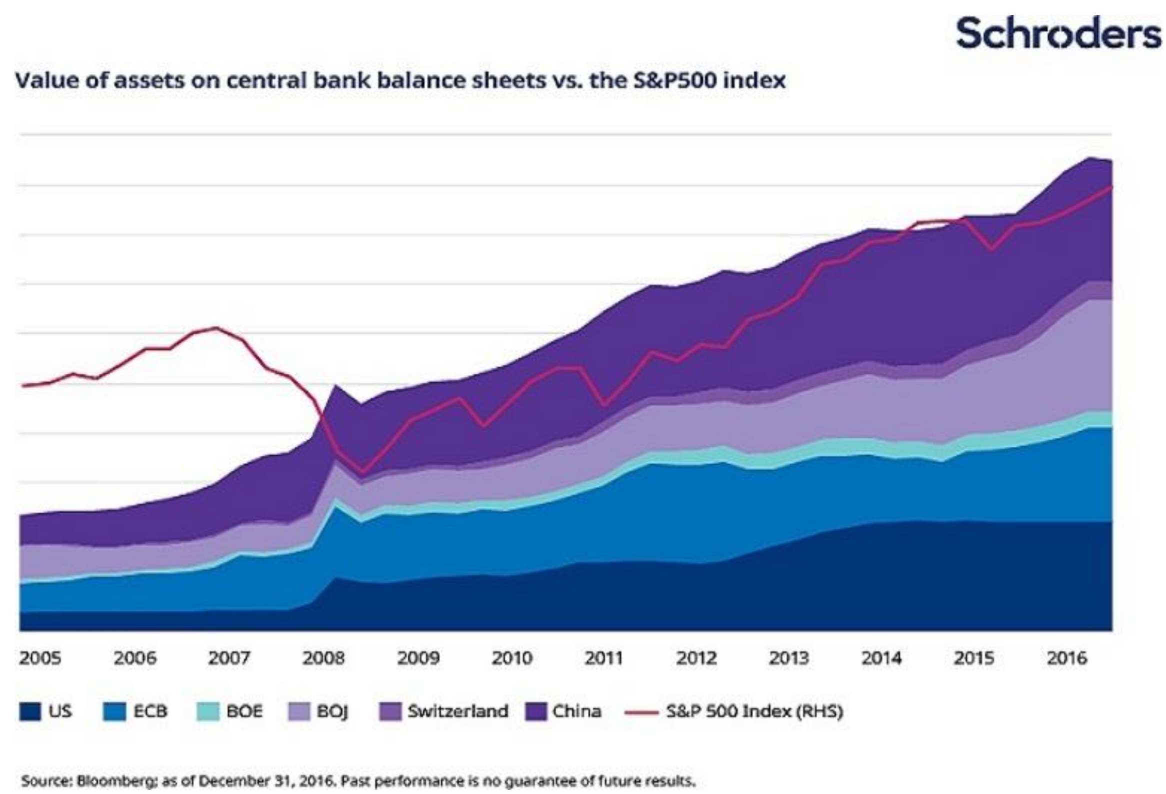
Egan-Jones has a long-established reputation for timely, accurate credit rating calls. EJR's founder was identified by Fortune Magazine as the number one person for warning about the 2007-08 credit crisis. See also academic studies.

Best Ideas – "The Roaring Teens" or "One Side of the Boat" (Addressing some underlying drivers in the economy and credit quality) - Feb. 2018

It is only in retrospect that historians settle on the appropriate sobriquet for particular times begging the question of what might be the most appropriate label for the current period. For bulls, it is hard to remember a time as favorable for shareholders, with most indices reaching weekly highs. For those who are less impressed or who have chosen to step out of the market, there are a series of concerns which in time, need to be addressed. Before suggesting which camp is correct, we thought it worthwhile to identify some of the major factors of the current conditions and evaluate whether such factors are likely to change materially.

- **Central Banks' Money Creation –** the central banks of the developed countries have supposedly have $20 trillion in assets from created money which are being used to suppress interest rates and support equity 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 rare and in our opinion is a major support 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.

