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 – A New Year, A New World, Jan. 2018

While many professionals in the investment community continue to worry, our view is that for the most part, economic prospects are fairly sanguine. Most economies are likely to grow over the next 18 months and inflation and interest rates are likely to remain reasonably low. Nonetheless, the world is going through massive disruptive changes and with those changes, are corresponding risks and opportunities. Below is a summary:

- **The New Tax Code** – normally a new tax law requires years to push through, but the current administration has completed it in months. The detailed impacts on the economy is attached in the Appendix.

  Result: the economy is likely to extend its growth phase for six to twelve more months and the re-domiciling of U.S. corporations is likely to slow. The Northeast and West Coast will become marginally less attractive because of limitations on the deductibility of state and local taxes and the appreciation rate for high-end housing is likely to decline. Limits on the corporate deductibility of interest expense and oversea cash repatriation might dampen demand for debt.

- **Shape and Level of Yield Curve/ Curtailing of QE** – the level and shape of the yield curve has befuddled most of the supposed experts, who have been slow to recognize the massive influence of the central bankers. We expect more of the same, with short-term rates rising slowly and the yield curve flattening. Regarding the curtailment of QE by other central banks (the FED's efforts ended a few years ago), we do not expect an end any time soon despite the rhetoric.

  Result: if the yield curve inverts, which appears increasingly likely, watch for an end of the FED's goal of increasing short-term rates.

Source: Bloomberg

- **North Korea** – claiming that the US will take action if China does not cut off petroleum supplies to N. Korea is the latest in the effort to rein-in the mischief. However, N. Korea is in discussions with S. Korea to maintain peace during the winter Olympics.

  Result: N. Korea will continue to develop its ability to deliver nuclear weapons but will be given incentives in the form of subsidies to act in a more civil manner. Note, the best gauge for predicting Kim's actions is whatever is in his interests.

- **Mid-term Elections** – with the Nov. 2018 elections, there is a strong possibility that the Republicans will lose control of both the Senate and the House. One could convincingly argue that they never had control, but they did pass the tax act.

  Result: Our view is that President Trump will attempt to push through an infrastructure bill and some modifications to Dodd Frank and later soften his rhetoric in an attempt to garner support from Democrats.

- **Brexit** – Theresa May was pushed to the wire and succeeded in negotiating a divorce. The next step is a negotiation of trade terms, which we expect to be completed with relatively few hitches.

  Result: UK's financial service sector will suffer but muddle through.

- **Accelerating Income Disparity** – Mr. Trump was elected with the support of many disenchanted, disenfranchised white males, many of whom believe Washington exacerbated their woes. With increased automation, the decline in the corporate tax rates, and the development of driverless cars and trucks, the income disparity is likely to grow.

  Result: The disparity will continue and accelerate despite massive efforts to address the problem. While the U.S. is generally perceived as providing opportunity to all, the income disparity problem is likely to persist. Watch for the eventual extension of a safety net (e.g., guaranteed minimal incomes) but only after an economic breakdown.

- **Bitcoin Mania** – as investment professionals watch from the sidelines, the young and tech savvy are getting rich on a concept which is still in its infancy. Meanwhile, regulators are struggling with how and if to regulated this new currency. Unlike a security, there are few regulations regarding currencies because of the usual sovereign protections. Although there is likely to be an eventual pull back, bitcoin and its counterparts might be up massively before this happens.

  Result: The central banks and sovereign treasuries are probably evaluating policies to maintain the benefits of block chain currencies but to gain control over such currencies. Watch for a requirement to register all transactions over a minimum amount in a manner analogous to the money laundering rules.

- **Middle East Chaos** – while the Middle East appears to be in a perpetual state of chaos, in our opinion, the area is less important with the development of fracking. Russia appears to have re-established some presence in Syria, but history has shown many such gains are often illusive. Saudi Arabia deserves some attention because of the decline in oil income and the uncertainty relating to the regime change.

  Result: The area is likely to remain chaotic for the foreseeable future.

- **Elevated Debt** – there are a variety of areas where debt has reached unsustainable levels: U.S. student and automobile-related debt, Chinese corporate debt, various sovereign debt (i.e., Japan and Italy) and yet with the massive central bank purchases and overall low interest rates, the pressure for restructuring such debt is ameliorated.

  Result: The problem remains but is unlikely to become a major problem while interest rates are low. In the meantime, Italy has addressed some of its banking problems with only minimal disruption to the market.

Below is a summary of our expectation for the next 12 to 18 months 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%	+3.0%	+5.0%	+4.0%
Currency Values	Decline	Mixed	Rise	Mixed	Mixed
Stimulus Change	Same	Same	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Slight Growth	Growth	Growth	Growth
Interest Rates	Low	Low	Slight Rise	Little Change	Varied
Asset Valuations	Varied	Improving	Improving	Improving	Improving

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	2.24	2.30	2.46	2.50	2.80	2.83
Germany	-0.192	-0.12	0.46	0.53	1.31	1.35
Italy	0.78	0.85	2.09	2.14	3.29	3.40
United Kingdom	0.772	0.80	1.29	1.35	1.84	1.88
Japan	-0.106	-0.03	0.047	0.06	0.81	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
Dollars to Euros	0.829 $/€	0.84 $/€
Dollars to Yuan	6.50 $/RMB	6.65 $/RMB
Dollars to Yen	112.2 $/¥	113.2 $/¥
Dollars to Pound	0.735 $/£	0.755 $/£

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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, 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.

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.

Appendix – U.S. Tax Reform Themes:

The tax reform act has dominated media headlines for the past couple of months became effective January 1. 2018. The tax bill will benefit domestic businesses, multinational businesses, and individual tax payers, although the magnitude varies. We expect the tax reform to be moderately inflationary and elevate U.S. growth to more than 3% in the near term (2018 and 2019). The longer term impact on U.S. growth will depend on whether corporation take advantage of the corporate tax rate cut to expand investment and production capacity. The cost of the tax reform, nearly $1.5 trillion will hopefully be offset by the GDP growth.

In our view, the tax bill contains four main themes for corporates:

I. A reduction of corporate tax from 35% to 21%;
   a. Implications: Businesses will have the option to raise wages, create jobs, invest in growth, or return capital to shareholders.

II. Implement a territorial taxation system, major implications include:
   a. One time repatriation tax (~15%);
   b. Tax U.S. based profit at 20% and non-U.S. profit will NOT be taxed;
   c. Additional BEAT (base erosion avoidance tax) at 10%; and
   d. Export subsidy (produce in the U.S. and sell internationally).

III. Allow expensing one time capital investment; and
   a. Implications: create HUGE incentives for capital investment

IV. Restrictions on interest deductibility and loss carry forwards.
   a. Implications: Highly leveraged company will lose some of their tax shield once they become profitable; and
   b. Implications: deferred tax asset will probably be written down against equity.

Overall, companies with U.S. operations will probably benefit as a result of the tax act and related tax reductions. Technology companies and pharmaceutical companies will probably benefit from its newly gained access of oversea earnings. Retail and consumer-oriented businesses could benefit from an increase in disposable income. Banks and energy businesses could gain from a significant reduction in tax. Transportation and telecom companies will enjoy higher capital expenditure deductibility.

On the other hand, highly leveraged companies will see a higher tax bill due to the restrictions in interest expense deductibility. Multinational will probably benefit less due to its prior ability to access tax havens.