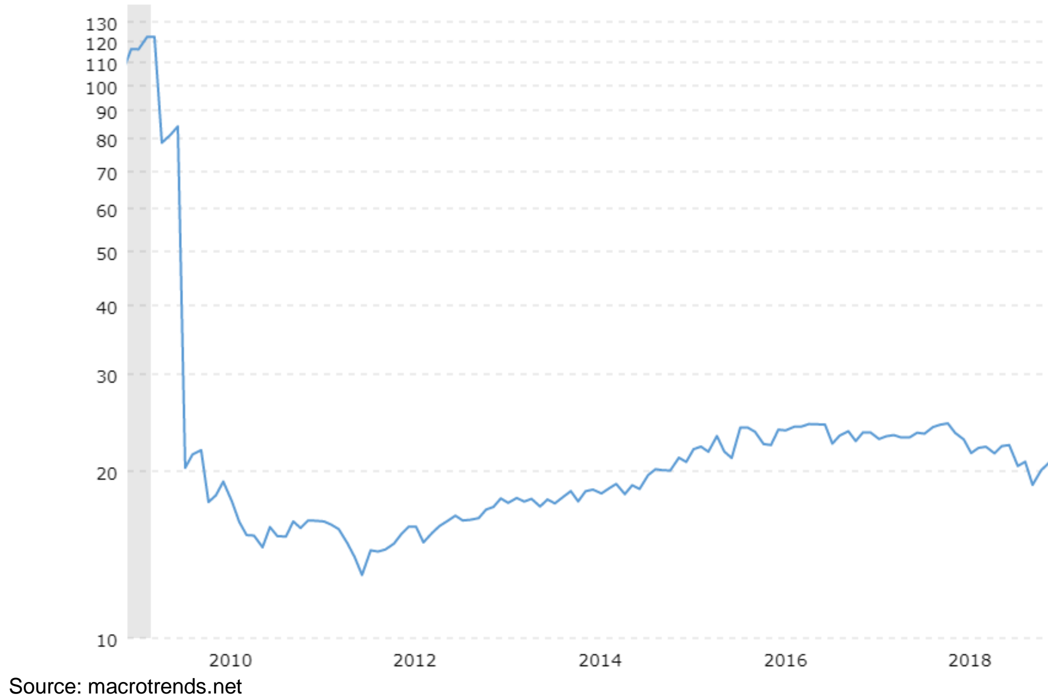
Figure VI: Five Year Forward Inflation Expectation %

Source: macrotrends.net

- **The Tax Act –** the corporate tax rate has been reduced from approximately 40% to 21% while depreciation allowances have been increased substantially. The net effect is approximately a 30% rise in a corporation's after-tax earnings.
  Prognosis – a 30% rise in earnings is massive (although not all corporations were taxed near 40%) and provides a huge stimulus to the economy.

- **Growth/ Stock Market Valuations –** the stock market has had an eight-year run with the normal concern that we are overdue for a downturn. However, from an earnings perspective, valuations do not appear to be too attenuated (see below).
  Prognosis – conditions have improved in most countries for economic expansion and perhaps we will see at least a couple more years of growth.

Figure VII: S&P 500 Price to earnings ratio



Source: macrotrends.net

- **Inflation –** most economic commentators have predicted over the past ten years that inflation would rise dramatically although to date, it has not. However, the tightening labor force is resulting in wage pressures.
  Prognosis – Our view is that inflation remains tepid and because of the use of technology and the ease of "transportation" via the internet and transit services.

Regarding various industries, below is a summary of some of the major developments:

Below is our summary of the major industries (see our Industry report)

Deteriorating:
Agriculture Prices/Ag
Airlines
Beverage
Health Insurance
Retail
Media
Metals and Mining
Power Generators
Restaurant Industry
Italy/Poland/Hungary
Argentina/Turkey
Venezuela/Possibly Greece
Telecom

Traditional Retailing

Improving:
Chemicals
Defensive Industries
Infrastructure
Packaging
Technology

Neutral:
Autos and Auto Suppliers
Banking
Insurance
Railroads
REIT
Utility Distribution

Need to watch:
Big Technology
Credit Card Network/Processors
Exploration and Production and Servicing Firms (Energy)
Healthcare
Tobacco
Wireless Providers

Major debt levels

Country	Last		Previous
Japan	253.0	17-Dec	250.0
Italy	132.2	18-Dec	131.0
Singapore	112.2	18-Dec	111.0
France	98.4	18-Dec	98.4
Spain	97.1	18-Dec	98.1
Canada	90.6	18-Dec	89.7
Argentina	86.2	18-Dec	56.6
Euro Area	85.1	18-Dec	87.1
United Kingdom	84.7	18-Dec	85.1
European Union	80.0	18-Dec	81.7
Brazil	77.2	18-Dec	74.1
India	68.7	17-Dec	69.6
Germany	60.9	18-Dec	64.5
South Africa	55.8	18-Dec	53.1
China	50.5	18-Dec	46.8
Mexico	46.0	18-Dec	46.0
Hong Kong	38.4	16-Dec	37.0
Turkey	30.4	18-Dec	28.3
Switzerland	27.7	18-Dec	29.3
Venezuela	23.0	17-Dec	31.4
Saudi Arabia	19.1	18-Dec	17.2
United Arab Emirates	18.6	18-Dec	19.7
Russia	13.5	17-Dec	12.9

https://tradingeconomics.com/country-list/government-debt-to-gdp