- **The Tax Act –** while the details of the recently-passed tax act are still being reviewed, 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 provide a huge stimulus to the economy.

- **Global Growth –** it is not only the U.S. which is growing, but every major country as evidenced by the rise in most major stock indices.
  Prognosis – conditions have improved in most countries for economic expansion; the cycles for such improvement are generally five to ten years.

- **Interest Rates/ Inflation –** nearly all economic commentators have predicted that interest rates would rise dramatically although to date, they have not.
  Prognosis – Our view is that interest rates are a reflection of inflation and economic growth and because of the use of technology and the ease of "transportation" (via the internet and transit services) inflation is likely to remain manageable.

Source: Bloomberg

- **Unpopular Leaders –** the apparent irony currently is that the leaders of the U.S. (Trump), the U.K. (May), Spain (Raju), Italy (Mattarella), and to a lesser extent Germany (Merkel) have been unpopular and yet the economies have strengthened. It begs the question of whether popular leaders are deleterious for the economy.
  Prognosis – we expect Trump will continue his attempts to improve the economy and will introduce major infrastructure spending plans in the near future which are likely to further stimulate the economy.

North Korea – President Kim increasingly has the ability to start a nuclear war. **Prognosis** – the news that North and South Korea are cooperating on the Olympics is positive; we believe Kim wants to remain in power and is angling for a partial removal of sanctions and additional subsidies.

Now for the contrary view, which we characterize as "one side of the boat". In our experience a dangerous time for investors is when the conventional wisdom is widespread, that is when there are few contrary opinions to provide balance. For example, during the 2007, 2008 credit crisis, few thought home prices would decline and therefore the global financial system nearly collapsed when that assumption proved to be false. Similarly, the Great Depression was set off after the Roaring Twenties with the collapse on Austria's Creditanstalt Bank. Currently, most investors are thrilled with the records set by the Dow, and most other indexes, the low unemployment and inflation rates, and expectations for record growth for the foreseeable future. Regarding what might catalyze a rout, it might be a bankruptcy by a major state, such as Connecticut, another accounting blow-up such as GE, Italy's electing to exit the EU, and Kim's pushing the wrong button.

While the contrary view is valid, 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: U.S. and Emerging Markets Expectation

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	+1.0%	+1.8%	+2.8%	+5.0%	+4.0%
Currency Values	Decline	Mixed	Decrease	Mixed	Rise
Stimulus Change	Decelerating	Decelerating	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Growth	Growth	Growth	Growth
Interest Rates	Low	Flat to Rise	Slight Rise	Little Change	Varied
Asset Valuations	Improving	Improving	Improving	Improving	Improving

Regarding interest rates, 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 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	2.54	2.60	2.75	2.9	2.99	3.00
Germany	0.009	0.30	0.726	0.93	1.36	1.39
Italy	1.03	1.1	1.96	2.14	2.99	3.40
United Kingdom	0.772	0.80	1.53	1.65	2.98	3.12
Japan	-0.067	0.03	0.095	0.20	0.81	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.2428	1.30
Yuan to Dollars	6.33 $/RMB	6.50 $/RMB
USD-JPY	109.6	110
GBP-USD	1.424	1.45

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The major gainer in the currency markets has been the pound as the market believes the UK will be able to negotiate Brexit gracefully and growth will resume. From a credit quality perspective, we expect the environment to be fairly propitious for most U.S. obligors. Regarding various industries, below is a summary of some of the major developments::

Deteriorating:

Retail Disaster – 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; we question the long-term effectiveness of its attempt to go up-market online. Watch Amazon's war with Netflix.

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; an infrastructure act will enhance the gains.

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.

US Manufacturing Exporters – The weaker U.S. Dollar helped, but the major driver is the health of the global economy.

Neutral

Airlines – The economic recovery and effective capacity management have helped. However, the increased fuel prices and increased competition are likely to depress margins and load factors slip from record levels.

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.